IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re:	:	Chapter 11
	:	
SENTINEL MANAGEMENT GROUP, INC.,	:	No. 07 B 14987
	:	
Debtor.	:	Hon. John H. Squires
	:	

NOTICE OF MOTION

PLEASE TAKE NOTICE that on Tuesday, October 28, 2008 at 9:30 a.m. or as soon thereafter as counsel may be heard, we shall appear before the Honorable John H. Squires in courtroom 680 at 219 South Dearborn Street, Chicago, Illinois, or before any other judge who may be sitting in his place and stead and present the attached **MOTION OF COMMODITY FUTURES TRADING COMMISSION FOR LEAVE TO FILE *AMICUS CURIAE* MEMORANDUM IN RESPONSE TO TRUSTEE'S MOTION TO CLARIFY OR IN THE ALTERNATIVE TO VACATE OR MODIFY THE COURT'S AUGUST 20, 2007 ORDER** at which time and place you may appear if you so desire.

Respectfully submitted,

Terry S. Arbit
General Counsel
Bradford M. Berry
Deputy General Counsel

s/ Martin B. White____________________
Martin B. White
Counsel

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Dated: October 24, 2008

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re:	:	Chapter 11
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SENTINEL MANAGEMENT GROUP, INC.,	:	No. 07 B 14987
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MOTION OF COMMODITY FUTURES TRADING COMMISSION FOR LEAVE TO FILE *AMICUS CURIAE* MEMORANDUM IN RESPONSE TO TRUSTEE'S MOTION TO CLARIFY OR IN THE ALTERNATIVE TO VACATE OR MODIFY THE COURT'S AUGUST 20, 2007 ORDER

The Commodity Futures Trading Commission ("CFTC") respectfully moves for leave to file an *amicus curiae* memorandum regarding (1) the statutory and regulatory scheme under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq*. ("CEA") that governed the handling of customer assets deposited with Sentinel Management Group, Inc. ("Sentinel) by futures commission merchants ("FCMs"); and (2) the implications of the statutory and regulatory scheme for the right of the FCMs that received a distribution of the proceeds of the sale by Sentinel of certain securities to Citadel Equity Fund, Ltd. and Citadel Limited Partnership in August 2007 to ownership of the proceeds in question. The *amicus* memorandum is attached.

The CFTC is the federal agency responsible for enforcing the CEA, including Section 4d, 7 U.S.C. § 6d, which governs the handling of customer funds by futures commissions merchants and their depositories. The CFTC also has promulgated regulations interpreting and implementing 7 U.S.C. § 6d. *See* 17 C.F.R. §§ 1.20 *et seq.* As a result, the CFTC has a strong interest in ensuring the proper application of the CEA and CFTC regulations in this proceeding. Further, as the agency responsible for enforcing the CEA, the CFTC has "a unique perspective" that is likely to be helpful to the Court. *See Voices for Choices v. Illinois Bell Telephone Co.*, 339 F.3d 542, 545 (7th Cir. 2003) (discussing justifications for *amicus* filings).

The CFTC therefore requests leave to file the attached *amicus curiae* memorandum.

Respectfully submitted,

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Bradford M. Berry
Deputy General Counsel

s/ Martin B. White
Martin B. White
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AMICUS CURIAE MEMORANDUM OF COMMODITY FUTURES TRADING COMMISSION IN RESPONSE TO TRUSTEE'S MOTION TO CLARIFY OR IN THE ALTERNATIVE TO VACATE OR MODIFY THE COURT'S AUGUST 20, 2007 ORDER

The purpose of this *amicus curiae* memorandum is to provide the court with the views of the Commodity Futures Trading Commission ("CFTC") regarding (1) the statutory and regulatory scheme under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq*. ("CEA") that governed the handling of customer assets deposited with Sentinel Management Group, Inc. ("Sentinel") by futures commission merchants ("FCMs"); and (2) the implications of the statutory and regulatory scheme for the right of the FCMs that received a distribution of the proceeds of the sale by Sentinel of certain securities to Citadel Equity Fund, Ltd. and Citadel Limited Partnership (collectively "Citadel") in August 2007 to ownership of the proceeds in question. The CFTC's intent, in its capacity as *amicus curiae* and as the agency responsible for the enforcing the CEA, is to provide the court with information that it believes will serve as useful context for the court's consideration of the Trustee's motion.

I. Rules Governing Handling of Customer Funds by Futures Commission Merchants

Generally speaking, an FCM is a broker that trades futures contracts for customers who open an account with the FCM and deposit cash or securities to serve as margin for the customer's trades. *See* 7 U.S.C. § 1a(20). Property deposited with an FCM to support futures trading constitutes "customer funds." 17 C.F.R. § 1.3(gg). The CEA requires FCMs to "treat and deal with all [customer funds] … as belonging to such customer." 7 U.S.C. § 6d(a)(2). In addition, [customer funds] … shall be separately accounted for and shall not be commingled with the funds" of the FCM. *Id*. However, an FCM does not need to maintain each customer's funds in an individual account. An FCM may commingle customer funds received from multiple customers in a single consolidated account. Such a consolidated customer fund account is generally called a segregated account because CFTC rules require that it be "segregated as belonging to commodity or option customers." 17 C.F.R. § 1.20(a). A segregated customer account must be maintained at a proper depository, which can include a bank, trust company, clearing organization, or an FCM. *Id*. No depository "that has received customer funds for deposit in a segregated account … may hold, dispose of, or use any such funds as belonging to any person other than the option or commodity customers of the futures commission merchant which deposited such funds." *Id.*; *see also* 7 U.S.C. § 6d(b).

FCMs are permitted to invest customer money in certain specified types of investments such as government bonds and certificates of deposit. 17 C.F.R. § 1.25(a). FCMs must "segregate such instruments as belonging to … commodity or option customers." 17 C.F.R. § 1.26(a). However, in the absence of an agreement to the contrary, the FCM can retain for its own account "any increment or interest" earned from the investment of customer funds. 17 C.F.R. § 1.29. An FCM may also agree to pass earnings on to customers or to share earnings with customers. If there are losses on the instruments purchased with customer funds the FCM must make up the loss by adding funds to the segregated account.[1]

[1] In their objection to the Trustee's motion to clarify or alter or amend the court's August 20, 2007 order concerning distribution of the proceeds of the Citadel sale, the SEG 1 FCMs suggest that, if the Trustee were able to obtain a judgment clawing back the distributed proceeds from the FCMs, the FCMs might have to seek redress from their customers, who were the ultimate beneficiaries of the distribution. In the view of the CFTC, any clawback of the distribution from

All property received by an FCM from customers to serve as margin is, by definition, customer funds and must be treated as such upon receipt. However, the dollar figure of customer funds for which the FCM is deemed responsible varies over time based on other factors as well. For example, money may be debited from the calculated customer fund amount to account for commissions to the FCM, margin payments to clearing houses, or customer withdrawals or redemptions. 7 U.S.C. § 4d(a)(2). Money may be credited to the segregated account based on the results of successful trades. 17 C.F.R. § 1.21. At all times, the FCM is required to keep enough money or other assets in the segregated customer account to cover the net calculated amount of customer funds. As of the close of each business day, the FCM must compute (a) the total amount of customer funds actually on deposit in the segregated account; and (b) the total amount of customer funds required to be on deposit taking into account customers' original deposits and the various required adjustments that are made over time. 17 C.F.R. § 1.32(a). The computation must be completed by noon of the next business day. 17 C.F.R. § 1.32(c). If there is a deficit, the FCM is required report it to the CFTC. 17 C.F.R. § 1.12(h).

To support this regulatory scheme, industry self-regulatory organizations and the CFTC conduct periodic and for-cause audits.[2] Periodic audits generally occur at irregular intervals varying between once every nine months and once every eighteen months. CFTC Financial and Segregation Interpretation No. 4-2 – Risk Based Auditing, CFTC Letter No. 99-32. For-cause

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the SEG 1 FCMs would not create any rights on the part of the FCMs against their own customers. This conclusion follows from the principle that, having elected to invest customer funds through Sentinel and benefit from the expected earnings, the FCMs are responsible for any losses resulting from their election. *See Craig v. Refco, Inc.* 624 F. Supp 944, 947 (N.D.Ill. 1985).

[2] For FCMs such as Sentinel that are not clearing members of futures exchanges, the self-regulatory agency is the National Futures Association.

audits may occur at any time. Like the daily computations required of FCMs, the audits reflect the status of an FCM's accounts as of a particular date chosen for the audit. *Id*.

II. Application to Sentinel

Sentinel, was in the business of, *inter alia*, investing segregated customer funds for other FCMs. By registering with the CFTC as an FCM, Sentinel qualified as a depository for futures customer funds under 17 C.F.R. § 1.20 and brought itself under the regulatory scheme described in the previous section. In terms of that scheme, other FCMs ("depositing FCMs" or "SEG 1 FCMs") functioned as customers of Sentinel. The depositing FCMs consolidated their own customers' funds not immediately needed for the margining of trades and turned the funds in question over to Sentinel. Sentinel, in turn, consolidated the originating FCMs' deposits into a combined segregated account it designated as "SEG 1." This account was held by Sentinel at the Bank of New York. The purpose of this arrangement was to enable Sentinel to invest the depositing FCM's customer funds in the type of instruments permitted for investment of customer funds under 17 C.F.R. § 1.25, with Sentinel and the depositing FCMs sharing the income on the investments. Under this arrangement Sentinel, a registered FCM holding consolidated customer funds in a depository account, owed a duty to the depositing FCMs (1) to treat their deposited funds as the originating FCMs' property and not as Sentinel's property and (2) to keep the deposited funds, including investment instruments purchased with those funds, segregated and not to commingle them with Sentinel's own assets. 7 U.S.C. § 6d(a)(2); 17 C.F.R. §§ 1.20, 1.26.

III. Effect of CEA Customer Funds Rules on Rights of Customers in Bankruptcy

One important consequence of the CEA provisions governing FCMs' handling of customer funds is the creation of a statutory trust with the FCM holding funds as a trustee for the benefit of the customers. Under 11 U.S.C. § 541(d), property held in trust by a debtor is not property of the bankruptcy estate. It therefore is not subject to avoidance under 11 U.S.C. § 549, which applies only to transfers of "property of the estate." 11 U.S.C. § 549(a).

While the statute and implementing regulations governing FCM customer funds do not use the word "trust," the rights and duties they create are precisely the sort that establish a trust both at common law and in other statutory contexts. *See generally In re Sawyer*, 112 B.R. 386, 390-91 (D.Colo. 1990). The statutory scheme defines a *res* subject to the trust—the cash or other property received by the FCM from its customers, with adjustments over time for the various debits and credits allowed by the statute and regulations, and any investment instruments purchased with customer funds. *See* 7 U.S.C. § 6d(a)(2); 17 C.F.R. §§ 1.20, 1.21, 1.26. The statute specifically requires the FCM and any depository to treat this *res* as the property of the customers. 7 U.S.C. §§ 6d(a)(2), 6d(b). And the statute and implementing regulations impose a variety of restrictions on how the *res* can be treated by the FCM, for example the segregation requirement and the limitations on types of permitted investments. 7 U.S.C. § 6d(a)(2); 17 C.F.R. § 1.25. As a result, courts have held that FCM customer funds constitute a statutory trust for purposes of bankruptcy law. *E.g., In re Sawyer*, 112 B.R. 386, 390-91 (in context of 11 U.S.C. § 523(a)(4)); *In re Scheuer*, 125 B.R. 584, 590-92 (Bankr.C.D.Cal. 1991) (in context of 11 U.S.C. § 523(a)(4)).

Section 541(d) of the Bankruptcy Code provides that the property of the bankruptcy estate does not include property in which the debtor holds, as of the commencement of the case, "only legal title and not an equitable interest." Under this provision, property subject to a statutory trust whose beneficiary is someone other than the debtor is not property of the estate.

Begier v. I.R.S., 496 U.S. 53, 59 (1990).[3] Thus, customer funds held by an FCM or in an FCM's depository account are not property of the estate of a bankrupt FCM and are not subject to clawback or other remedies that apply only to estate property.

IV. Application to Trustee's Claims Against SEG 1 FCMs in this Case

The Trustee contends that the securities that were sold to Citadel in August 2007 should not be considered to be the property of the SEG 1 FCMs even though the securities were in the Sentinel SEG 1 account at the time of sale. This is so, according to the Trustee, because Sentinel, at various points in time, moved securities among its various accounts, including its own proprietary clearing account and its so-called SEG 3 account. However, there are a number of underlying legal and factual considerations that, in the view of the CFTC, support the SEG 1 FCMs'claim to the proceeds of the Citadel sale. First, the mere fact that a security may have been removed from the SEG 1 account at some point in time, or even commingled in another Sentinel account, does not mean that the security in question is excluded from the scope of the statutory trust created by 7 U.S.C. § 6d(a)(2). The statute mandates that customer funds be kept in a segregated account as a protective measure but it also separately specifies that "all money, securities, and property" received by an FCM from customers must be treated as the property of the customers. 7 U.S.C. § 6d(a)(2) (emphasis added). It would be paradoxical if misconduct by an FCM in regard to maintenance of segregation would negate the purpose of segregation, which is to ensure that FCMs treat customer funds as the property of customers.

In other legal contexts involving statutory trusts, courts have held that commingling of trust and non-trust assets does not remove property from the scope of a trust so long as the appropriate nexus can be established between the commingled assets and the trust. *Bergier v.*

[3] *Bergier v. I.R.S.* and 11 U.S.C. § 541(d) substantially overrule *U.S. v. Randall*, 401 U.S. 513 (1971) on which the Official Committee of Unsecured Creditors relies in its Reply at 10

I.R.S., 496 U.S. 53, 65-66, *C.H. Robinson Co. v. Alanco Corp.*, 239 F.3d 483, 487 (2d Cir. 2001) (scope of statutory trust may be broader than common law trust). Generally speaking, the required nexus derives from the statutory scheme that creates the trust. *Id*. Given the statutory and regulatory scheme with respect to the treatment of customer funds by FCMs set forth above, it is clear that violations of segregation, and even commingling of customer funds with other assets handled by Sentinel, did not automatically remove FCM customer property from the scope of the trust established by the CEA.

A second consideration is the undisputed fact that the securities sold to Citadel were in the SEG 1 account at the time of sale. The Trustee contends that some or all of these securities should not be treated as segregated customer funds because of the prior history of their handling by Sentinel. This approach to defining what assets are deemed to be customer funds is likely to seriously undermine the protective scheme for such funds established by the CEA. As described above, the basic protective mechanism established by the statute is the requirement that FCMs always maintain actual assets in segregation an amount equal to the calculated amount of customer funds for which they are responsible. Enforcement of this requirement is based ultimately on audits matching the amount of actual funds in segregation at any given point in time with the calculated customer fund obligation of the FCM. For this matching process to be effective, regulators and self-regulatory organizations must be able to rely on the observed amount of assets in segregation at the time the computation or audit is performed.

The Trustee's theory in this case would undermine the ability of customers and regulators to rely on the observed assets in segregation because, according to the Trustee, assets in segregation at the time a computation or audit is performed might not "count" as customer funds based on their past history. By undermining the ability of customers and regulators to rely on ordinary accounting methods to determine if available segregated assets match the amount required, the Trustee's theory could seriously weaken the protective system for FCM customer funds under the CEA.

Respectfully submitted,

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