# Recommendations on the Policy Response to the MF Global Bankruptcy

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## Summary

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Liquid, competitive and legally protected commodity markets are an integral component of American economic success. The insolvency of MF Global calls into question many aspects of legal protections that commodity market participants heretofore considered unassailable. The history of failures of commodity brokers has been a model of success for regulators and risk managers, giving rise to the mantra that no customer has ever lost any money as the result of the default of a member of an exchange. MF Global's failure has shattered that notion and exposed tremendous shortcomings in the system designed to protect customer assets. For this reason, the collapse of MF Global deserves a robust policy response which amends the existing regulatory structure and contemplates new mechanisms in order to strengthen the safeguards which protect customer property.

The Commodity Customer Coalition seeks a policy response that focuses on mollifying the effects of FCM insolvency on customers, creditors and market participants, as well as reducing the probability of future bankruptcies. To this end, we recommend the remedies summarized below and detailed throughout this document:

- **Create a customer protection fund: The FCM Insolvency Liquidity Facility ("FCMILF"):**
  Commodity customers would benefit from a protection fund which concentrates on providing liquidity to unlock their collateral for trading purposes, rather than a compensation scheme akin to traditional insurance. This fund, which we have termed the FCMILF, should have two functions. First, it should supply adequate liquidity to aid in the transfer of customer accounts from the insolvent FCM to solvent FCMs. If a shortfall of customer property impedes the transfer of accounts, FCMILF should provide liquidity for the transfer of customer positions on a fully margined basis and as much unencumbered customer property as the assets and borrowing capacity of FCMILF warrant. Second, it should 'step into the shoes' of customers, fronting customers the balances of their accounts to the extent possible and assuming the balance of their claims in the bankruptcy court. The CCC believes this FCMILF could be funded through a transactional revenue model similar to the fee assessed to commodity transactions which partially funds the operations of the National Futures Association ("NFA").

- **Take measures to mitigate risks associated with firms maintaining dual registration as Broker-Dealers of securities and Futures Commission Merchants ("BD/FCMs")**:
  The ongoing Securities Investor Protection Corporation ("SIPC") investigation has revealed that MF Global was using commodity customer property to fund its illiquid broker-dealer business. In some cases, MF Global used commodity customer funds to finance wires to securities customers, literally taking the assets of one customer and paying them to another. Additionally, owing to the separate processes which exist in the Bankruptcy Code to deal with commodity and securities bankruptcies, substantial confusion complicated the early stages of MF Global's bankruptcy. Congress should consider the following potential remedies:
  - Force the separation of BD/FCMs into two distinct legal entities. This measure would prevent commodity customer property from being used to fund broker-dealer operations. It would also prevent the subjective application of divergent sections of the Bankruptcy Code, as the broker-dealer entity would be liquidated in a Securities Investor Protection Act ("SIPA") proceeding while the FCM entity would be subject to a separate Chapter 7 liquidation;
  - If BD/FCMs are not separated, mandate that excess equity in commodity customer accounts are afforded the insurance protections of SIPC-covered securities accounts and assets;
  - Extend the Regulation 4d segregated funds protections to all customer property tendered to an FCM;

- Mandate that the holding company, affiliates and subsidiaries of an FCM subordinate their property at the FCM entity to customer claims in the event of a shortfall in customer property;
- Create specific and severe civil and criminal penalties for misuse of customer property.

- **Bankruptcy Reforms**
  - Establish a statutory right for a Customers' Committee of insolvent FCMs with parents in Chapter 11 proceedings, giving customers similar rights to those afforded to a Chapter 11 Creditors' Committee;
  - Prevent the application of the 'Safe Harbor' provision in the Bankruptcy Code in cases where segregated customer property is involved;
  - Introduce market forces to determine fees paid to counsel for bankruptcy Trustees or place reasonable limits on these fees;
  - Make statutory provisions which formalize the appointment process of SIPA Trustees and allow more competition among firms seeking to offer services to SIPC Trustees.

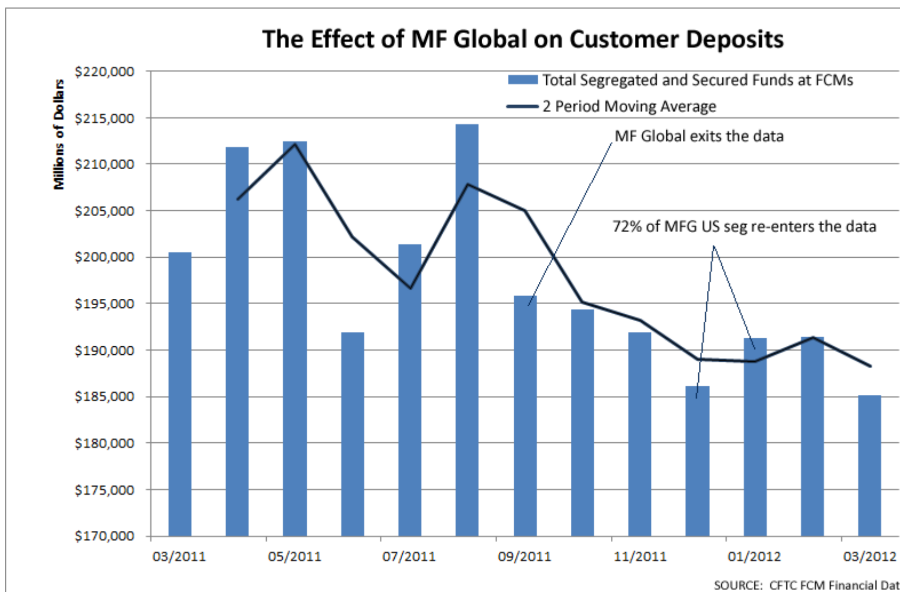
The Commodity Customer Coalition ("CCC") is a non-profit advocate for commodity customers affected by the collapse of MF Global. It was formed in the days immediately following MF Global's October 31st bankruptcy after it became clear that every entity which purported to protect and advocate for commodity customers failed to do so. The group represents more than 8,000 commodity customer accounts of MF Global and maintains a strong presence in the Bankruptcy Court and media on behalf of its membership.

This report represents our analysis of available information regarding the bankruptcy of MF Global. It is intended to provide a conceptual overview of reforms that may benefit commodity customers. It consists of the opinion of the author which were derived from his research. Enacting legislation based on the measures recommended herein will require a great deal of additional study.

## The Case for a Robust Policy Response

MF Global's insolvency has shaken public confidence in the integrity of our commodity markets, as well as in the legal protections afforded to participants. Without adequate changes to the regulatory regime governing FCMs, another MF Global-sized failure is not only possible, it is probable. The first domino to fall will be the withdrawal of excess collateral from FCMs by market participants. This will leave less of a cushion to absorb more historically familiar causes of FCM insolvency, like outright theft for the benefit of principals or failure of an FCM to properly manage the risk of customer default. The prevailing zero interest rate environment has all but erased the traditional revenue stream for FCMs (interest on customer deposits). Add in volatile market conditions, the concentration of assets in a few systemically connected financial institutions and a deflationary sovereign debt crisis in Europe and conditions which may lead to an increase in FCM insolvencies are present. The net effect will be illiquid and inefficient markets, higher prices for consumer goods and more losses borne by customers.

**Figure 1**




This crisis of trust is evidenced by the overall trend toward declining segregated customer funds held by FCMs post-MF Global. Since MF Global's collapse, balances of customer collateral at FCMs have experienced a sustained decline. While there may be additional factors behind this drop, a likely contributing factor is a response to MF Global's shortfall in customer property.

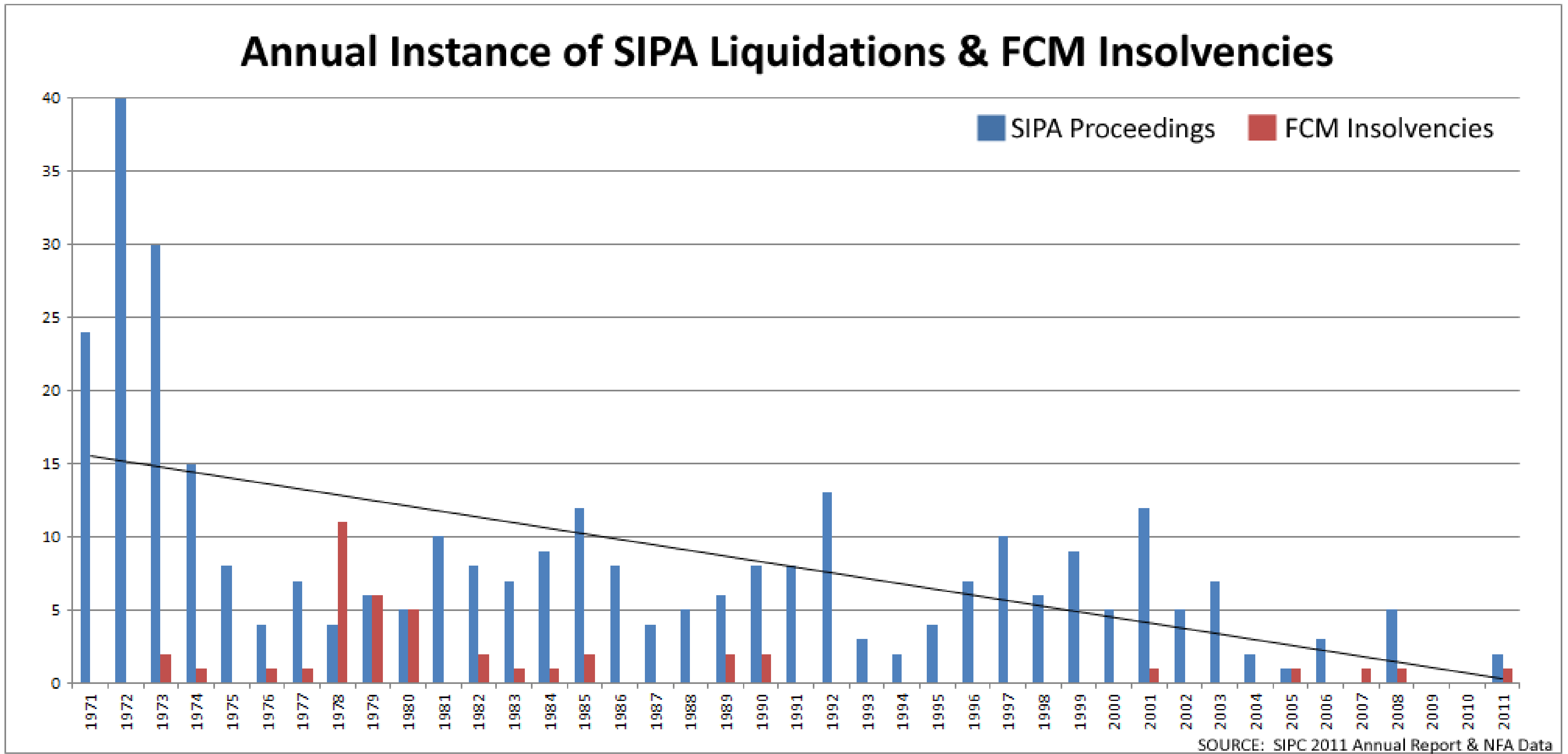
As Figure 1 demonstrates, there has been a sharp decrease in customer property held by FCMs since 2011's 3rd quarter. The initial drop is attributable to MF Global's wholesale exit from the CFTC segregation data in September 2011. However, a corresponding rise fails to appear as the SIPA Trustee makes substantial distributions to MF Global customers' accounts at new FCMs in November and December of 2011. Some of MF Global's customers may be permanently lost, but it appears assets in segregation are declining across firms. It stands to reason that commodity customers may be less likely to leave unencumbered collateral at an FCM as they do not believe the protection scheme in place is sufficient to safeguard their assets. The net effect is to reduce liquidity at all FCMs and increase the chance that future liquidity stress events could fell FCMs.

Despite this trend and the alarming macro conditions, many are dismissive of the calls for a policy response to MF Global. They note that FCM bankruptcies are infrequent and, prior to MF Global, no customer of an FCM ever lost any money as the result of a clearing member default. Indeed, there have only been 15 FCM bankruptcies in the last 30 years and in most of them very little customer money was at risk.[1] In the 30 years prior to 1980, there were 67 FCM insolvencies.[2] A glance at this reduction in the rate of FCM insolvency may lead one to conclude that MF Global is an isolated incident. Yet, while it is clear that the pace of FCM failure is in decline, FCM bankruptcies have become cosmic in scale.

[1] National Futures Association data.

[2] 1986 Customer Protection Study. National Futures Association. 1986. p 14.

Figure 2



Of the 15 largest bankruptcies in American history[3], four of them had commodity operations and were registered as FCMs with the CFTC: Lehman Brothers Holdings, Enron Corp, MF Global Holdings and Refco, Inc. To be sure, Enron's primary business was not typical of an FCM, nor would it have been considered a commodity broker in the sense that it held customer collateral for the purpose of margining positions on futures exchanges. However, its presence in the FCM space is an ominous one. Lehman maintained a thriving institutional FCM business, holding more in segregated customer funds than MF Global did at the time of its bankruptcy. However, its FCM operation only constituted about 1.5% of its total assets in its bankruptcy filing. Refco and MF Global derived the overwhelming majority of their revenue from their FCM operations, and a significant portion of these operations were devoted to small, 'retail' scale customers. All told, these firms exposed close to $25 billion in customer property to insolvency risk.

**Table 1**

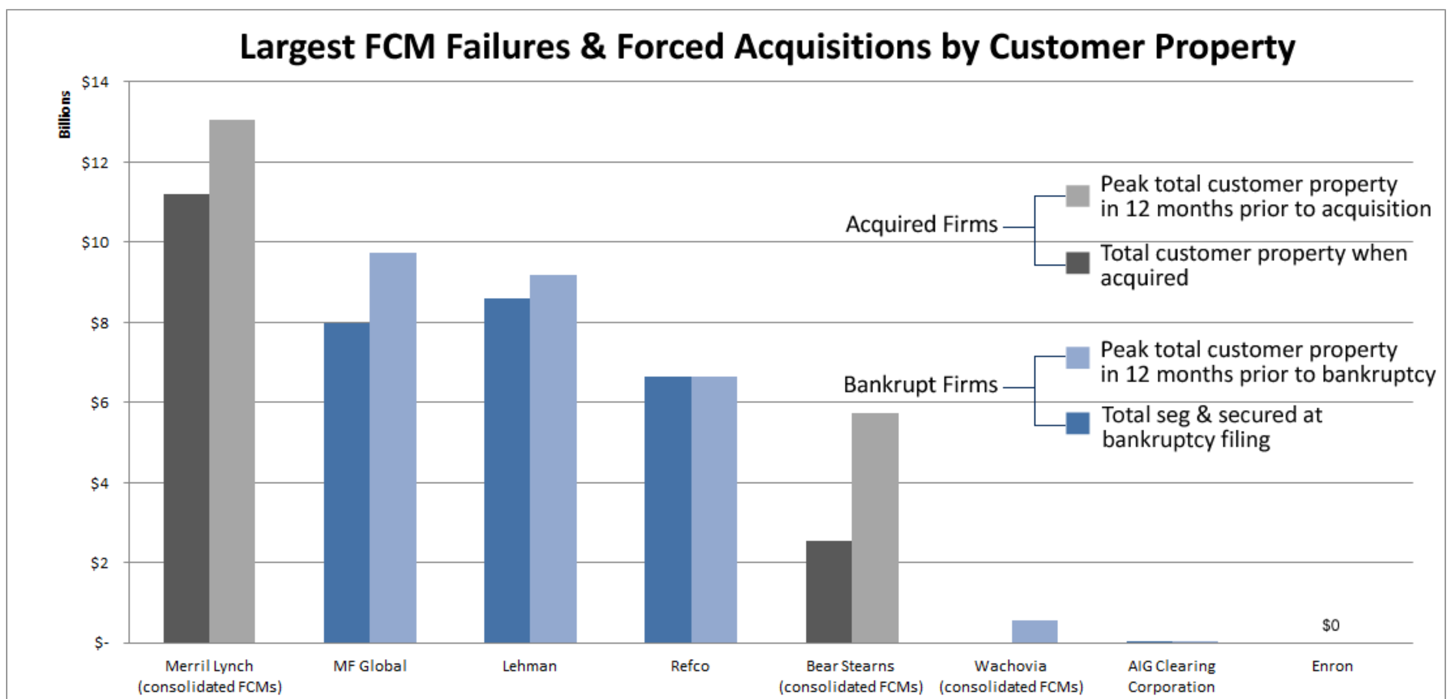
**Largest US Bankruptcies By Filing**

| Company/Year | Assets |
|---|---|
| **Lehman Brothers Holdings Inc (2008)** | **$639 B** |
| WorldCom Inc (2002) | $103 B |
| General Motors Corp (2009) | $91 B |
| CIT Group Inc (2009) | $80 B |
| **Enron Corp (2001)** | **$65 B** |
| Conseco Inc (2002) | $61 B |
| **MF Global Holdings Ltd (2011)** | **$41 B** |
| Chrysler LLC (2009) | $39 B |
| Thornburg Mortgage Inc (2009) | $36 B |
| Pacific Gas and Electric Co (2001) | $36 B |
| Texaco Inc (1987) | $34 B |
| Financial Corp of America (1988) | $33 B |
| **Refco Inc (2005)** | **$33 B** |
| Washington Mutual Inc (2008) | $32 B |
| IndyMac Bancorp Inc (2008) | $32 B |

But for extraordinary central bank and Treasury intervention during the financial crisis of 2008, Table 1 would include at least four additional bankruptcies of firms with registered FCM operations: Bear Stearns, Wachovia, Merrill Lynch and AIG. These firms were either merged with other firms at the behest of policy makers or otherwise bailed out by Treasury and the Federal Reserve. Bear Stearns and Merrill Lynch were two of the largest FCMs in the country, as ranked by customer property in their possession. Wachovia and AIG maintained clearing operations as FCMs and did not hold large balances of customer collateral.

Combining these forcibly acquired firms with the above bankruptcies means that since 2008, almost $45 billion in customer property has been exposed to insolvency risk from FCMs that nearly failed or filed for bankruptcy. This is more than the entire amount of customer funds held in segregation by all FCMs in any year prior to the year 2000.[4] While FCM insolvencies are infrequent, they have become so large that they pose systemic risks to markets and related financial and non-financial institutions.

Figure 3

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[3] Ranked by assets listed in the company's bankruptcy filing: http://en.wikipedia.org/wiki/Chapter_11,_Title_11,_United_States_Code#Largest_cases

[4] CFTC FCM Financial data.

The firms in Figure 2 have more in common that just being in the FCM business. All of them were publicly traded firms. All except Refco and Enron were also registered as broker-dealers with the Securities and Exchange Commission ("SEC") and members of SIPC.[5] Half of them were Primary Dealers of Treasury securities with the Federal Reserve Bank of New York (Merrill, MF, Lehman and Bear).

Of the 116 FCMs reporting to the CFTC as of March 2012, 58 of them--exactly half--are also registered as broker-dealers with the SEC. They are known as 'dual registered' or 'dual licensed' firms. These 58 firms maintain nearly 91% of all the customer property held by FCMs. What is more startling is the fact the 80% of all the customer property held by FCMs is concentrated in just 10 of these firms. All but one of these top 10 firms is publicly traded. All of the 9 publicly traded FCMs at the top are members of SIPC and are Primary Dealers of Treasury securities with the Federal Reserve Bank of New York.

These 9 institutions received a combined $11.75 trillion, or 60% of the total assistance to non-central bank financial institutions provided by the Federal Reserve Bank, during the financial crisis of 2008 and 2009.[6] Some have criticized the effort for a policy response from Congress to the MF Global bankruptcy on the grounds that we do not need to extend bailouts to commodity brokers. The reality is that the biggest commodity brokers have already been bailed out.

**Table 2**

| FIRM | FCM Rank by Assets | Rank as Recipient of FED Assistance* | Publicly Traded? | SIPC Member? | Primary Dealer? |
|---|---|---|---|---|---|
| GOLDMAN SACHS & CO | 1 | 8 | GS-NYSE | Yes | Yes |
| JP MORGAN SECURITIES LLC | 2 | 13 | JP-NYSE | Yes | Yes |
| NEWEDGE USA LLC | 3 | N/A | N/A | No | No** |
| BARCLAYS CAPITAL INC | 4 | 5 | BARC-LON | Yes | Yes |
| DEUTSCHE BANK SECURITIES INC | 5 | 11 | DBK-ETR | Yes | Yes |
| UBS SECURITIES LLC | 6 | 14 | UBS-NYSE | Yes | Yes |
| CITIGROUP GLOBAL MARKETS INC | 7 | 1 | C-NYSE | Yes | Yes |
| MERRILL LYNCH (BANK OF AMERICA) | 8 | 2 | BAC-NYSE | Yes | Yes |
| CREDIT SUISSE SECURITIES (USA) LLC | 9 | 10 | CSGN-SIX | Yes | Yes |
| MORGAN STANLEY & CO LLC | 10 | 3 | MS-NYSE | Yes | Yes |
| **MF GLOBAL INC** | **8*** ** | **N/A****** | **YES** | **YES** | **YES** |

**Excluding Central Bank Liquidity Swaps (CBLS)*
*** Newedge USA LLC is a joint venture and equally owned subsidiary of French investment banks Société Générale and Crédit Agricole CIB. While neither parent bank is a SIPC member, Société Générale is a Primary Dealer of the NY Fed.*
****Rank in last month it published data to CFTC prior to its bankruptcy.*
****MF Global was not a direct recipient of FED assistance, but it was one of 799 stocks for which the SEC prohibited short selling during the financial crisis of 2008 (see Securities Exchange Act of 1934 Release No. 34-58592).*
*SOURCES:*
*- Felkerson, James. (2011). $29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility. Working Paper No. 698, Levy Economics Institute of Bard College. p 33.CFTC FCM Financial Data, March 2012*
*- SIPC Member Database (http://www.sipc.org/Who/Database.aspx).*
*- NY Federal Reserve List of Primary Dealers (http://www.newyorkfed.org/markets/pridealers_current.html).*

Certainly the rate of FCM insolvency has declined; but what has increased is the probability that the next broker failure will pose systemic risks to the global financial system.

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[5] Refco was registered as a broker-dealer, but not its FCM entity. Refco's broker-dealer business was housed in a separate corporate entity, Refco Securities, LLC. The benefit of this corporate structure will be explored in the section of this document on "Addressing the Problem of BD/FCMs."

[6] Felkerson, James. (2011). $29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility. *Working Paper No. 698, Levy Economics Institute of Bard College*. p 33.

Of course, the key difference between the MF Global bankruptcy and either the Lehman or Refco bankruptcy is that MF Global had an enormous shortfall in customer funds at the time of its bankruptcy. This shortfall prevented a transfer of customer accounts to new firms, whereas the transfer of customer accounts was not hindered for Refco or Lehman. As a result, MF Global's customer assets became frozen in a liquidation carried out under SIPA. Though the commodity futures niche of finance is a highly regulated one, there is no standard framework to mitigate the impact of such an asset freeze on the customers affected or the market as a whole. In fact, as MF Global was dually registered as both a broker-dealer of securities and an FCM, divergent and conflicting areas of the Bankruptcy Code exacerbated uncertainty and magnified the damage of the asset freeze.

Though initial distributions of property to customers were made quickly, now MF Global's customers are mired in a bankruptcy quagmire typical of failed large multinational financial conglomerates. The prospect for asset recovery looks good, but the timeline is dreadful. MF Global's holding company and affiliates have all asserted claims on its FCM's estate. The litigation will take years to complete. Meanwhile, two bankruptcy Trustees and their army of attorneys--whose combined bills for the first four months of the bankruptcy topped $40 million--reduce the pool of the debtor's assets which can repay customer losses.

Without substantial changes to commodity regulations, future FCM insolvencies will be as unwieldy as MF Global and perhaps more systemically threatening. Our proposals seek to simplify and reform existing regulations, update and clarify existing law and install new mechanisms funded and directed by private industry to protect both customers and taxpayers from the risk of commodity broker default. If another firm were to fail today with a shortfall in customer property, the same mistakes would repeat but their impact would be magnified. Congress has the ability to change this outcome. For your consideration, we offer the following proposals to mitigate the impact of future FCM defaults.

## Establishing a Different Kind of Insurance: The FCM Insolvency Liquidity Facility (FCMILF)

Many in the commodities business espouse that customer segregation protections rule out the need for an account insurance mechanism for commodities customers. The argument is predicated on the lack of customer losses stemming from clearing member defaults. Those who adhere to this argument will have to find new justification for its merit in a post-MF Global world. Even though it is still possible for MF Global's customers to receive a 100% recovery of their assets via the ongoing SIPA liquidation, the timetable to get those assets could be as long as 6 years. Many have already incurred losses due to MF Global's default.

Some took losses as a result of forced liquidation of futures positions immediately following the bankruptcy filing, either directly as a result of the clumsy liquidation or in the cash market as their hedge was severed. Others face incalculable damages, real and those derived from opportunity costs, as a result of frozen collateral. The most perilous effect of the asset freeze was that it locked out market participants from using their collateral to manage their risks through commodity markets. Had the MF Global debacle occurred during volatile markets, this impact would have greatly magnified.

Faced with these facts, those who are reflexively against commodity account insurance will cite that the modern marketplace is too big for insurance to cover cost effectively. There is now a few hundred billion in segregation in the US, so any attempt to insure such a bounty would be too expensive to be effective. Yet there are over $3 trillion dollars in assets at broker-dealers and trillions more held at banks, and each entity has its own separate US government owned insurance corporation protecting its customers (SIPC and FDIC respectively). So why should commodity customers be any different, especially if the segregation protection proves to be a paper tiger?

Commodities customers do have different needs than securities customers or clients of depository institutions. But it is precisely because of the distinctive structure of futures markets that a liquidity insurance provision would be an effective, economical means to shield commodity customers from insolvency risk. We agree that a traditional compensatory insurance fund for these customers would either be too expensive to raise or too small to be effective. The roots of every major recent FCM insolvency has been liquidity stress. The effect of liquidity stress on customer property can be addressed through a mechanism aimed at removing customer assets from insolvent firms at the onset of bankruptcy. This can be done inexpensively; it can be self-sustaining and executed without having to enact a government-backed insurance scheme. It will not only protect customer assets, but produce the ancillary benefits of protecting liquidity in commodities markets and providing a circuit breaker to protect against the systemic risks of FCM failure. We have termed this insolvency response mechanism the FCM Insolvency Liquidity Facility ("FCMILF").

**Examining NFA's Customer Account Protection Study | Historical Perspective on Insurance**

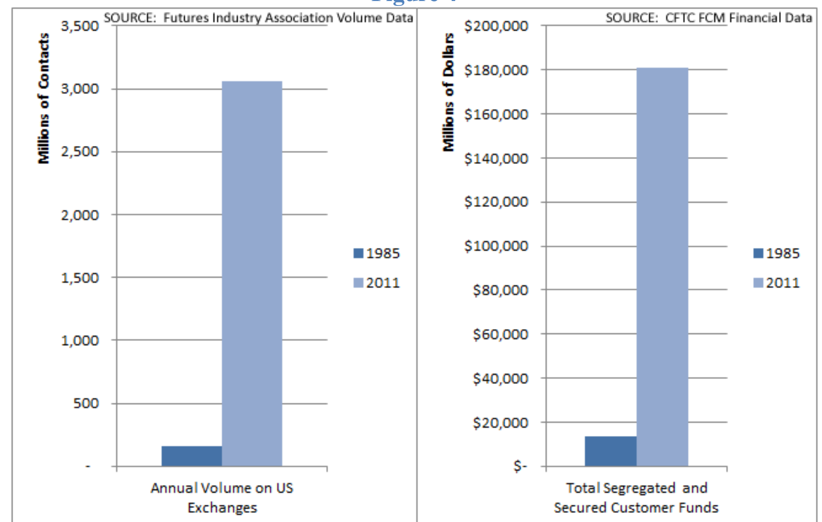
The most often cited study which ponders an insurance mechanism for the futures industry is the 1986 National Futures Association ("NFA") "Customer Account Protection Study". This study was requested by the CFTC to examine if insurance could play a role in reducing the impact of FCM failures. At its inception, the CFTC was instructed by Congress to consider the need for an insurance scheme similar to the Securities Investors Protection Corporation ("SIPC"), which offers insurance for securities customers. They decided it was not necessary at that time, as adequate protections appeared to be in place. The failure of the FCM Volume Investors Corporation in 1985 prompted the CFTC to request that the NFA revisit the concept of insurance for commodity accounts.

The NFA looked at historical instances of FCM insolvency from 1939 to 1985. Its examination revealed that there was no trend toward more insolvencies or greater customer losses from the FCMs that did fail. Citing theft and customer default as the primary historical reasons for default, they examined creating an insolvency response mechanism that ranged from commercial insurance to industry funded self-insurance. The NFA evaluated not only a SIPC-like system, but one which ensured account transfers or compensated different customers at different amounts. They noted that securities and banking insurance schemes were developed to provide retail customers confidence in those industries. At the time, retail customers accounted for only 5% of futures volume, whereas about 50% of stock was directly or

indirectly owned by retail investors. Given that there was no crisis of confidence in the industry and substantial customer protections were already in place, the NFA concluded that there was no need for an insurance mechanism for commodity accounts.

The conclusions reached by the NFA in 1986 as a result of this study were well founded at the time. However, the commodity futures industry has radically changed since 1986. At the time of the NFA study, virtually no futures trading was conducted electronically. Almost every contract traded in the US in 1985 was transacted on trading floors via the 'open outcry' method. By January 2011, almost 89% of the contracts traded at the country's largest futures exchange, CME Group ("CME"), were conducted electronically. The Intercontinental Exchange ("ICE"), the second largest futures exchange in the US, has no futures markets traded via open outcry.

Figure 4




In 1985, the average Futures Commission Merchant ("FCM") held about $28.5 million in customer segregated funds. Today the per FCM average is closer to $1.7 billion. Adjusting for inflation, the total amount of customer funds held in segregation in 1985 was nearly $13.5 billon. As of March 2012, that has exploded to over $181 billion--a 14 fold increase.

Trading volumes have increased in concert. In 1985, the total number of contracts traded was around 158 million. By 2011, there has been nearly a 20 fold increase to over 3 billion contracts per year. On the following page, Figure 5 shows there have been two periods of exponential growth in trading volume. Each coincides with innovations which expanded the reach of commodity futures. In the early 1970's, the introduction of financial futures brought commodity trading from gain pits into financial instruments like bonds, stocks and foreign currency. In the early 2000's, the expansion of these products to viable electronic platforms reduced the costs of trading and once again ushered in parabolic expansion in trading volume.

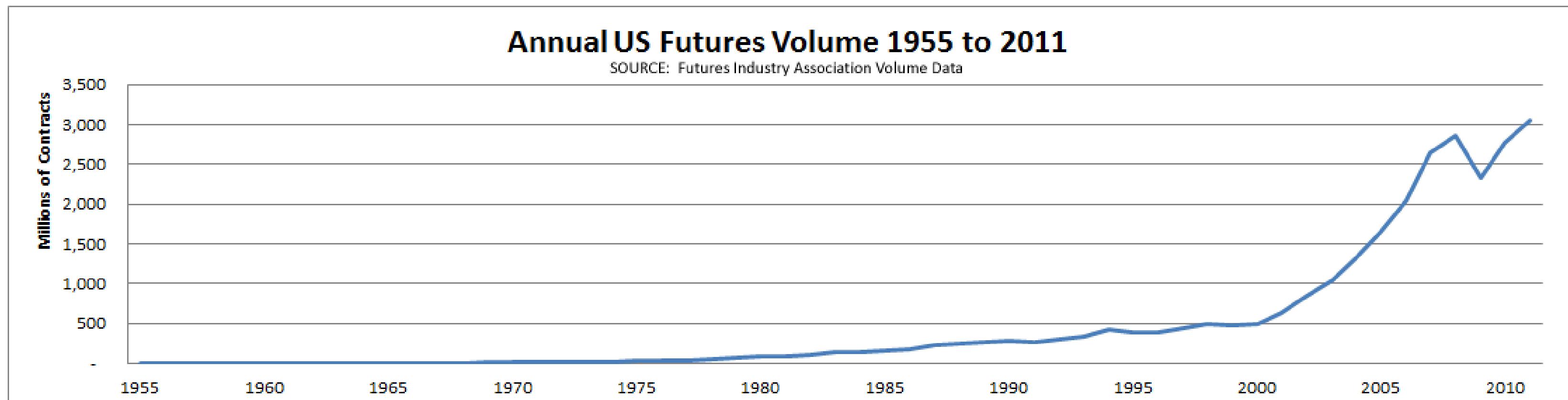
These developments have rendered moot many of the assumptions used as a basis for the conclusions reached in the NFA's study. Commodity markets are vastly different than they were in 1985, as are their participants and the regulations that frame them. Today, much greater capital is housed in far fewer firms. While insolvencies have declined, the size of those insolvencies has exploded. Firms are failing for entirely new reasons and customers are taking losses. It is time to reexamine an insurance mechanism for commodity accounts.

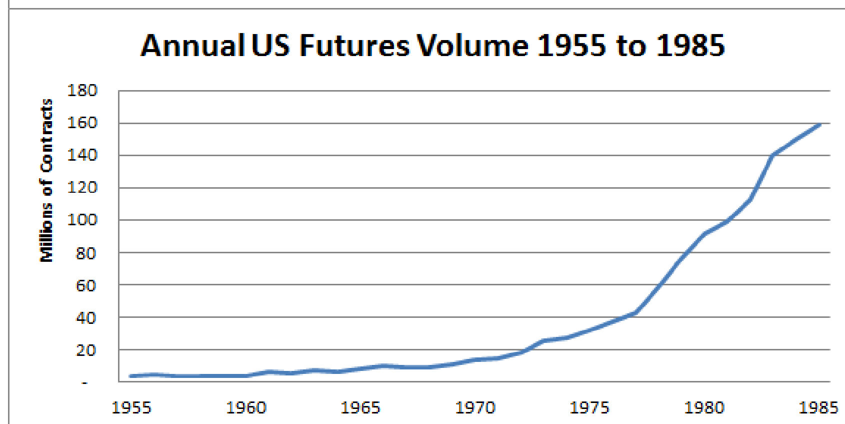
**Why a Customer Protection Fund Could Work for Commodities**

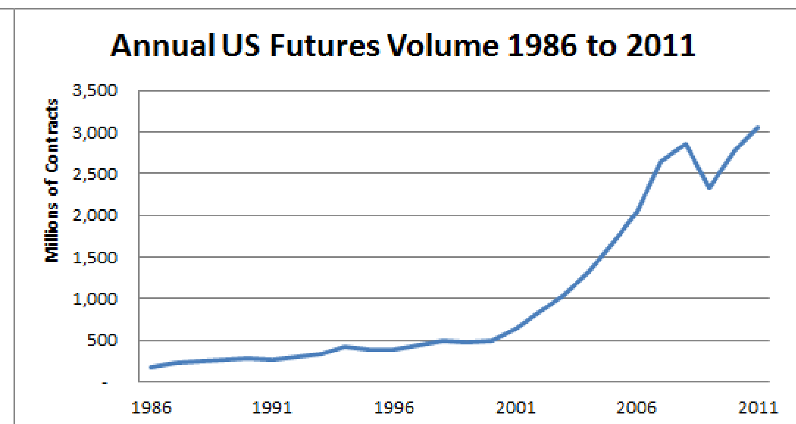
The nature of commodities trading makes it easier to protect more customer property with a smaller fund than is possible in securities. Customers deposit funds with FCMs to margin positions on exchanges. When they initiate positions, the margin required to hold the position is sent by the FCM to the exchange. So when an FCM becomes insolvent, a substantial portion of its customers' funds reside outside of its control at futures exchanges. CME Group noted that it held $2.4 billion of MF Global's nearly $6 billion in customer property. Additional exchanges held substantial portions of MF Global's customers' property as well, supporting our supposition that it is unnecessary to insure the total amount of segregated funds at an FCM.

**Liquidity Insurance Through FCMILF**

The SIPC insurance model is based on compensating the customer for insolvency loss. What we are proposing would have an element of compensation, but its primary focus would be on filling shortfalls to assist in the transfer of customer accounts to new FCMs. The goal of this liquidity facility, which we have termed the "FCMILF", would be to allow unfettered access to trading collateral and open positions for customers of insolvent FCMs. This not only protects the customers of the failed FCM, it serves to protect the liquidity of the commodity markets as a whole.

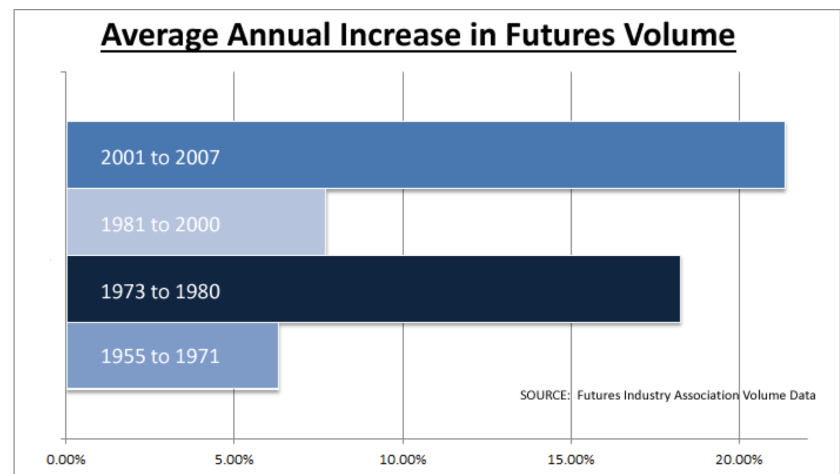



Volumes of exchange traded derivatives in the United States experienced two periods of parabolic growth. In the early 1970's, financial futures were introduced. This innovation expanded the pool of market participants from traditional agricultural constituencies to large financial institutions. Over the next ten years, various products were introduced which allowed financial institutions to hedge risks associated with securities, currencies and interest rates. The average annual increase in volume, which had been steady around 7% over the period from 1955 to 1971, nearly tripled in the next decade.

Although electronic trading of futures contracts began in the late 1980's, their use was relatively limited given policies which restricted access of electronic markets to exchange members. In the early 2000's, the CME enacted an "Open Access Policy" enabling direct access electronic trading for non-members. The annual volume of futures contracts exploded again. By 2003, the average annual volume for each subsequent year would be greater than the total number of contracts traded in the 30 year period from 1955 to 1985 combined.



The transfer of accounts from an insolvent FCM to solvent FCMs prior or concurrent to a bankruptcy filing is essential to maintaining the strength of the customer segregation protection. It ensures that customer property does not become mired in a bankruptcy proceeding, where it is subject to the costs and delays of litigation. Moreover, the quick transfer of accounts prevents triggering foreign bankruptcy proceedings or action from foreign regulators to freeze customer collateral in the foreign affiliates of the defunct FCM.

In the case of MF Global, FCMILF would step in and provide the collateral necessary to transfer accounts to another broker. Such action could have supported the widely reported potential sale of MF Global's FCM business to the FCM Interactive Brokers. The deal collapsed as the shortfall in segregated accounts was discovered the early morning hours prior to MF Global's Chapter 11 filing. So instead of MF Global selling its FCM business to a competitor for a financial gain, which would have benefited MF Global's estate, its business was transferred to other brokers for no financial gain. That resulted in an enormous loss of potential recoveries for both the customers and creditors of MF Global.

Assuming the required amount to effect the transfer exceeds the assets in FCMILF (which it very likely would in the first decade or two of the fund), it would need to borrow the funds from the Federal Reserve Bank that are required to plug the shortfall. In the case of MF Global, the initial amount required to effect an account transfer would have been something in the neighborhood of $1 billion. This amount would fall quickly and considerably as collateral is traced and recovered. Though the SIPA Trustee discusses the shortfall in MF Global's assets at $1.6 billion, half of that amount is simply tied up in foreign affiliates and not in the Trustee's control. Even if FCMILF's liquidity offering does not facilitate a sale, it could still effect a transfer before foreign assets become locked up in their jurisdiction. This would greatly reduce the shortfall of assets at a defunct FCM, as well as the funds needed to facilitate a transfer of all customer accounts.

Should the amount required to transfer all customer property held at a bankrupt broker exceed the borrowing capacity of FCMILF or the Fed's willingness to lend to it, FCMILF should first focus on transferring open positions on a fully margined basis to new brokers. Once that is complete, FCMILF should work with those involved to see how much unencumbered collateral for which it can finance a transfer. Then FCMILF would simply operate as a buyer of bankruptcy claims, paying out customers their total assets (to the extent possible) and having those customer claims assigned to FCMILF. FCMILF would need statutory rights to a super-priority claim over the assets of the estate of the failed broker in the interim period between the failure of the FCM and assignment of claims. That way it could safely and quickly advance recoveries.

**Structure and Governance of FCMILF**

FCMILF could be structured either as a private non-profit corporation or as a government owned corporation. The benefit of being structured as a government owned corporation is that would allow the fund to borrow from the US Treasury. SIPC proves that a government owned corporation can provide services at no cost to the taxpayer, but the futures industry desires that the model of self-regulation which has served the industry to date persists. As long as FCMILF is given the statutory ability to borrow funds from the Federal Reserve Bank at the discount window, it does not need to be structured as a government owned corporation.

The NFA is the best candidate to manage the FCMILF. It could hold elections or otherwise appoint a board of directors to the FCMILF and allocate staff to manage the operations of the fund. As the NFA's budget is already stretched thin, the administration of the fund would need to be paid for out of the fund's assets. Given that it will not be an actively managed fund, investing most likely only in treasury securities according to a strict allocation formula, its expense ratios would be very low.

**Raising Capital for the Fund**

The CCC believes the FCMILF could be adequately funded through a small transaction fee assessed on every futures and option on futures contract traded in the United States. This is how the NFA raises the bulk of its funds. A 1 cent fee would have raised around $35 million in 2011.[7] Such a fee is not cost prohibitive and is not likely to dampen futures volume, as evidence by the fee history of the NFA. The NFA's assessment fee was $0.01 in 2010 and doubled to $0.02 in

[7] Futures Industry Association volume data.

2011. Futures volume was about 9.5% higher in 2011 than it was in 2010, reaching its highest volume in history and recovering from the 20% decline from 2008 to 2009 following the financial crisis.[8] It appears that there has been no dampening effect as a result of the recent increase in the NFA's assessment fee.

Assuming the average annual commodity trading volume going forward equals what it has averaged since the use of electronic trading became widespread, a 1 cent fee would average raising $25 million dollars every year. The fund would likely have low management costs, as it should be restricted to an allocation model which only invests a portion of the capital limited to US Treasury securities. If we assume that the yield on the 10 year note returns to 3.5% over the course of the next 10 years, that the fund's annual expenses are 10% of the annual amount raised and the fund maintains a 15% cash balance, the FCMILF would have around $275 million in assets in a decade. If interest rates return to their historical averages, the fund will near a billion dollars in 30 years. This assumes there is no cost to the fund due to insolvency, but also assumes no growth in futures volumes.

If we set the $25 million average raised number as an annual target in 2011 dollars and adjust for inflation, this is what the historical fee per contract would look like compared to the NFA's assessment fees:

**Table 3**

| Assessment Fee Rates (per contract): | Futures | Options | Hypothetical FCMILF Fee (for both options and futures) |
|---|---|---|---|
| FY83 | $0.165 | $0.10 | $0.07 |
| FY84 | $.165/ $.14 | $.10 / $.08 | $0.07 |
| FY85 | $0.14 | $0.08 | $0.07 |
| FY86 | $0.14 | $0.08 | $0.06 |
| FY87 | $0.14 | $0.08 | $0.05 |
| FY88 | $0.14 | $0.08 | $0.05 |
| FY89 | $0.12 | $0.07 | $0.05 |
| FY90 | $0.10 | $0.06 | $0.05 |
| FY91 | $0.10 | $0.06 | $0.05 |
| FY92 | $0.12 | $0.07 | $0.05 |
| FY93 | $0.12 | $0.07 | $0.04 |
| FY94 | $.12/ $.10 | $.07 / $.06 | $0.04 |
| FY95 | $.08 / $.07 | $.04 / $.035 | $0.04 |
| FY96 | $0.07 | $0.035 | $0.04 |
| FY97 | $0.07 | $0.035 | $0.04 |
| FY98 | $.12 / $.10 | $.035 / $.05 | $0.03 |
| FY99 | $0.10 | $0.05 | $0.04 |
| FY00 | $0.09 | $0.045 | $0.04 |
| FY01 | $0.07 | $0.035 | $0.03 |
| FY02 | $.07/$.06/$.05 | $.035/$.02/$.025 | $0.02 |
| FY03 | $.04/$.03 | $.02/$.015 | $0.02 |
| FY04 | $0.03 | $0.015 | $0.01 |
| FY05 | $0.03/$0.02 | $0.015/$0.01 | $0.01 |
| FY06-FY07 | $0.02 | $0.01 | $0.01 |
| FY07 | $0.02 | $0.01 | $0.01 |
| FY08 | $0.04/$0.01 | $0.01/$0.005 | $0.01 |
| FY09-FY10 | $0.01 | $0.005 | $0.01 |
| FY11 | $0.01/$0.02 | $0.005/$0.01 | $0.01 |

Had the FCMILF come into existence the same year as SIPC (1971) and had it used the above numbers as a target, a conservative estimate of its present holdings is $1.3 billion.[9] It would never have experienced a loss as a result of an

[8] Futures Industry Association volume data.

FCM default, so it would have had all of the collateral it needed to effect the transfer of MF Global's accounts to new brokerages.

**Who Qualifies for Protection**

The NFA's examination, as well as the proposal for a protection fund offered by the SIPA Trustee, seek to narrow the scope of the definition of customer in order to focus on retail customers. The CME went a step further in the development of its Family Farmer and Rancher Protection fund, which seeks to protect only the smallest, most sympathetic plaintiff at risk in FCM insolvency. This would have the benefit of limiting the size of the fund required to protect customers. However, this is short sighted and does not take into account how customers indirectly access modern commodity markets. As is explored in the next section, new securities products which hold positions in futures--ETFs and ETNs--have expanded the exposure of the retail investor beyond direct trading on exchanges. Moreover, institutional counterparties at FCMs will need the guarantee of liquidity to protect their operational exposure to FCM default. The CCC believes that any protection scheme designed for the futures industry should be available to all customers of an FCM. By not limiting the definition of customer, it is necessary to maintain a larger fund, but that fund in turn reduces the risk of an FCM default being the forerunner of financial contagion.

Regardless of its structure, a protection fund focused on liquidity is feasible and warranted by the current state of commodity regulation. Its existence would mitigate the impact of future FCM insolvencies and reduce systemic risks concentrated in BD/FCMs. Congress should consider legislating the authority to create and manage the FCMILF.

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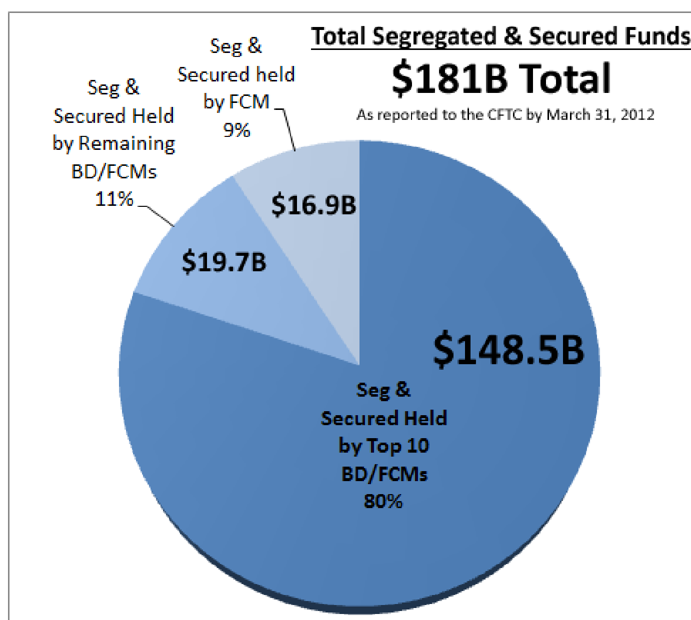
[9] Figures adjusted for inflation. Calculated using Treasury data for note and bill rates, Futures Industry Association volume data and NFA FCM insolvency data for the period from 1971 to 2011. Calculation can be furnished upon request.

## Addressing the Problems of BD/FCMs

Securities and commodities brokerages are two very different businesses. Transactions in securities are fundamentally initiated by extensions of credit. When a customer purchases shares of a publicly traded company, he actually receives a short term loan from his broker, as the broker purchases the shares and settles them in the customer's account over several days. Then those securities are held by the broker for the benefit of the customer. Futures transactions are facilitated by performance bonds, deposits of collateral which customers make to ensure they have the financial means to meet the obligations of the contracts they are trading. Futures transactions settle instantaneously in a customer's account. Positions in futures contracts are contractual obligations, not assets in the sense of securities.

Figure 5




FCMs and Broker-dealers have divergent risk appetites, with FCMs typically favoring a much more conservative risk profile. Historically, FCMs have shied away from taking proprietary risk, while broker-dealers have no such aversion. As a result of these and other disparities, commodities and securities brokerage firms require very different management and regulation. However, as the result of benefits from capital efficiencies and the concentration of enormous wealth in a few banks, today 91% of all customer property held at registered FCMs is held by firms dually registered as BD/FCMs.[10]

As these firms have grown in size and complexity, so has the regulatory regime seeking to protect markets and investors from their failure. The resulting complicated regulatory framework gives rise to loopholes which permit regulated entities to game the system for their benefit. Enacting more complicated regulation to patch these loopholes will only give rise to more loopholes which need patching. It is in the nature of regulators to be one step behind those being regulated. More complicated rules only obfuscate the real inner workings of these firms and make regulators even more ineffective.

The simplest solution to dealing with the problems arising from complicated BD/FCM entities, who work under two different and increasingly complicated regulatory structures, is to bar them from being comingled in the same legal entity. While regulatory bodies generally refrain from mandating business structure, dual registration poses serious threats to commodity customer property. As securities margin accounts are not fully segregated, a liquidity stress event poses a greater risk of shortfalls for broker-dealers than it does for fully segregated FCMs. Therefore, dually registered firms pose a greater risk of default for commodity customers. Forcing separate legal entities for these businesses will help prevent an illiquid broker-dealer from dipping into customer property to fund its operations. Moreover, it will ensure that there is no costly conflict favoring certain classes in bankruptcy due to divergent treatment in the Bankruptcy Code.

**The Use of Commodity Customer Property for Broker-Dealer Operations**

The investigation of the SIPA Trustee has revealed that MF Global gamed the regulatory scheme protecting customer property to support its over-leveraged, undercapitalized broker-dealer operation. MF Global's securities brokerage was laden with illiquid proprietary investments and was essentially functionally insolvent entering the second quarter of 2011. Though MF Global's interest in sovereign debt peaked at $7 billion in October 2011, in September of 2011 it was

[10] CFTC FCM Financial data for period ending March 31, 2012.

already 4.5 times the total equity of the firm.[11] The SIPA Trustee notes in his report that "as MF Global's liquidity needs intensified, senior management looked increasingly to the FCM as a source of liquidity for the non-FCM business".[12]

The source of the liquidity they transferred from the FCM to their broker-dealer came from commodity customer property. The SIPA Trustee's investigation has revealed that MF Global was in the practice of accounting for secured funds via the so-called 'Alternative Method'. This method permits a firm to understate the amount of money it is required to keep secured for its customers by only totaling their open trade equity, margin requirements, securities and net options value. As the SIPA Trustee notes in his report, if a customer opened an account with $100,000 in secured funds but held no positions, the Alternative Method would state that MF Global had to set aside $0 for this account.[13] Unencumbered cash is completely ignored. The way MF Global saw things, that was $100,000 which they could 'loan' themselves intraday to finance their broker-dealer operations.

Normally the amount MF Global borrowed from secured funds did not exceed the amount of capital the firm had invested itself in secured funds. The borrowed funds were also normally repaid by the close of business on the day they were borrowed. But as liquidity became stressed, MF Global began transferring amounts greater than the firm had invested in secured funds and for longer periods. The SIPA Trustee reports that one of the activities they were financing with these transfers was wire transfers to securities customers. Taking the money of one customer and paying it to another is a trait of a Ponzi scheme. Yet, as MF Global read the rules, this activity was compliant with relevant regulations.

Beyond transferring customer funds from the secured account for its own benefit, the SIPA Trustee's report indicates that many MF Global employees viewed the segregated customer account as a potential source of intraday proprietary liquidity. As the liquidity stress became magnified, they used a pedantic reading of the rules to reason that the segregated customer account was also up for grabs as long as they repaid the account by the end of the day.

**Another Liquidity Swipe**

Another example of BD/FCM misuse of customer property in the search of liquidity took place between JPMorgan and Lehman prior to Lehman's bankruptcy. In April 2012, the CFTC fined JPMorgan $20 million for unlawful handling of Lehman's customer segregated funds. The crux of the violation stems from the fact that JPMorgan, a custodial bank holding Lehman's segregated funds, extended Lehman credit on the intraday value of its customer property--for nearly 22 months prior to its bankruptcy. The credit was extended in order for Lehman to carry out its proprietary trading, mostly repo transactions.[14] Two days after Lehman filed for bankruptcy, JPMorgan declined to release Lehman's customer funds on the grounds that Lehman did not have positive net free equity at their bank anymore.

So JPMorgan aided Lehman in borrowing against its customers' funds, as though it was its own capital, and then attempted to withhold the customer property from Lehman--and ultimately from the customers themselves--after the bankruptcy. They released the funds two weeks after Lehman's bankruptcy filing, only after they were ordered to do so by the CFTC. JPMorgan allowed Lehman to use its customer property to back house trades. In concept, this is extraordinarily similar to the set of facts in the collapse of another FCM, Sentinel Management Group, Inc, which failed in 2007. Sentinel was a cash management firm which allegedly used customer property to back personal investments. A 20 count indictment was handed down in the case in June 2012, listing 18 counts of wire fraud, 1 count of securities fraud and 1 count of making false statements to a pension plan.

Both the JPMorgan and MF Global incidents illustrate that any regulatory regime enacted to shield customer funds held in BD/FCMs can and will be gamed. This gives rise to several problems native to the BD/FCM model:

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[11] Report of the Trustee's Investigation and Recommendations. SIPA Liquidation Proceeding of MF Global, 2012. p 8.

[12] Report of the Trustee's Investigation and Recommendations. SIPA Liquidation Proceeding of MF Global, 2012. p 11-12

[13] Footnote 23. Report of the Trustee's Investigation and Recommendations. SIPA Liquidation Proceeding of MF Global, 2012. P 38.

[14] CFTC Press Release 4/4/2012.

# Warning Signs

## MF Global Net Income & Excess Net Capital

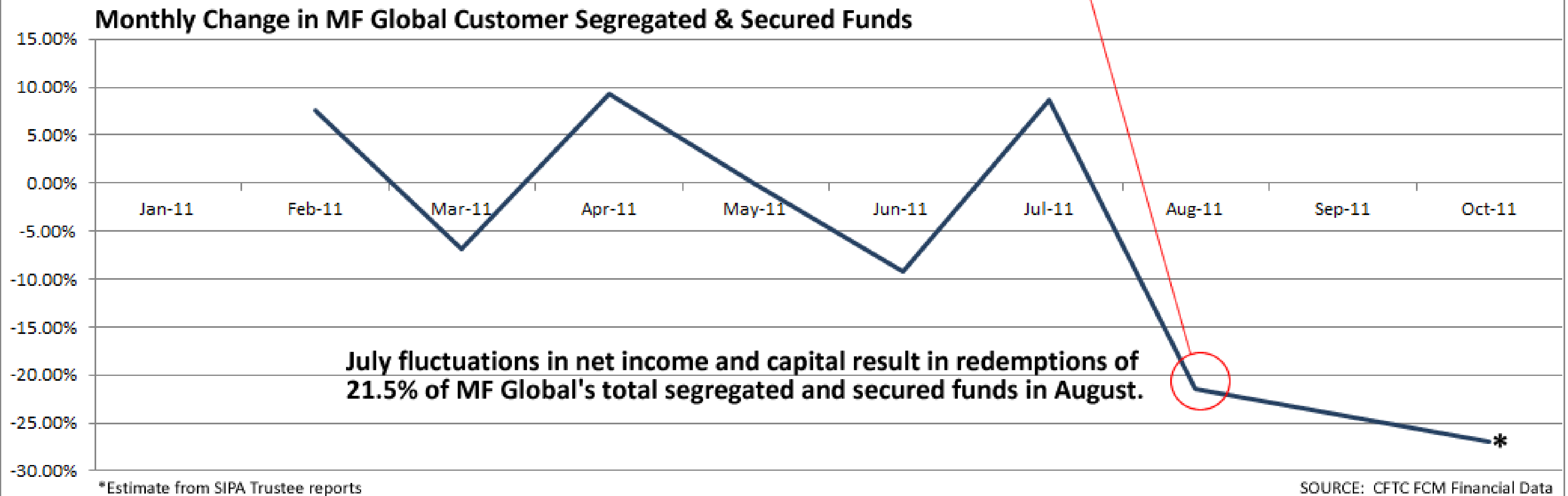
Adjusted Net Income
Excess Net Capital

Millions of Dollars
700
600
500
400
300
200
100
0
-100
-200
Jan-11
Feb-11
Mar-11
Apr-11
May-11
Jun-11
Jul-11
Aug-11
Sep-11
Oct-11

No Data Available

SOURCE: CFTC FCM Financial Data

# The 'Run on the Bank' Begins



- **BD/FCMs are actively using segregated customer property held at their FCM to facilitate their operations**:
  This is evidenced in both the Lehman and MF Global failures. Broker-dealers are inherently illiquid and have grown more illiquid with the explosion of leverage with respect to their capital structure in the last decade. Even though that leverage is receding, the illiquidity remains. As a result, investment banks are prone to exploit regulations and counterparty arrangements to access the liquidity of customer property at an FCM.

- **Conflicts of interest are inherent between BD/FCMs that are also investment banks:**
  The systemic connection between investment banks in the regulated banking, securities and commodities spaces raises serious conflicts of interest which are not easily rationalized. JPMorgan was a custodian of customer funds for both Lehman and MF Global. In both instances, JP Morgan withheld funds it knew or should have known belonged to customers. In the MF Global case, JPMorgan was MF's chief creditor, a custodian of segregation and a trading counterparty. JPMorgan has also been a buyer of MF Global's assets in bankruptcy, purchasing MF Global's stake in the London Metals Exchange, buying and selling MF Global's portfolio of sovereign debt and even buying customer claims in bankruptcy.

- **The regulators are ineffective at policing BD/FCMs use of customer funds as well as the above conflicts of interest**:
  JPMorgan was extending credit on the value of Lehman's customers' money for 22 months with impunity. Only after Lehman collapsed and JPMorgan tried to keep the property of Lehman's customers did regulators uncover violations. MF Global's ruse relied on a parsimonious interpretation of the rules, one which the regulators were unable to uncover because the firm imploded so quickly.

**The Institutional Client Misconception**

A misconception exists that a failure of a large institution-focused BD/FCM will not impact retail futures customers in the way that a failure of a typical commodity broker would. Therefore it is not relevant to focus on their structure as a means to soften the impact of BD/FCM insolvency on retail clients. This is based on the fact that large BD/FCMs are investment banks and their FCM operations typically do not solicit or service the commodity accounts of individuals or small market participants. After all, the SIPA Trustee chose to transfer MF Global's commodity accounts to smaller, private client-focused FCMs like RJ O'Brien ("RJO") and Rosenthal Collins Group ("RCG") instead of the above BD/FCMs. However, the explosion of securities products which use commodity futures exposes private clients to insolvency risk from these large BD/FCMs, in many cases without those clients fully understanding that they are exposed to this risk.

Exchange Traded Funds ("ETFs"), akin to a mutual fund traded on an exchange like shares of a listed investment company, can be baskets of exchange traded derivatives. That makes these commodity backed ETFs a form of commodity pool. Many Exchange Traded Notes ("ETNs") which offer exposure to commodities are senior unsecured debt securities which track commodity benchmarks that are composed of futures. This makes ETNs indirectly linked to commodity futures, as their benchmarks are baskets of derivatives. Both ETFs and ETNs can be purchased via broker-dealers through secondary markets like the NYSE. Buyers of these securities include retail investors and institutions ranging from the endowment funds of universities to sovereign wealth funds. 17 of the largest mutual funds and 15 of the largest hedge funds use ETFs.[15]

The top 5 ETFs which track futures have a market cap of over $8 billion and use UBS, Deutsche Bank and Barclays Capital to hold their collateral for commodities trading. If the BD/FCM holding the collateral of the ETF becomes insolvent, the ETF's assets are at risk, as would be the value of the shares of the ETF. This means customers who have never opened an account with an FCM or directly traded futures have exposure to FCM insolvency if those customers hold ETFs or

[15] Curtain & Williams. ETFs: An Australian Perspective on a Global Phenomenon. *Russell Research*. May 2010. p 7.

ETNs backed with commodity futures or over the counter ("OTC") derivatives. If any of these ETFs are trading futures on foreign exchanges, the FCM holding assets for the ETF would be able to borrow the ETFs unencumbered cash to fund its operations in the same way MF Global did.

**The Benefits of Separate Entities**

There are several benefits to barring broker-dealers and FCMs from being housed in the same legal entity. Firstly, it would simplify and preserve the priority of classes in bankruptcy for each separate entity. The bankruptcy of each entity would be treated as intended by the Bankruptcy Code. SIPC member entities would go through a SIPA Liquidation, while commodity brokers would go through a Chapter 7 proceeding tailored for FCMs. At present, the SIPC statute forces automatic stay of all other proceedings. This virtually ensures legal wrangling will be a large component of any BD/FCM bankruptcy, as commodity customers do not have the insurance protection of their securities counterparts. The lack of insurance makes commodities customers more sensitive to administrative costs, especially if there is a shortfall in customer property.

Second, barring dual registered entities would stop the wholesale raiding of customer property by a liquidity-stressed BD/FCM. Separating securities and commodities brokerage entities makes it more difficult for a firm to dip into its customer accounts to raise liquidity for its proprietary operations.

There are some historical examples of firms which have housed broker-dealer and FCM operations in separate entities under the same holding company structure. Failed broker Refco housed its FCM (Refco, LLC) in a separate legal entity from its broker-dealer (Refco Securities, LLC). Of course there was no shortfall in customer property at Refco, so when its parent firm filed for Chapter 11 protection, none of its regulated subsidiaries entered bankruptcy.

**Extending SIPC Insurance to Unencumbered Balances**

If barring the combination of FCM and broker-dealer operations into a single entity does not come to pass, Congress should consider extending SIPC coverage to include the unencumbered collateral of commodity accounts held by BD/FCMs. We were unable to obtain any reliable data regarding how much excess margin funds are on deposit with an FCM on average. But if we look at MF Global as an example, somewhere between 50% to 55% of the customer property it held in approximately 38,000 customer accounts was unencumbered--not margining an open position--at the time of its collapse. In the MF Global scenario, SIPC would likely be on the hook for a large portion of the shortfall amount. Therefore BD/FCMs should have their SIPC membership fees, currently 0.25% of net operating revenues, double to 0.50%.[16]

**Expanding the Segregation Protection**

The distinction between segregated and secured funds should be eliminated. MF Global exploited the rules governing the treatment of secured funds in order to finance its broker-dealer operations with customer property. Attempting to enact a complicated regulatory framework to strengthen the secured funds protection would be pointless, when an easy fix is workable: extend the segregation protection to all property tendered by a customer to an FCM.

**Subordinating Holding Company and Affiliate Claims to Customers**

MF Global's holding company and affiliates have filed 54 claims against commodity and securities customer property totaling nearly $1 billion. 18 of those claims are against the segregated and secured pools of commodity customer property, totaling almost $75 million. Whether or not these claims have merit, the SIPA Trustee must reserve capital in the pool of customer property. This diminishes the speed at which he is able to distribute property to customers of MF Global.

Even if these claims have merit, they should be subordinated to customer claims as long as a shortfall persists for customers of MF Global. Quite simply, MF Global's holding company and affiliates should not be able to retrieve their

[16] 2011 SIPC Annual Report.

capital through the same segregation system they subverted to misuse customer property. Affiliated entities of an FCM should be legally required to subordinate their claims to customer claims.

**Addition of Specific Civil and Criminal Penalties for Using Customer Property to Fund Proprietary Operations**

MF Global implemented a strategy specifically designed to subvert the intention of legal protections of customer property in order to fund their proprietary operations. Though we contend that crimes were committed in the final days of MF Global, a notion has been bandied about in the media that no crime was committed because the principals involved did not intend to steal client funds. This is preposterous, but it is revealing as to the mindset of those in charge at MF Global. Those involved in implementing MF Global's liquidity plan thought that they had sufficient legal cover in breaking the segregation protections.

Had specific and severe civil and criminal penalties been articulated in the law for the intentional misuse of segregated funds, it is doubtful that executives would have risked prison or costly civil penalties in their efforts to raise liquidity. Congress should consider legislating appropriate consequences to deter FCM management from considering segregated funds as a source of proprietary liquidity.

## Bankruptcy Reforms

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Reforming the Bankruptcy Code will be one of the most difficult policy challenges resulting from the MF Global bankruptcy. It will require working with a number of Congressional committees and raise the ire of many special interest groups with divergent interests. However, in order to mitigate the impact of future FCM insolvencies (especially those of BD/FCMs), reforms to the Bankruptcy Code are necessary.

The NFA has empanelled a committee to recommend specific language to update the Bankruptcy Code. As such, rather than recommending specific language, we would like to provide a broad overview of the changes we think would be of the most benefit to customers of failed FCMs.

**Establish a Statutory Provision for a Customers' Committee of Insolvent FCMs**
JPMorgan and Bank of America are two of the largest financial institutions in the US. While customers of MF Global have to scrape together donated funds and organize intermediaries like the CCC to represent them to the Court, two of the largest banks in the US pay for their legal expenses relating to MF Global from the assets of their holding company's estate. As members of the Creditors' Committee, they can maximize the return to unsecured creditors at little or no expense to them. Customers of FCMs with parent companies in Chapter 11 proceedings should have a statutory right to form a Customers' Committee of the bankrupt parent, with similar rights as the Creditors' Committee. This will ensure that customers are afforded adequate legal representation without additional costs.

**Prevent the Application of the 'Safe Harbor' Provision in FCM Insolvencies**
The "safe harbor" provisions of the Bankruptcy Code are intended to prevent the bankruptcy of non-debtor counterparties to securities and derivatives transactions involving insolvent firms. Unless there is an actual fraud in these transactions, counterparties are permitted to shield the collateral transferred from debtors from claw backs. In the case of MF Global, unless an actual fraud is proven--which requires the element of intent--counterparties who received customer funds will be permitted to keep them by invoking safe harbor provisions of the Bankruptcy Code. To be blunt, the law should not allow the recipients of stolen property the means to keep it.

Congress should examine ways to prevent the application of safe harbor provisions when transactions may involve segregated property of commodity customers.

**Introducing Market Reforms or Fee Limits for Administration of Bankruptcy Cases**
Large corporate bankruptcy liquidation is big business in the US. There is no doubt that unwinding a firm with a complicated legal structure and intricate business lines like MF Global requires experienced, dedicated professionals in order for it to be done cost effectively. More expensive law firms may indeed be more experienced and better equipped to deal with this type of bankruptcy. The CCC is of the opinion that, in total, the SIPA Trustee has done a good job in managing the MF Global liquidation. However, the SIPA Trustee is not the only Trustee assigned to MF Global. Together, the US and SIPA Trustees have introduced fee applications to the court totaling around $45 million for the first four months of the MF Global liquidation proceedings. Attorneys for the Creditors' Committee will introduce fee applications costing millions more. Fees for accounting and other professionals will cost millions more. As this case is expected to drag on for years, excessive administration costs--which will reach into the hundreds of millions--may reduce recoveries for customers.

The cost of adjudicating a large corporate bankruptcy is completely out of line with the market rates for attorneys in other practice areas. There is an enormous glut of unemployed attorneys on the market. The National Association of Legal Professionals recently released a report which states that the employment rate for law school graduates is at an 18 year low.[17] Yet this surplus in labor has produced no such savings in fees charged to debtors' estates. In fact, there are shocking bill rates being foisted upon firms in bankruptcy. Former Solicitor General Theodore Olson is billing $1,800 in

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[17] NALP Press Release: Law School Grads Face Worst Job Market Yet - Less Than Half Find Jobs in Private Practice. 6/6/12.

his work with LightSquared, Inc., a technology firm seeking Chapter 11 protections.[18] This is the highest bill rate to ever be publicly disclosed.[19] Though Mr. Olson has legal experience matched by few in his profession, is it reasonable for him to bill what 20 or more contract attorneys would cost per hour? Would this rate be charged anywhere else but in a bankruptcy case?

By comparison, hourly bill rates for counsel for the SIPA Trustee appear to be a bargain. But attorneys representing both MF Global's SIPA Trustee and US Trustee, as well as attorneys representing the Creditors' Committee, are charging rates which are above what they would be able to bill to clients not in bankruptcy. Below are the rates for counsel and staff for the SIPA Trustee, provided by the law firm Hughes, Hubbard and Reed ("HHR"), as listed in the Trustee's fee application.

Table 4

SIPA Trustee Bill October 31, 2011 to February 29, 2012

| Service | Average Hourly Rate | Hours | Total $ |
|---|---|---|---|
| Paralegals | $214.00 | 5,089.00 | $1,089,017.10 |
| Staff Attorneys | $303.29 | 6,249.10 | $1,871,599.95 |
| Litigation Support | $245.92 | 642.70 | $158,052.60 |
| Partners | $766.12 | 7,163.90 | $5,488,413.75 |
| Counsel | $652.19 | 1,714.10 | $1,117,919.70 |
| Associates | $460.80 | 22,580.90 | $10,405,214.10 |

| Composite Bill Rate (Including Support Staff) | Total Hours | Total Billed |
|---|---|---|
| $463.41 | 43,439.70 | $20,130,217.20 |

| Composite Bill Rate (Partners & Associates Only) | Total Hours | Total Billed |
|---|---|---|
| $534.33 | 29,744.80 | $15,893,627.85 |

*Source: FIRST APPLICATION HHR LLP FOR ALLOWANCE OF INTERIM COMPENSATION FOR SERVICES RENDERED AND REIMBURSEMENT OF ACTUAL AND NECESSARY EXPENSES INCURRED FROM OCTOBER 31, 2011 THROUGH FEBRUARY 29, 2012.*

Below is data for median bill rates for firms specializing in finance, investments and banking in New York City in 2011.

Table 5

Median Litigation Billing Rates in NYC

| Firm Size | Attorney | Rate | Savings | $ Savings | Total Savings |
|---|---|---|---|---|---|
| 1-50 | Associate | 240 | 47.92% | $4,985,798.10 | |
| | Partner | 375 | 51.05% | $2,801,951.25 | $7,787,749.35 |
| 51-200 | Associate | 236 | 48.78% | $5,076,121.70 | |
| | Partner | 412 | 46.22% | $2,536,886.95 | $7,613,008.65 |
| 201-500 | Associate | 420 | 8.85% | $921,236.10 | |
| | Partner | 638 | 16.72% | $917,845.55 | $1,839,081.65 |
| 501+ | Associate | 460 | 0.17% | $18,000.10 | |
| | Partner | 780 | -1.81% | -$99,428.25 | -$81,428.15 |

*Source: RateAnalyzer by TyMetrix Legal Analytics.*

[18] Smith, Jennifer. "Bankruptcy Fees: The $1,800-an-Hour Ted Olson Edition." *Wall Street Journal*. 6/6/12

[19] Smith, Jennifer. "Bankruptcy Fees: The $1,800-an-Hour Ted Olson Edition." *Wall Street Journal*. 6/6/12

The SIPA Trustee notes on the first page of his fee application to the court a composite hourly bill rate of $463.41, but that is watered down by litigation support staff, paralegals and staff attorneys. The composite hourly bill rate for partners and associates is a less attractive $534.33 and accounts for more than 78% of the total fee application. The good news is that counsel for the SIPA Trustee's average bill rates for partners and associates are in line with those of large law firms, who have more than 500 attorneys. The bad news is counsel for the Trustee does not fall into the large law firm category. Sources report HHR has between 290 and 375 attorneys in its employ, which places it squarely in the category of firms with 201 to 500 attorneys. This means the Trustee is billing almost 17% more for partners and 9% more for associates than the median for firms of its size in its practice area. For just the first 4 months of MF Global's SIPA liquidation, that premium cost the estate (and potentially the customers) of MF Global over $1.8 million.

When one goes on to examine bill rates for litigation support staff, paralegals and staff attorneys, the disparity between the bankruptcy rate and market rate is far greater. Legal staffing services report that the top end of 2011 hourly bill rates for experienced paralegals in New York City is between $35 and $50 per hour.[20] Adding in a generous $50 per hour for overhead would push the hourly bill rate in New York City for a top paralegal to $100. This means that HHR is billing MF Global's estate $114 more per hour than open market price for these services. This begs a question as to how much of a markup, and therefore how much of a premium, law firms are charging debtors. Contract attorneys in the New York City area are fetching between $45 and $75 per hour.[21] Assuming the same $50 per hour overhead, the markup rate is even greater than it is for paralegals--over 60%. While the CCC understands that it costs more to litigate in the most expensive jurisdiction in the US, should it cost this much more?

Furthermore, is it necessary to use large law firms to manage MF Global type bankruptcies? The first four months of litigating MF Global's case for the SIPA Trustee required the work of over 126 attorneys, 24 of whom were partners and 74 of whom were associates of HHR. Though when you examine the spread of hours, this required only about 18 billable hours per partner per week and about 15 billable hours per associate assigned to the case. This would be a manageable workload for a firm with 200 lawyers. The firm could make it even more manageable by outsourcing simple elements of the case, like document review, to contract attorneys. This is a common practice in the modern labor-saturated legal market. If we step down into the next smaller category of law firms who have between 50 and 200 attorneys, the savings to the debtor's estate (and customers) rises dramatically--to nearly half of what HHR is requesting in its fee application.

The nature of bankruptcy is resistant to innovations which have brought legal costs down for the market. Firms who are not in bankruptcy use in-house counsel and contract attorneys to defray the costs of working with more expensive outside counsel. Businesses have been able to use this vertical integration of their legal needs to negotiate better rates with outside counsel when it is necessary to outsource legal work. In fact, many corporate law firms are using more and more contract attorneys to make working on large cases more cost effective.

In bankruptcy, no such market driven decisions are made. The debtor is in no position to negotiate legal fees which creates a paradigm of 'it costs what it costs'. Judges rarely rebuke bankruptcy attorneys for excessive fees, many of them having come from large law firms themselves. Since all other customers' and creditors' claims are subordinated to the administrative fees of a bankruptcy case, a budget appears to be of no concern to law firms working in bankruptcy.

We are not the only group to raise concerns over hourly bill rates for attorneys in large corporate bankruptcies. The Justice Department has long been advocating to reform how attorneys get paid in bankruptcy cases. They want firms to draw up budgets, disclose the rates they charge for other matters and explain any variations. While the Justice Department's efforts are laudable, Congressional action will be required to bring attorneys fees for bankruptcy cases in line with non-bankruptcy work.

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[20] Robert Half International, Inc. data.

[21] Robert Half International, Inc. data.

**A Reform Outside of the Bankruptcy Code: Revise the Process by Which SIPC Picks Trustees**

The CCC would like to be clear that we are of the opinion that the SIPA Trustee has done a good job in recovering assets for customers of MF Global. We take issue with his fees and wonder if the process by which SIPC selects Trustees is providing the most cost effective and expedient legal services for customers of member firms. One method to help reduce the cost of FCM bankruptcies at BD/FCMs without amending the Bankruptcy Code would be to introduce market reforms into how SIPC selects Trustees.

One possibility would be to open the process up to permit firms to bid for appointments. This would allow for more competitive rates, determined by a bidding process. In March 2012, the Government Accountability Office ("GAO") completed a review of the Madoff liquidation, presently being conducted under the direction of SIPC. They reached a similar conclusion that while the Trustee had done an admirable job, the process would benefit from a more transparent and competitive Trustee selection process. Its recommendations were as follows:

1. *Advise SIPC to document its procedures for identifying candidates for trustee or trustee's counsel, and in so doing, to assess whether additional outreach efforts should be adopted and incorporated.*
2. *Advise SIPC to document its procedures and criteria for appointment of a trustee and trustee's counsel for its cases.*

A market driven SIPA liquidation means higher recoveries for customers of failed BD/FCMs. SIPA would benefit from a diversity of potential Trustees. Congress can make these changes without wading into the Bankruptcy Code.