

**REPLY DEADLINE:
January 18, 2012**

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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:

**MF GLOBAL HOLDINGS,
LTD, et al.,**

Debtors.

In re:

MF GLOBAL INC.,

Debtor.

Chapter 11

Case No. 11-15059 (MG)

Jointly Administered

Case No. 11-02790 (MG) (SIPA)

**RESPONSE OF COMMODITY CUSTOMER COALITION TO TRUSTEE'S
MEMORANDUM REGARDING THE LEGAL PRINCIPLES AND FRAMEWORK
FOR THE ALLOCATION AND DISTRIBUTION OF CUSTOMER PROPERTY**

In response to the Trustee's Memorandum Regarding the Legal Principles and Framework for the Allocation and Distribution of Customer Property filed on December 12, 2011 [Dkt. No. 726] (the "Trustee Memorandum"), the Commodity Customer Coalition ("CCC") states as follows:

INTRODUCTION

The MFGI Trustee submitted a brief setting forth the "Trustee's position regarding how he expects to allocate and distribute the property of the MF Global, Inc. ["MFGI"] estate under statutory and regulatory provisions applicable to this proceeding." (Trustee Mem. at 1.) The brief is thorough and, largely, comprehensive. CCC would like to address two points: (i) the extent of the priority that ought to be accorded customers; and (ii) the application of customer subaccount classifications.

To begin with, the Trustee acknowledges that the CFTC regulations adopt a regime that "provides for the allocation of non-customer property to satisfy demonstrated shortfalls in regulatory compliance to the extent necessary to satisfy customer claims," as described in the Securities Investor Protection Act. Yet, the Trustee appears equivocal about what property can or should be used to remedy what, in this case, are "demonstrated shortfalls in regulatory compliance." (Trustee's Mem. at 24-25.) CCC seeks an order from the Court that is unequivocal, as follows:

1. Customers are entitled to a first-priority interest (with the exception of certain administrative expenses) in any and all MFGI property, to the extent needed in order to fill the reported \$1.2 billion shortfall in customer segregated funds;
2. Customers' first-priority right must follow customer funds to *each and every* entity to or through which customer funds flowed; and
3. The Trustee must immediately begin to pursue claims to recover customer funds (even if it requires an entity to or through which customer funds flowed to give up

alternative funds), so that decisions about distribution and allocation of customer property in these proceedings can be made quickly and efficiently.

CCC has contacted several future commission merchants, many of whom have indicated that they support the CCC's position on allocating the MFGI estate and resolving claims against it. CCC will supplement this filing when additional future commission merchants come forward.

Next, while the CCC has no disagreement with the general concept of customer account subclasses for commodity customers, as set forth in the Trustee's Memorandum at paragraphs 22-24, the CCC respectfully reserves the rights of its members to object to the application of these account subclasses, at such time as the Trustee may formally seek the Court's approval of any distributions based on such allocations.

ARGUMENT

A. Customer Funds Deserve Absolute Priority, Wherever They Are Found, And The MFGI Trustee Should Aggressively Pursue Their Recovery.

MFGI customers are entitled to a first-priority lien on the assets of MFGI and any other entity through which customer property passed, to the extent needed to make MFGI customers one-hundred percent whole. The Commodity Exchange Act ("CEA") and Commodity Futures Trading Commission ("CFTC") regulations broadly define customer property to include any assets needed to make customers whole (so-called "substitute assets"), and grant customers a first-priority right in all such assets. Then, the Bankruptcy Code and CFTC regulations obligate a trustee to track down customer funds, wherever they may be found, and return them to the estate for distribution to customers. Under principles of either statutory or constructive trusts, the absolute priority granted to customers—including the priority in "substitute assets"—must follow customer funds to any entity through which such funds passed. To hold otherwise would

be to nullify the protections that the CEA, the CFTC regulations, and the Bankruptcy Code afford customer property. The CCC respectfully requests that the Court support, and the Trustee immediately begin pursuing the return of customer funds based upon, these principles.

As a futures commission merchant (“FCM”), MFGI was required under the CEA and CFTC regulations to segregate commodity futures customers’ funds and property. *See* 7 U.S.C. § 6d; 17 C.F.R. §§ 1.20(a), 30.7. The CEA explicitly requires that FCMs treat and deal with all customer funds as belonging to such customers and that customer funds “shall be separately accounted for and shall not be commingled with [FCM] funds.” 7 U.S.C. § 6d(a)(2). Any entity that has received, or through which such funds have passed, ought to have the same duties. *See, e.g.*, 11 U.S.C. § 764(a) (customer funds shall be treated as “customer property” wherever they may be found); 17 C.F.R. § 190.08(a)(ii)(F) (customer property includes property that has been converted); *see also Smith v. M&M Commodities, Inc. (In re Smith)*, 72 B.R. 61 (N.D. Iowa 1987) (finding that obligation to segregate customer funds and not to commingle them under 7 U.S.C. § 6d creates a statutory, technical trust under the Bankruptcy Code).

The basic definitions of customer property are found in CFTC Regulation 190.08 and Bankruptcy Code Section 761. Bankruptcy Code Section 761(10) defines various categories of “customer property.” Under Congressional mandate, the CFTC also provided a definition of “customer property” in 17 C.F.R. Section 190.08(a) that is expansive. *See* 7 U.S.C. § 24(a) (granting authority to the CFTC, “[n]otwithstanding title 11 of the United States Code . . . [to provide] that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property.”)); *see also* Trustee’s Mem. at ¶ 19.

In addition to customer segregated property (17 C.F.R. § 190.08(a)(1)(ii)(A)), “customer property” includes all property needed to make up any shortfall in the funds that should have

been held for customers, whether properly segregated or not. *See* 17 C.F.R. § 190.08(a)(1)(i) (“Customer property includes . . . [a]ll cash, securities, or other property or the proceeds . . . received, acquired, or held by or for the account of the debtor, from or for the account of a customer”); *and* 17 C.F.R. § 190.08(a)(1)(ii)(J) (customer property includes “cash, securities, *or other property of the debtor’s estate*”). In short, the concept of customer property (hereinafter “Customer Property”) is broadly defined and expansively construed, regardless of whether it was specifically segregated or even traceable to a customer account, to include as much of the debtor’s property as is needed to ensure that customers receive a *complete return* of their property.

The Bankruptcy Code and CFTC regulations also contemplate that customers have a first-priority right in this broadly-defined Customer Property, wherever such property may be found. Bankruptcy Code Section 766(h) provides that the “trustee shall distribute [C]ustomer [P]roperty . . . in *priority to all other claims*,” with the exception of certain administrative expenses. According to the CFTC, “[t]he Commission believes that the Bankruptcy Act makes clear that the customer priority for commodity customers is to be broader than a priority in the property actually segregated by the debtor in their behalf.” 48 Fed. Reg. at 8717.

This first-priority right extends to all property of the debtor’s estate, to the extent of any shortfall in customer funds and even to Customer Property that was removed from the debtor’s estate. As set out above, “Customer Property” includes so-called substitute assets, to the extent of any shortfall. *See* 17 C.F.R. § 190.08(a)(1)(ii)(J).¹ In addition, the definitions of Customer

¹ The CCC notes that *In re Griffin Trading Co.*, 245 B.R. 291 (Bankr. N.D. Ill. 2000), *vacated*, 270 B.R. 883 (Bankr. N.D. Ill. 2001), questions the applicability of 17 C.F.R. § 190.08(a)(1)(ii)(J) and proposes that the issue of priority as to MFGI general estate property be addressed if and when all efforts have been

Property include any property that was “unlawfully converted from and that is the lawful property of the estate.” 11 U.S.C. § 761(10)(A)(viii); 17 C.F.R. § 190.08(a)(ii)(F) (using mildly different language, to the same effect). In short, MFGI commodity customers ought to receive a first-priority right over all creditors to the extent needed to make them whole—whether such property is considered “other property” of MFGI, is found at entities other than MFGI, or passed through entities other than MFGI.

Indeed, the Bankruptcy Code obligates the Trustee to take action to recover Customer Property—including property that “was unlawfully converted” from the liquidation estate—for distribution to customers. Section 764(a) provides that “any transfer by the debtor of property that, but for such transfer, would have been customer property, may be avoided by the trustee, and such property *shall be treated as customer property*, if and to the extent that the trustee avoids such transfer” (emphasis added). The improperly transferred property is to be returned to the MFGI estate and treated as Customer Property subject to distribution. *Id.*; *see also* 17 C.F.R. § 190.08(a)(1)(ii)(D). Accordingly, even if such property is found at MF Global Holdings, Ltd. and its subsidiaries (collectively, “MFGH”) or *any other entity*, the Bankruptcy Code explicitly requires the MFGI Trustee to bring avoidance actions against parties that received Customer Property from MFGI and return that property to customers.

To the extent that MFGH or any other parties impermissibly received Customer Property from MFGI, they held Customer Property in trust for MFGI customers subject to the requirements of the CEA and CFTC regulations, and are liable for any violations of those strictures for at least two reasons. *First*, the requirement to segregate customer funds under the

made by the Trustee to return of MFGI customer property to the MFGI estate and it is apparent that a shortfall of customer property still exists.

CEA creates a *statutory trust* over the customer property, with MFGI holding the funds as trustee for the benefit of the customers. *In re Smith*, 72 B.R. at 63 (specifying that the obligation under 7 U.S.C. § 6d to segregate funds creates a technical trust under the Bankruptcy Code). The rights and duties created by the CEA are similar to those establishing a trust at both common law and by statute. *See id.*; *In re Sawyer*, 112 B.R. 386, 390-91 (D. Colo. 1990). Courts have found that FCM customer funds are held in statutory trust for the purposes of bankruptcy law. *E.g.*, *In re Smith*, 72 B.R. at 63; *In re Sawyer*, 112 B.R. at 390-91; *In re Scheuer*, 125 B.R. 584, 590-92 (Bankr. C.D. Cal. 1991). **Second**, any party receiving converted customer property also holds them in a *constructive trust* for the benefit of the MFGI customers. “When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest equity converts him into a trustee.” *See Cassirer v. Sterling Nat’l Bank & Trust Co. (In re Schick)*, 246 B.R. 41, 45 (Bankr. S.D. N.Y. 2000). The only manner in which a party other than MFGI could acquire Customer Property was through conversion, fraud, or other impermissible acts. At the same time, the MFGI customers were completely innocent of any wrongdoing and totally reliant on MFGI. Any title purportedly obtained as a result of MFGI’s dealings was far from equitable, and should cause subsequent holders of MFGI Customer Property to become trustees over said property.

Under either a statutory or constructive trust, **any** holder of Customer Property took that property in a custodial capacity, subject to the CEA and CFTC regulations. The CEA and CFTC regulations unequivocally require all holders of Customer Property to treat it in a manner that is consistent with such property belonging to the customers. 7 U.S.C. § 6d(a)(2); 17 C.F.R. §§ 1.20(a), 30.7. Any subsequent holders that improperly disposed or converted Customer Property for their own benefit, rather than the MFGI customers’ benefit, violated the CEA and

CFTC regulations and are directly liable to the MFGI customers—even if such subsequent holders need to provide substitute assets to make customers whole.

With regards to MFGH (or any other entity), to the extent that it received Customer Property and improperly disposed or converted it, MFGI customers should be granted a first priority lien against MFGH’s cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents under these trust principles. To do otherwise would be to render the protections afforded by the CEA, CFTC regulations, and the Bankruptcy Code a nullity. Indeed, to the extent that MFGH still holds Customer Property, it is not property of the MFGH estate and must be returned to the MFGI estate immediately.

A bankruptcy estate only includes “legal or equitable interests *of the debtor* in property as of the commencement of the case.” 11 U.S.C. § 541(a) (emphasis added). “Property in which the debtor holds . . . only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.” 11 U.S.C. § 541(d). A debtor “does not own an equitable interest in property he holds in trust for another, that interest is not ‘property of the estate.’” *Begier v. IRS*, 486 U.S. 53, 59 (1990); *see also Sanyo Electric, Inc. v. Howard’s Appliance Corp. (In re Howard’s Appliance Corp.)*, 874 F.2d 88, 93 (2d Cir. 1989) (“Indeed, the Supreme Court has declared that, while the outer boundaries of the bankruptcy estate may be uncertain, ‘Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition.’”) (quoting *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.10 (1983)). As such, to the extent Customer Property was within MFGH’s possession at the commencement of its bankruptcy, it is not property of the MFGH estate and must be immediately turned over to the MFGI estate for distribution to the commodity customers.

Finally, the commodity customers call on the MFGI Trustee to begin such avoidance actions immediately. The Trustee has asked MFGI customers to submit claims forms by January 31, 2012, so that their subclasses can be designated, their net equity can be determined and their *pro rata* shares for distribution can be calculated. In order to effectively make the *pro rata* calculations, the Trustee must amass all Customer Property. All Customer Property not within the MFGI estate must be recovered and returned to the MFGI estate expeditiously, so as to be included as part of the Trustee's distribution.

B. The CCC Reserves the Right to Challenge Application of Customer Subaccount Classifications.

The CCC supports the Trustee's suggestion regarding the application of the account subclasses set forth in applicable CFTC regulations. (Trustee Mem. ¶¶ 22-24.) In particular, the CCC agrees that "property held by or for the account of a customer, which is segregated on behalf of a specific account class, or readily traceable on the 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." 17 C.F.R. § 190.08(c)(1). However, the CCC reserves its right to challenge these classifications as applied.

CONCLUSION

For the foregoing reasons, the CCC supports entry of an order in keeping with the suggestions of the Trustee for allocating the MFGI estate and satisfying claims against it, provided: (i) commodity customers have the right to challenge the application of commodity account subclasses to their individual property and (ii) any such order shall make it clear that:

1. Customers are entitled to a first-priority interest (with the exception of certain administrative expenses) in any and all MFGI property, to the extent needed in order to fill the reported \$1.2 billion shortfall in customer segregated funds;

2. Customers' first-priority right must follow customer funds to *each and every* entity to or through which customer funds flowed; and
3. The Trustee must immediately begin to pursue claims to recover customer funds (even if it requires an entity to or through which customer funds flowed to give up alternative funds), so that decisions about distribution and allocation of customer property in these proceedings can be made quickly and efficiently.

Dated: January 9, 2011

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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

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| In re: MF GLOBAL HOLDINGS, LTD, et al., Debtors. |
| In re: MF GLOBAL INC., Debtor. |

Chapter 11

Case No. 11-15059 (MG)

Jointly Administered

Case No. 11-02790 (MG) (SIPA)

CERTIFICATE OF SERVICE

I, the undersigned, an attorney, certify that I served a true and correct copy of the foregoing **Response of Commodity Customer Coalition To Trustee's Memorandum Regarding The Legal Principles And Framework For The Allocation And Distribution Of Customer Property** on all counsel of record via the Court's CM/ECF system on this 9th day of January, 2012.

In addition, via e-mail (pursuant to the Order Pursuant to Section 105(a) of the Bankruptcy Code and Bankruptcy Rules 1015(c) and 9007 Implementing Certain Notice and Case Management Procedures and Related Relief [Dkt. No. 418]:

- a. Hughes Hubbard & Reed LLP, counsel to the Trustee, at One Battery Park Plaza, New York, New York, 10004 (Attn: Christopher K. Kiplok, Esq., Jeffrey S. Margolin, Esq., and Eleni D. Theodosiou-Pisanelli, Esq.):
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