Nos. 13-1232, 13-1278 (cons.)

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

FREDERICK J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust	)	
	)	**On Appeal From The United States District Court For The Northern District Of Illinois, Eastern Division**
Plaintiff-Appellee,	)	
	)	**No. 09-cv-0136**
v.	)	
	)	**Hon. James B. Zagel**
FCSTONE, LLC,	)	
Defendant-Appellant.		

MOTION OF FUTURES INDUSTRY ASSOCIATION FOR LEAVE TO FILE *AMICUS CURIAE* BRIEF

Pursuant to Federal Rule of Appellate Procedure 29, the Futures Industry Association ("FIA") respectfully moves for leave to file an *amicus curiae* brief in support of the position of Appellant FCStone, LLC and urging reversal. Its *amicus curiae* brief is submitted with this Motion. Counsel for Appellant FCStone, LLC has consented to the relief requested; counsel for Appellee Grede does not consent to the relief requested.

The FIA is the leading trade organization for the futures, commodity options and cleared swaps markets. FIA's membership consists of futures commission merchants ("FCMs"), which act as intermediaries for clients active in financial markets around the world, and major global exchanges, clearinghouses, trading platforms, technology vendors and legal and consulting services firms representing this industry. The FIA's FCM members play a critical role in the management of systemic risk in the global financial markets. They provide the majority of the funds that support clearinghouses and commit a substantial amount of their own capital to safeguard customer transactions.

FIA plays a leading role in commenting on proposed legislation and regulations and developing consistent standards and practices throughout the industry. In addition, the FIA and its members are deeply involved in the operational aspects of the futures industry, and, in particular, the operations of FCMs and depositories. As a result, the FIA has a unique level of expertise with respect to the operational and custodial practices that are central to the decision on appeal and the importance of those practices to futures market participants and the markets themselves.

The FIA's interest in this case concerns the potential harm to futures market customers and to the vitality and efficiency of the markets themselves from certain of the district court's rulings, if not reversed. The FIA's views will be helpful to the Court's understanding of why certain erroneous analysis and rulings of the district court regarding the application of Section 4d(a)(2) of the Commodity Exchange Act, 7 U.S.C. § 6d(a)(2), could have harmful effects on the workings and vitality of the futures markets generally and interests of futures customers and FCMs in those markets. The FIA's views also will assist the Court by providing its members' collective expertise with respect to the common, lawful and accepted practices in the holding and investment of customer funds, which the district court's decision did not seem to have taken into account and could thwart in the future.

The FIA membership has an overriding interest in the proper interpretation and application of CEA Section 4d(a)(2) as one of the foundations of futures markets. The district court's errors in its analytical approach to Section 4d(a)(2) and its rulings on the effect of commingling and the purported legal barrier to tracing are borne of misunderstandings of Section 4d(a)(2)'s protections and, in certain respects, the mechanics of accepted practices for holding and investing futures customers' funds through omnibus customer accounts. General application of the district court's erroneous rulings potentially could affect the vitality and efficiency of futures trading to the detriment of all market participants.

The FIA's interest in the industry and market effects of the decision and the technical information about investment of futures customer funds it can provide are distinct from the personal interests and arguments of Appellant FCStone. Further, the FIA has made every effort to hew closely and faithfully to the Court's guidance that *amicus* participants not regurgitate the arguments of the parties and other *amici* to the extent they were known. The FIA is aware that the NFA also is seeking leave to file an *amici curiae* brief. The FIA respectfully submits that the matters addressed in the NFA's brief are different from those in the FIA's brief. We understand that the NFA, which is a registered self-regulatory organization under the CEA, will focus on issues of regulatory and legal policy and provide detailed analysis of the statutory and regulatory scheme. FIA's brief in contrast is focused on the industry and market affects of the decision, and, accordingly, will provide assistance to the Court on matters not covered by the NFA.

CONCLUSION

For all the foregoing reasons, the FIA's Motion for Leave to File an *Amicus Curiae* Brief should be granted.

Respectfully submitted,

/s Charles R. Mills
Charles R. Mills
Lawrence P. Patent
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Counsel for Futures Industry Association

CERTIFICATE OF SERVICE

I hereby certify that on June 6, 2013, I electronically filed the foregoing document with the Clerk of the Court for the United States Court of Appeals for the Seventh Circuit by using the CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the CM/ECF system.

s/__________________________

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June 6, 2013

Nos. 13-1232 and 13-1278

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Frederick J. Grede, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust, Plaintiff-Appellee,

v.

FCStone, LLC, Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division,
Case No. 09 C 136
The Honorable Judge James B. Zagel

BRIEF OF *AMICUS CURIAE*, FUTURES INDUSTRY ASSOCIATION, IN SUPPORT OF APPELLANT FCSTONE, LLC AND URGING REVERSAL

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CIRCUIT RULE 26.1 DISCLOSURE STATEMENT

Appellate Court No: 13-1232, 13-1278

Short Caption: Grede as Liquidation Trustee of the Sentinel Liquidation Trust v. FCStone, LLC

To enable the judges to determine whether recusal is necessary or appropriate, an attorney for a non-governmental party or amicus curiae, or a private attorney representing a government party, must furnish a disclosure statement providing the following information in compliance with Circuit Rule 26.1 and Fed. R. App. P. 26.1.

The Court prefers that the disclosure statement be filed immediately following docketing; but, the disclosure statement must be filed within 21 days of docketing or upon the filing of a motion, response, petition, or answer in this court, whichever occurs first. Attorneys are required to file an amended statement to reflect any material changes in the required information. The text of the statement must also be included in front of the table of contents of the party's main brief. **Counsel is required to complete the entire statement and to use N/A for any information that is not applicable if this form is used.**

[✓] All New — **PLEASE CHECK HERE IF ANY INFORMATION ON THIS FORM IS NEW OR REVISED AND INDICATE WHICH INFORMATION IS NEW OR REVISED.**

(1) The full name of every party that the attorney represents in the case (if the party is a corporation, you must provide the corporate disclosure information required by Fed. R. App. P 26.1 by completing item #3):

Futures Industry Association

(2) The names of all law firms whose partners or associates have appeared for the party in the case (including proceedings in the district court or before an administrative agency) or are expected to appear for the party in this court:

K&L Gates LLP

(3) If the party or amicus is a corporation:

i) Identify all its parent corporations, if any; and

None

ii) list any publicly held company that owns 10% or more of the party's or amicus' stock:

None

Attorney's Signature: s/ Charles R. Mills Date: June 5, 2013

Attorney's Printed Name: Charles R. Mills

Please indicate if you are *Counsel of Record* for the above listed parties pursuant to Circuit Rule 3(d). **Yes** X **No** ____

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None

Attorney's Signature: s/ Lawrence B. Patent Date: June 5, 2013

Attorney's Printed Name: Lawrence B. Patent

Please indicate if you are *Counsel of Record* for the above listed parties pursuant to Circuit Rule 3(d). **Yes** ____ **No** X

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None

Attorney's Signature: s/ Megan E. Vetula Date: 6/5/2013

Attorney's Printed Name: Megan E. Vetula

Please indicate if you are *Counsel of Record* for the above listed parties pursuant to Circuit Rule 3(d). **Yes** ______ **No** X

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FEDERAL STATUTES AND REGULATIONS

MISCELLANEOUS

GLOSSARY

CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
FCM	Futures Commission Merchant
FIA	Futures Industry Association
NFA	National Futures Association
SEC	Securities and Exchange Commission
SIPA	Securities Investors Protection Act

I. THE IDENTITY OF THE *AMICUS CURIAE* AND ITS INTEREST IN THE CASE

The Futures Industry Association ("FIA") is the leading trade organization for the futures, commodity options and cleared swaps markets. FIA's core constituency consists of futures commission merchants ("FCMs"), which act as intermediaries for clients active in financial markets around the world. FIA's FCM members play a critical role in the managing of systemic risk in the global financial markets. They provide the majority of the funds that support clearinghouses and commit a substantial amount of their own capital to safeguard customer transactions. FIA's membership also includes the major global exchanges, clearinghouses, trading platforms, technology vendors and legal services and consulting firms representing this industry.

The FIA is uniquely positioned to understand and express the concerns of the futures market from a commercial perspective. The FIA's interest in this case concerns the potential harm to futures markets customers and to the vitality and efficiency of the markets themselves from certain of the district court's rulings, if not reversed. The FIA membership has an overriding interest in the proper interpretation and application of CEA Section 4d(a)(2) and (b), 7 U.S.C.

§ 6d(a)(2) and (b), because it is one of the foundations of efficient and vibrant futures markets. Those provisions, enacted in 1936 and 1968, require segregation of futures customer funds and create a statutory trust for the protection of futures customers.

The district court's decision creates perilous uncertainty regarding whether futures customers in depositing their funds with an FCM can be assured Section 4d(a)(2) and (b)'s protections will apply. The district court's rulings about the effects of commingling futures customer property and a purported legal barrier to tracing segregated customer property that is wrongfully removed from a segregated customer account are hostile to common, lawful and accepted practices in the investment and protection of futures customers' funds.

II. ARGUMENT

Customer confidence in the futures markets and in the safeguards for the protection of customer funds is essential to the long-term viability of the futures industry. The district court's opinion, if not reversed, would erode such confidence and substantially impact the futures markets. FIA strongly urges the Court to reverse the district court's decision in order to maintain the statutorily-provided protection for futures customers, or, at the very least, make clear that the district court's decision is unique to the facts at hand and is not applicable to futures customer assets generally.

A. The District Court's Decision Erodes the Certainty That Futures Market Customers and the Markets Themselves Need That Customer Funds Will Be Protected under CEA Section 4d(a)(2) and (b)

It is critical to the proper functioning and continued vitality of futures markets that customers know and be confident that their funds and property deposited with an FCM to margin futures contracts will be protected by the statutory trust and other protections established by CEA Section 4d(a)(2) and (b).[1] Section 4d(a)(2) and (b)'s protections serve two vital purposes.[2] First, they assure customers that their funds and property will be protected from claims of the FCM's general creditors and non-futures customers. Second, in the event of an FCM financial failure, they assure that the funds and property can be

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[1] Additional futures customer asset protections are found in rules promulgated pursuant to CEA Section 4d(a)(2) and (b), such as CFTC Rules 1.20-1.29, 17 C.F.R. §§ 1.20-1.29 (2012).

[2] The FIA recognizes that the National Futures Association, in its *amicus curiae* brief, provides amplification of the statutory scheme of customer protection and in the interest of brevity will not repeat the same.

immediately transferred to the segregated customer accounts of solvent FCMs to continue to support the ongoing obligations of open trades. This prevents the bankruptcy of one FCM to cascade and cause harm to others and throughout the markets. These tenets of futures customer asset protection are threatened by the district's court decision as it creates uncertainty as to the protection futures customers will receive.

As the CFTC has explained:

> Customer segregation accounts are a critical customer protection feature of the United States commodity laws. The accounts are designed to ensure that customer funds are protected and available for immediate withdrawal or transfer, even if an FCM experiences financial distress or enters into bankruptcy.

In the Matter of JPMorgan Chase Bank, N.A., CFTC Docket No. 12-17, 2012 WL 1143791, at *2 (Apr. 4, 2012). *Accord*, *e.g.*, *Hunter v. Madda Trading Co.*, CFTC Docket No. R78-64-78-161 1981 WL 26142, at *2 (CFTC Sept. 2, 1981).

Further, Section 4d(b) makes it unlawful:

> for a depository to use or hold an FCM's customer segregated funds as belonging to any person other than the customers to whom they belong. Without immediate access to customer funds, the FCM is hindered in its ability to satisfy margin requirements. In times where there is market disruption, any impediment or restriction upon

> the ability to immediately withdraw funds "could magnify the impact of any market disruption and cause additional repercussions."

In the Matter of JPMorgan Chase Bank, 2012 WL 1143791, at *5, *citing Financial and Segregation Interpretation No. 10*, 70 Fed. Reg. 24,768 (May 11, 2005).

1. Uncertainty over Section 4d protections will adversely affect the futures markets

Uncertainty over whether Section 4d(a)(2) or, instead, some other regime will govern futures customer funds in the event of an FCM bankruptcy could materially change the inherent risks in futures markets and threaten customer protection. The well-publicized adverse effects for futures markets and FCMs from the alleged failures of MF Global and Peregrine Financial to comply with Section 4d demonstrate the importance of that protection for futures customers and FCMs alike.

The district court's decision also employs an analytical approach to the issues that opens the door to litigate Section 4d(a)(2)'s application to the funds and property in segregated futures customer accounts and amplifies the unpredictability of the outcome. The factual and legal issue before the district court was a narrow one – whether the proceeds from Sentinel's sale of securities to Citadel from the SEG 1 account were futures customer property. The resolution of that issue should turn on only one consideration – were the securities sold to Citadel in fact futures customer property?

The district court, however, eschewed determining the history of the securities sold to Citadel, choosing instead to rule based on Sentinel's overall handling of its securities portfolio, including other, unrelated securities. The determination of whether specific property is entitled to Section 4d(a)(2) protections should rest entirely on the history and circumstances of that specific property. The history and circumstances of the FCM's handling of unrelated property should have no bearing on, or legal relevance to, the determination.

The district court's approach creates a potential legal trap for futures customers. For example, it could allow an FCM's prior Section 4d(a)(2) violations with respect to the handling of other property – of which a new futures customer might be unaware – to vitiate Section 4d(a)(2)'s protections for a customer's later deposited property even if the FCM's earlier violations had no relationship to the handling of that later deposited property. Any cloud over Section 4d(a)(2)'s enforceability arising from the district court's flawed logic could adversely affect confidence in futures markets generally.

2. Statutory provisions protect futures customers' assets from all other claims

The district court's determination that Section 4d(a)(2)'s protections are not enforceable against the claims of investment advisory account customers based on the court's view that those customers have special protections under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, *et seq*., and Securities and Exchange Commission Rule 206.4(2), 12 C.F.R. § 206.4(2)(2013), is erroneous. Section 4d(a)(2), by its plain terms and purpose, creates a statutory trust for all futures customer property that shields that property from the claims of any third party, be it the FCM's general unsecured creditors or any non-futures customers. *See, e.g.*, *Marchese v. Shearson Hayden Stone, Inc.*, 822 F.2d 876, 877 (9th Cir. 1987). Section 4d(a)(2)'s protections turn on the character of the property to be protected, not the legal status of a third-party claimant.[3] Indeed, there is no legal basis cited in the district court's opinion to support the idea that a regulatory

[3] As discussed below, it is clear that the property at issue was futures customer property subject to protection under Section 4d(a)(2).

scheme to protect the assets of one type of customer can be ignored and undone simply due to the existence of other types of customers whose claims have not been satisfied.[4]

Any suggestion by the district court's opinion that the protections of Section 4d(a)(2) can be undermined by the claims of non-futures customers threatens the current structure of the futures industry.[5] Many FCMs also are registered as securities broker-dealers. Futures customers need to know when deciding to deposit funds with a dually registered FCM/securities registrant that Section 4d will govern and protect their futures funds and that those protections will not be vitiated because a separate regulatory scheme governs securities

[4] CFTC bankruptcy regulations even establish priorities for different types of customer accounts, which must be recognized as separate classes of account by a bankruptcy trustee: (1) futures accounts; (2) foreign futures accounts; (3) leverage accounts; (4) delivery accounts; and (5) cleared swaps accounts. 17 C.F.R. § 190.01(a) (2013).

[5] The district court's opinion has potential ramifications for all types of customer asset regimes. If a court can ignore the statutory protections of futures customers in order to meet unpaid claims of securities customers, what is to prevent application of the district court opinion, if not reversed, to support ignoring, for example, securities customer asset protections in order to meet unpaid claims of other types of customers?

accounts of the same entity.[6] Otherwise, futures customers are substantially unprotected in the event of FCM insolvency.

3. Immediate and absolute transfer of futures customer accounts is essential to the viability of the futures markets

Uncertainty over the enforceability of Section 4d's protections invites chaos at the outset of any FCM financial failure. This case is a concrete example. At the time Sentinel filed for bankruptcy, the CFTC expressly advised the bankruptcy court that the failure to transfer the property held in Sentinel's SEG 1 account could cause immediate insolvency for other FCMs, too, spreading the financial harm and roiling the markets. *See* Appellant's Brief at 3. Without certainty that Section 4d(a)(2) protects the property that should be held in segregated accounts for the benefit of futures customers, the FCM's general creditors and non-futures customers will endeavor to try to prevent the transfer of property in futures customer segregated accounts to other FCMs, just as they did in this case. Only through a prompt transfer of a

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[6] Securities accounts with broker-dealers are subject to an entirely separate regulatory regime that includes an insurance fund for the benefit of broker-dealer customers pursuant to the Securities Investors Protection Act, 15 U.S.C. § 78aaa, *et seq*. That insurance fund does not cover losses to futures accounts. There is no insurance covering futures customer accounts losses. CEA Section 4d and the statutory trust it creates are the critical source of protection for futures customers.

customer account to another FCM can a futures customer be assured that its positions will not be unwillingly liquidated (potentially at fire sale prices) and be stripped of hedges needed for commercial purposes.[7]

The much-delayed timing of the district court's clawback order is also highly problematic for the futures markets. Customers and FCMs alike rely on the principle that funds held in segregated accounts are and will always be treated as customer property. The fact that the clawback of funds is ordered years after *a bankruptcy court authorized the original transfer* could further jeopardize the confidence of futures customers in the strength of the Section 4d protections.

In addition, FCMs will be reluctant to take on customer accounts from failed FCMs for fear of being subject to clawback at a later time. Such a result could unnecessarily bar customers from continuing in the futures market as other FCMs would not take their accounts and, ultimately, erode liquidity in the market. The portability of futures accounts from an insolvent FCM to solvent FCMs is essential to prevent significant market disruption. Moreover, the clawback order could

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[7] In a Chapter 7 bankruptcy, open commodity contracts must be liquidated or offset by the trustee promptly and in an orderly manner if such contracts have not been transferred by the seventh calendar day after the filing of the petition in bankruptcy. 17 C.F.R. § 190.02(e) and (f).

create an undesirable incentive for customers receiving funds in similar circumstances to withdraw their funds, and close their accounts with the hope that that will better shield exposure to any later clawback. Such a customer "run on the bank" could have deleterious effects.

In order to preserve the purpose of the statutory protections afforded futures customers, the district court's decision must be reversed to eliminate uncertainty for the futures markets.

B. The District Court's Treatment of Tracing Is Harmful to Futures Customers and Common CEA-Compliant Futures Market Practices

1. Securities wrongly removed from a futures customer account are entitled under Section 4d to be traced and returned to the futures customer account

The district court erroneously ruled that securities wrongfully removed from Sentinel's segregated futures customer account are not subject to tracing to determine a customer's ownership interest in them if the customer has only a *pro rata* interest in the investment pool of securities rather than title to particular securities themselves.[8] This

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[8] The district court ruled:

> But for tracing purposes the critical shortcoming of [FCStone's forensic accountant's] report is that it fails to adequately account for the fact that none of Sentinel's

premise is antithetical to Section 4d(a)(2) and (b), the Bankruptcy Code, and the CFTC's regulations implementing the Code. More troubling still, Sentinel's pooling of securities in a segregated customer account is not distinguishable from the typical handling of customer funds and securities by any other FCM or depositories, something that may not have been known to the court.

It is well established under the Bankruptcy Code, the CFTC's implementing regulations and Section 4d(a)(2) and (b) that the unauthorized removal of customer property from a segregated futures customer's account does not extinguish the customer's continuing property interest in it. *E.g.*, *In re Bucyrus Grain Co., Inc.*, 127 B.R. 45, 51-52 (D. Kan. 1988). In the Bankruptcy Reform Act of 1978, Congress

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> customers held specific ownership interests in securities. Rather, they owned pro rata portions of investment portfolios, which Sentinel was free to fill with any of the securities in its pool of assets so long as those securities met the portfolio's investment criteria.
>
> * * *
>
> Sentinel's investment model makes tracing essentially impossible because, upon deposit, customer funds were immediately converted into an abstract ownership interest. In other words, Sentinel's pooled investment model renders tracing impracticable because there is no specific form of converted trust property to trace.

Grede v. FCStone, LLC, 485 B.R. 854, 879 (N.D. Ill. 2013) (emphasis omitted).

enacted specific provisions to Chapter 7 governing commodity broker bankruptcies to assure that customer property wrongfully removed from a segregated account would retain its status as customer property. Code Section 761(10)(A)(viii) thus expressly defines "customer property" to include:

> cash, a security, or other property, or proceeds of such cash, security, or property, received, acquired, or held by or for the account of the debtor, from or for the account of a customer –
> (A) including –
>
> * * *
>
> (viii) *property that was unlawfully converted from and that is the lawful property of the estate*[.]

11 U.S.C. § 761(10)(A)(viii) (emphasis added).

The CFTC's implementing Rule 190.08(a)(1)(ii)(F), which the CFTC promulgated in 1983, provides the same definition. 17 C.F.R. 190.08(a)(1)(ii)(F). CFTC Regulation 190.08(c) further provides that property that is segregated on behalf of a specific account class, or readily traceable on the bankruptcy filing date to customers of such account class, must be allocated to the customer estate of the account class for which it is segregated or to which it is readily traceable.[9]

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[9] In contrast to Code Section 761, Congress had enacted a scheme of insurance protection for customers of securities broker-dealers in SIPA. Having determined

Congress enacted Code Section 761 (10)(A)(viii) pursuant to the CFTC's urging to establish clear statutory authority to permit converted customer property that could be traced to be returned to the customers. CFTC Chairman William T. Bagley testified before Congress that the ad hoc common law theories then used to justify tracing were inadequate:

> [T]he treatment which commodity customers will be accorded by a trustee in bankruptcy is, in the main, open to speculation. *To date, bankruptcy trustees have employed a form of tracing to protect commodity customers' funds in the event of the bankruptcy of a futures commission merchant.*
>
> * * *
>
> The CFTC believes such ad hoc approaches are inadequate to protect the funds of commodity customers on deposit with the various persons engaged in the commodity futures trading industry. The size of the industry and the unique problems which may be encountered in the event of the failure of a futures commission merchant . . . *make it imperative that Congress amend the Bankruptcy Act to provide specific statutory protection for commodity customers.*

Bankruptcy Act Revision: Hearings on H.R. 31 and 32, before the Subcomm. on Civil and Constitutional Rights of the H. Comm. on the

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not to enact an insurance program for futures customers, Congress intended that Code Section 761 provide the greatest protection for futures customers.

Judiciary, 94th Cong. 2d Sess. 2377, 2378 (1976) (Statement of William T. Bagley, CFTC Chairman) (emphasis added). Congress responded by enacting Code Section 761(10)(A)(viii), among others, that assured that customer property wrongfully removed from a segregated account would retain its status as customer property.

There is no reasonable basis to conclude that Congress would have intended that the definition of customer property in Chapter 7 of the Code, enacted to assure Section 4d(a)(2)'s protections in commodity broker bankruptcies, would not apply equally to the enforceability of Section 4d(a)(2)'s protections within a Chapter 11 bankruptcy of an FCM. *See also, e.g.*, *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (statute subject to same meaning regardless of nature of proceeding); *In re Diasonics Sec. Litig.*, 599 F. Supp. 447, 461-62 (N.D. Calif. 1984) (same).

2. "Pooling" does not destroy a futures customer's protected interest

The district court's ruling on tracing compromises the protections for customer securities held in what are commonly called omnibus futures customer accounts. Pooling of customer funds and securities in omnibus segregated futures customer accounts is the typical practice in the futures industry and has been for the past century. It is expressly authorized by CFTC Rule 1.21:

> Money and equities accruing in connection with futures customers' open trades, contracts, or commodity options *need not be separately credited to individual accounts but may be treated and dealt with as belonging undivided to all futures customers having open trades, contracts, or commodity option positions* which if closed would result in a credit to such futures customers.

17 C.F.R. § 1.21 (emphasis added). Section 4d(a)(2) also expressly authorizes that the money and property of future customers may be commingled.

Pooling securities in an omnibus segregated customer account benefits the customer. For a customer to have a specific individualized interest in a particular security would require holding customer funds and securities in an individual account for the customer. The operational complexity of holding customer securities in an individual account as margin to support futures trading would be very costly, potentially even affecting the economic utility of futures trading.

Further, it would be impractical, if not impossible, to try to tie a particular security to a particular customer's specific funds because such smaller lots of securities cannot be adjusted quickly and efficiently enough to respond to the volatility in the market value of a customer's open futures positions, the frequent changes in a customer's positions themselves, and the changes in the market value of the securities. The longstanding futures market practice of omnibus customer accounts should not be jeopardized by the erroneous rulings of the district court.

The district court also erred in its conclusion that customers have no direct property interest in the securities within the segregated account. In the event an FCM files for bankruptcy, the securities in the segregated account are exclusively the property of the customers, each of which has a *pro rata* interest in them and to the proceeds from their sale. 17 C.F.R. §§ 190.01(n), 190.08(a)(1).[10]

The commingling relating to the securities sold to Citadel should not affect the futures customers' rights in them.[11]

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[10] In bankruptcy, after all customers have been made whole, an FCM may have a claim to only any excess margin funds or securities in which it holds a residual financial interest pursuant to CFTC Rule 1.23. 17 C.F.R. § 1.23.

[11] Contrary to the district court's concern with commingling (*Grede*, 485 B.R. at 875-76), the use of a single securities clearing account for purchasing securities should not defeat the application of CEA Section 4d(a)(2)'s protections as long as the securities allocated to the segregated accounts are equal to the customer funds withdrawn. The dispositive issue under Section 4d(a)(2) is whether futures customer funds were exchanged for the securities. That an FCM originally purchased a security in its own name with its own funds or even commingled funds is not relevant to Section 4d(a)(2)'s protections. Where a security is allocated to a segregated customer account on the FCM's books, and customer funds were

C. FCMs Are Not Guarantors Against Losses Caused by Custodians

Generally, an FCM is not liable to its customers for losses arising from the insolvency or wrongdoing of a third-party depository, but can be liable to customers for losses on investments made for the FCM's benefit. *Compare* Liability of Futures Commission Merchants, and Clearing Ass'ns, Administrative Determination No. 230 (Nov. 23, 1971) (attached hereto) of the Commodity Exchange Authority (the CFTC's predecessor agency) (absence of liability for custodial failure) *with Marchese v. Shearson Hayden Stone, Inc.*, 644 F. Supp. 1381 (C.D. Cal. 1986) *aff'd*, 822 F.2d, 876 (9th Cir. 1987) (liability for investment losses).

Accordingly, the FCM community has operated for over forty years on the understanding that FCMs are not liable for customer losses caused by the insolvency of third-party custodians. Administrative Determination No. 230 provided that an FCM may not be liable for losses resulting from the deposit of customer funds with a bank that subsequently closes or is unable to repay the FCM's deposit as long as the FCM, (i) had used due care in selecting the bank, (ii) had

exchanged for it, its status as customer account property is clear. 17 C.F.R. §§ 1.20(c) and 190.08(a)(1)(i).

not otherwise breached its fiduciary responsibilities toward the customers, and (iii) had fully complied with the requirements of the CEA and the regulations relating to the handling of customers' funds. There is no precedent to the contrary.

Significantly, FCMs have no choice but to interface with a host of depositories in handling customer funds, which makes the liability issue of great importance. For example, an FCM will be required to transfer customer margin money for any futures contract transaction cleared by a designated clearing organization of which the FCM is not a member to the omnibus customer account of a clearing member FCM. For the FCM to be liable for any losses arising from a clearing member's insolvency imposes a risk of immense liability that many FCMs cannot absorb. Based on the understanding that they are not liable for custodian losses, FCMs today do not factor risk of liability for third-party depository insolvencies or wrongdoing into the pricing for their services. In addition, FCM agreements with their customers may disclaim such liability.[12]

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[12] The traditional apportionment of liability is understandable. Pursuant to Section 4d(a)(2) and CFTC Rules 1.20 – 1.22, all depositories, including FCMs, are subject to identical restrictions with respect to the handling of customer funds and property, and CFTC Rule 1.25 restricts each to a prescribed list of permissible

The district court's sweeping declaration that FCStone was a *de facto* guarantor against any and all of its customers' losses failed even to consider the cause of customer losses, *i.e.*, whether they were from Sentinel's insolvency or from a loss of principal from the drop in the market value of the customer investments when sold. If the former, the court's conclusion would be clearly erroneous.

The indiscriminate nature of the court's declaration, however, is highly problematic for the FCM community. If read to mean that FCMs are liable for any losses arising from third-party depositories, it, by fiat, adversely impacts the efficiency and economics of futures trading for both customers and FCMs.

D. FCMs Are Not "Initial Transferees" of Funds Transferred from One Segregated Customer Account to Another Segregated Customer Account

The district court's rationale that FCStone should be deemed an initial transferee under Bankruptcy Code Section 550(a)(1) cannot be

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investments. Accordingly, FCMs have no ability to expand a custodian's powers to increase risks beyond those restricted by the CFTC regulations. Further, as a practical matter, FCMs have little or no access to the internal workings of third-party custodians or other means to police their internal activities. In such circumstances, there is no legal basis or good cause to declare FCMs to be guarantors against losses caused by custodians.

squared with the CFTC's Rules governing segregated accounts. The district court concluded that FCStone was an initial transferee because its segregated customer accounts that received the transfer of funds from Sentinel's SEG 1 account had, in aggregate, excess funds prior to the transfer. CFTC Rules 1.21, 1.25(e), 1.26(a), and 1.27(a), however, make clear that any funds and property in a segregated customer account are always deemed, regardless of any permissible residual interest the FCM may have in them, to be customer property unless and until any residual FCM property is removed. 17 C.F.R. §§ 1.21, 1.23, 1.25(e)[13], 1.26(a) and 1.27(a) (2012).[14]

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[13] "Investments permitted by § 1.25 that are owned by the futures commission merchant and deposited into a segregated account pursuant to § 1.26 shall be considered futures customer funds until such investments are withdrawn from segregation." CFTC Rule 1.25(e).

[14] Consistent with the terms of CFTC Rules 1.23 and 1.25(e), the National Futures Association ("NFA") in recently voting to incorporate the requirements of CFTC Rules 1.20-1.30 into the NFA's rules reiterated the existing law: "To comply with Regulation 1.22, an FCM is permitted pursuant to Regulation 1.23 to maintain excess funds in the customer segregated and secured amount accounts. The excess funds in these accounts are referred to as the FCM's residual interest and *the funds are for the exclusive benefit of the FCM's customers while held in these accounts."* NFA Interpretive Notice 9066 – NFA Financial Requirements Section 16: FCM Financial Practice and Excess Segregated Funds/Secured Amount Disbursements (Sept. 1, 2012) (emphasis added), *available at* https://www.nfa.futures.org/nfaManual/NFAManuel.aspx?Rule1D=9066&Section=9.

Further, the CFTC has explained that FCMs' contributions of funds and property to customer accounts is not a choice, but a necessity. *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*; *Proposed Rule,* 77 Fed. Reg. 67,866, 67,886 (Nov. 14, 2012) ("FCMs, by virtue of practical necessity, must keep proprietary funds in segregated futures customer accounts in order to act as a buffer between futures customers whose funds are commingled in such accounts."). Indeed, an FCM is not free to withdraw funds or property in which it has a residual interest from the account if it would result in the FCM "failing to hold sufficient funds to meet its obligations to its futures customers." *Id.* *See also* NFA Financial Requirements Section 16. Finally, due to market volatility, an FCM generally will not know during a trading day if any particular customers' positions have insufficient margin. Accordingly, the FCM must keep its own additional funds in customer accounts to avoid margin deficit violations.

These restrictions on withdrawal of FCM funds or property in which it has a residual interest mean that during the time an FCM's funds or property is deposited in a customer account, it is at risk of loss to the FCM. If a customer were to have substantial market losses causing the omnibus customer account to become undersegregated, not only would the FCM be barred from withdrawing funds or property from the account, it would be obligated to post its own additional funds or property to the account to cure the deficiency. The FCM would be barred from withdrawing funds and its residual interest. Indeed, those funds would be used to meet claims of customers in the event of the FCM's bankruptcy under Part 190 of CFTC rules.

Given these restrictions, the district court's reasoning that FCStone should be deemed an initial transferee because its commitment of funds to segregated customer accounts created excess margin is perverse. It erroneously assumes an FCM is free at any time to withdraw any excess margin from the customer accounts, and it penalizes an FCM for doing what the CFTC regulations require *for the benefit of customers.*[15]

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[15] Further, the strict regulation of segregated customer funds under CFTC Rules 1.20-1.27 does not permit, as the district court erroneously opined (*Grede*, 485 B.R. at 882), an FCM to transfer customer funds from a third-party depository's segregated customer account directly into the FCM's proprietary account as long as there is excess margin in the FCM's segregated customer accounts. CFTC Rule 1.21 expressly states that "[s]uch money and equities shall be treated and dealt with as

CONCLUSION

For all the foregoing reasons, the district court's decision should be reversed.

Respectfully submitted,

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Dated: June 6, 2013

belonging to the . . . customer in accordance with the provisions of the Act and these regulations." 17 C.F.R. § 1.21.

RULE 29(c)(5) STATEMENT

Pursuant to FRAP 29(c)(5), no party's counsel authored this Brief in whole or in part, no party or a party's counsel contributed money that was intended to fund preparing or submitting the Brief, and no person – other than the Futures Industry Association, its members, or its counsel – contributed money that was intended to fund preparing or submitting the Brief.

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CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

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CERTIFICATE OF SERVICE

I hereby certify that on June 6, 2013, I electronically filed the foregoing document with the Clerk of the Court for the United States Court of Appeals for the Seventh Circuit by using the CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the CM/ECF system.

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ATTACHMENT

Commodity Futures Trading Commission
Administrative Determinations

NUMBER: 230

DATE: NOVEMBER 23, 1971

SUBJECT: CUSTOMERS' FUNDS; LIABILITY OF FUTURES COMMISSION MERCHANTS AND CLEARING ASSOCIATIONS FOR FUNDS IN A DEFUNCT BANK

230

UNITED STATES DEPARTMENT OF AGRICULTURE

COMMODITY EXCHANGE AUTHORITY

WASHINGTON, D.C. 20250

November 23, 1971

Reply to: 1160

Subject: Liability of Futures Commission Merchants and Clearing Associations

To: Associate Administrator

Division Directors

Regional Directors

If a futures commission merchant or a clearing association deposits regulated commodity customers' funds in a bank and the bank is later closed and unable to repay the funds, the liability of the futures commission merchant or clearing association would depend upon the manner in which the account was handled. It would not be liable if it had used due care in selecting the bank, had not otherwise breached its fiduciary responsibilities toward the customers, and had fully complied with the requirements of the Commodity Exchange Act and the regulations thereunder relating to the handling of customers' funds. If two banks were available in a particular city only one of which was a member of FDIC and the futures commission merchant or clearing association without a compelling reason elected to use the nonmember bank, we would contend that it had not used due care in its selection.

ALEX C. CALDWELL

Administrator

See original document-page 1

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