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# Maintenance Of Market Strategies In Futures Broker Insolvencies: Futures Position Transfers From Troubled Firms

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# MAINTENANCE OF MARKET STRATEGIES IN FUTURES BROKER INSOLVENCIES: FUTURES POSITION TRANSFERS FROM TROUBLED FIRMS

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## Introduction

Increasingly, banks, pension funds, and other large institutional investors acting as money managers for the savings of small public customers are entering the nation's futures markets. As a result, commodity brokers, or futures commission merchants (FCMs),[1] are becoming substantial financial intermediaries. On the average, an FCM today holds more than $36 million in customer funds, over four times the 1980 figure.[2] Although FCM failures and resulting bankruptcies remain unusual events and the federal regulatory and industry self-regulatory protections against such events have increased substantially in the past decade, even the potential for customer loss and market disruption stemming from an FCM failure underscores the need for effective responses to a broker insolvency. In their absence, the resulting losses are likely to be viewed as the disastrous privations of uninformed pensioners little able to bear them rather than a foreseeable consequence of poor credit

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1. The Commodity Exchange Act, 7 U.S.C. § 1 (1982) *et seq.*, the federal regulatory framework for commodity futures trading in the United States, defines "futures commission merchant" to include "individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom." 7 U.S.C. § 2 (1982).

2. *See* Division of Trading and Markets, Commodity Futures Trading Commission, *Follow-up Report on Financial Oversight of Stock Index Futures Markets During October 1987* at Appendix I (Jan. 6, 1988); *Commodity Account Protection,* A Study by the Division of Trading and Markets, Commodity Futures Trading Commission at 32-33 (July, 1985) (1985 figures); National Futures Association, *Customer Account Protection Study* at 37 (Nov. 20, 1986). As the Division of Trading and Markets *Commodity Account Protection* study points out, institutional traders such as banks, pension plans, registered investment companies, commodity pools, mutual funds and insurance companies represent vehicles for participation in the futures markets by large numbers of individual public customers. *Commodity Account Protection* at 15.

decisions by sophisticated, informed institutions participating in complex markets.[3]

Commodity brokers are currently subject to direct federal regulation under the Commodity Exchange Act (CEA or Act)[4] and regulations promulgated thereunder,[5] as well as supervision by industry self-regulatory organizations (SROs) that are subject to federal oversight. In 1974, Congress established the Commodity Futures Trading Commission (CFTC or Commission) as the successor to the Commodity Exchange Authority under the Department of Agriculture and vested it with exclusive jurisdiction over commodity futures and options trading in the United States.[6] The CFTC administers and enforces the provisions of the CEA and related regulations, which include requirements for registration of FCMs[7] and other commodity professionals,[8] compliance by FCMs and other CFTC registrants who handle customer funds with minimum financial requirements established by the CFTC,[9] segregation of and separate accounting for customer funds by FCMs,[10] maintenance of adequate books and records,[11] specified risk disclosures to customers,[12] and supervision of customer accounts and personnel handling such accounts.[13] In addition to the CFTC's authority to administer and enforce these and other regulatory requirements directly, the CEA contemplates the exercise of substantial self-regulatory responsibilities by each designated contract market (exchange) and registered futures association.[14] Each SRO is required to maintain an affirmative action program to assure the integrity of the markets it supervises, the financial viability of its members, and the safety of customer funds.[15]

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3. On October 19, 1987, the Dow Jones Industrial Average fell 508 points, or 23 percent, the largest single drop in history, following a drop of 236 points, or 9.5 percent, the prior week. This market event further emphasizes the points made in this article, including the importance of the isolation of risk at a defaulting firm, clearing firms' continued support of open positions notwithstanding individual customer defaults, and the daily mark-to-market and settlement process which limits counterparty risk in the futures markets.

4. The Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* (1982).

5. 17 C.F.R. § 1 *et seq.* (1987).

6. Commodity Futures Trading Act of 1974, Pub. L. No. 463, 88 Stat. 1389 (1974).

7. Section 4d(1) of the CEA, 7 U.S.C. § 6d(1) (1982).

8. Sections 4k, 4l, and 4m of the CEA, 7 U.S.C. §§ 6k, 6l and 6m (1982).

9. Section 4f(2) of the CEA, 7 U.S.C. § 6f(2) (1982). CFTC Rule 1.17, 17 C.F.R. § 1.17 (1987), specifies the minimum capital required to be maintained by FCMs and provides a method for calculating an FCM's available capital. Each "contract market," that is, CFTC-designated exchange, must maintain and enforce financial rules that are no less stringent than the minimum capital requirements established by the CFTC's regulations. 17 C.F.R. § 1.52 (1987).

10. Section 4d(2) of the CEA, 7 U.S.C. § 6d(2) (1982).

11. 17 C.F.R. §§ 1.31-1.35 (1987).

12. 17 C.F.R. § 1.55 (1987).

13. 17 C.F.R. § 166.3 (1987).

14. "Contract markets" are exchanges authorized or "designated" by the CFTC for the trading of specific futures contracts. 7 U.S.C. §§ 2, 7 (1982). The National Futures Association (NFA) is currently the only registered futures association.

15. Under the CEA and Commission regulations, SROs must maintain, *inter alia,* "affirmative action" programs to assure compliance with applicable CEA provisions, Commission regulations and contract market bylaws, rules and regulations. 7 U.S.C. §§ 7a(8),

In the event that despite such regulatory and self-regulatory programs an FCM failure nonetheless occurs, another commodity-related statutory framework, Subchapter IV of Chapter 7 of the Bankruptcy Code,[16] enacted in 1978 to address problems unique to commodity broker[17] failures, may be applicable. Although these bankruptcy provisions are designed to minimize customer losses and market dislocations caused by broker insolvencies, they have been in place for only ten years and, given the futures industry's record of relatively infrequent insolvencies, have seldom been called into operation. In the absence of substantial historical experience testing the efficacy of regulatory and self-regulatory responses to commodity broker insolvencies, the consequences of commodity broker failures remain uncertain. Recent developments, however, including the March 1985 failure of Volume Investors Corporation (Volume), a registered FCM and a clearing member of the Commodity Exchange, Inc. (COMEX), increasing participation in the futures markets by professionally managed funds, such as pension and mutual funds, and public concern over market volatility and the effects of "informationless" technical trading programs, have sharpened public interest in the potential customer and market impacts of commodity broker insolvencies. Such concerns, in the context of increasingly interdependent markets, suggest the importance of dispelling uncertainty concerning the consequences of broken failures and the efficacy of the regulatory and self-regulatory responses to such events, uncertainty which may adversely affect the otherwise proven regulatory system for futures and futures options.

This article examines one broker's failure, that of Volume Investors Corporation, as an illustration of certain customer and market protection problems which can be engendered by a commodity broker's failure, assesses current regulatory protections against such problems, and suggests potential improvements to the system. This analysis suggests that although a foolproof regulatory shield against the effects of a commodity broker's failure may be impossible to construct, a systematic approach toward achieving the two principal goals of any meaningful regulatory response, customer protection and market integrity, may be both possible and practicable. As protection of the customers of the failed firm and protection of the overall market against

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7a(9), 21(p), 21(q). The minimum elements of such programs are addressed in Commission Regulation 1.51, 17 C.F.R. § 1.51 (1987). *See also* Division of Trading and Markets, "Guideline No. 2," 1 Comm. Fut. L. Rep. (CCH) ¶ 6430 (May 13, 1975) (staff explanation of Regulation 1.51 requirements). SROs must also adopt and enforce rules prescribing minimum financial and related reporting requirements for their members who are registered FCMs no less stringent than those applicable under CFTC regulations and must adequately enforce such rules, as set forth in Regulation 1.52, 17 C.F.R. § 1.52. Specific requirements for SRO financial oversight programs are summarized in the Division of Trading and Markets' Financial and Segregation Interpretation 4-1, 1 Comm. Fut. L. Rep. (CCH) ¶ 7114A (July 29, 1985).

16. 11 U.S.C. §§ 761-766, enacted as part of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

17. The Bankruptcy Code defines "commodity broker" to include an FCM, foreign FCM, clearing organization, leverage transaction merchant and commodity option dealer with respect to which there is a customer, as defined in Section 761(9). 11 U.S.C. § 101(5) (1982).

the "domino" or "ripple" effects of a firm failure may not necessarily be inconsistent goals, approaches that maximize customer protection without diminishing market stability should be explored.

Part I of this article reviews the factual circumstances of Volume's default and subsequent receivership, the impact of those events upon the individual customers of the firm and the marketplace as a whole, and significant regulatory issues raised by those events. In Part II, this article addresses provisions of the Bankruptcy Code and CFTC regulations that respond to the unique problems presented by commodity broker bankruptcies. This section focuses upon the two principal purposes of the relevant Bankruptcy Code provisions, protection of the customers of an insolvent FCM and maintenance of the integrity of the overall market in the face of an FCM failure, and the statutory and regulatory measures intended to advance those purposes. This section also analyzes the likely efficacy of the Code's treatment of the transfer of open futures positions of an insolvent FCM to solvent FCMs as a vehicle for both customer and market protection, by preserving the essential hedging and risk reduction functions of the commodity futures markets and reducing market disruptions resulting from an FCM failure. Part III considers the Volume episode in light of these Bankruptcy Code policies, concluding that while the Code's paramount purposes were substantially achieved, the goal of transferring positions was not, a result that reflects that in the current self-regulatory context the recovery of account equity over time is far more readily achievable than maintaining the continuity of open contractual positions. Part IV discusses the potential practical benefits of position transfers for commodity customers and other market participants and the difficulties in achieving them and suggests measures that could be taken to increase the likelihood that transfers of positions from insolvent to solvent FCMs will occur in the future. These suggestions reflect the view that if the costs and benefits of a program to effect position transfers on a systematic basis were carefully assessed, the futures industry could well conclude that a modestly funded program would not only assist a failed firm's customers but also would yield significant economic benefits for the exchange marketplace as a whole, by reducing clearing risk and preserving market strategies of importance to futures market participants, however sophisticated.

## I. The Default and Receivership of Volume Investors Corporation

### A. The Events of Default and Liquidation

On March 20, 1985, Volume Investors Corporation, a clearing member of the COMEX and of several other clearing organizations, defaulted on a margin call from the COMEX Clearing Association (COMEX Clearing) reported at in excess of fourteen million dollars.[18] At the time of its default,

18. *See* G. Szala, "How COMEX Firm's Failure Is Shaking Up The Industry." FUTURES, June 1985 at 68.

Volume had more than one hundred customer accounts.[19] The firm's default apparently arose from the coincidence of the accumulation by three related Volume customers, who were also floor traders on the COMEX, of extraordinarily large and, indeed, allegedly illegal, uncovered short call gold option positions and an unprecedented movement in the price of gold.[20] According to an administrative enforcement complaint filed by the CFTC following Volume's default, the three floor trader-customers, James Paruch, Gerald Westheimer and Valerie Westheimer, traded their Volume accounts under common control and/or pursuant to an express or implied agreement or understanding.[21] As a result, their positions were allegedly required to be aggregated for purposes of compliance with exchange position limits[22] and the CEA.[23] At that time, COMEX had adopted a speculative position limit of 4,000 options for short call gold option positions.[24] By March 18, 1985, the Westheimers and Paruch reportedly held among them a total of approximately 12,000 uncovered short call options on gold futures contracts, three times the permissible concentration of positions if those accounts were in fact under common control.[25]

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19. First Report of Receiver ¶ 21 (April 10, 1985), CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

20. On March 18 and 19, 1985, international gold markets experienced a sharp price surge. COMEX spot gold, which had closed at $295 per ounce on Friday, March 15, rose to $303 per ounce on Monday, March 18, and to $339 per ounce on Tuesday, March 19. These price increases, which have been attributed to crisis conditions in the Ohio savings and loan industry caused by the failure of ESM Government Securities, Inc., contrasted sharply with gold price movements in the preceding several months as well as with general price trends in prior years. Spot gold futures had generally traded in relatively small price increments within a range of $290 and $310 per ounce from January 1983 though mid-March, 1985, with a dip to $281 in February. Since early 1983, the price of gold had generally trended downward. *See generally Volume Investors Corporation,* Report of the Division of Trading and Markets, Commodity Futures Trading Commission (July 1985) at 10-11; Kerwin, *Let My Money Go: Customers are Trapped by a COMEX Broker's Failure,* BARRON'S (April 1, 1985) at 13.

21. Complaint ¶ 14, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985).

22. COMEX Rules 4.46(a)(2) and 4.47(a)(ii) and (b).

23. 7 U.S.C. § 6a(5) (1982); Complaint ¶¶ 14-17, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985).

24. Complaint ¶ 13, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985); COMEX Rule 4.47(a)(ii) and resolution fixing gold option position limits adopted pursuant thereto.

25. *See* Wohl v. Westheimer, 610 F. Supp. 52, 53 (S.D.N.Y. 1985); *Volume Investors Corporation, supra* note 20, at 6-7. If the Westheimer and Paruch positions were, as the CFTC's complaint contends, under common control or traded pursuant to an express or implied agreement or understanding, aggregation of the three traders' positions was required. *See supra* notes 22 and 23. The CFTC's complaint charged the Westheimers and Paruch with holding positions in violation of Section 4a(5) of the CEA, 7 U.S.C. § 6a(5), which renders it unlawful for any person to violate any bylaw, rule, regulation or resolution of a contract market fixing position limits. The CFTC's complaint also charged Volume and its principals with violation of CFTC Regulation 166.3, 17 C.F.R. § 166.3 (1987), which requires diligent supervision by each Commission registrant of the handling of commodity accounts and all other activities relating to its business as a Commission registrant, in failing to bring the Westheimer and Paruch accounts into compliance with applicable COMEX position limits.

On March 18 and 19, 1985, spot month gold prices rose by more than $44 per ounce on the COMEX, including a $36 price rise on March 19 alone, the largest one-day percentage price rise ever recorded in gold.[26] This price rise dramatically increased the previously *de minimis* margin required to sustain the option positions written by the Westheimers and Paruch,[27] reflecting the operation of the daily mark-to-market system in the futures industry by which profits and losses are calculated and payable on a daily basis and the movement of those formerly out-of-the-money positions into the money.[28]

On March 19, 1985, Volume made margin demands upon the three customers totalling approximately twenty-six million dollars.[29] Because the Westheimers and Paruch were unable to meet these margin demands,[30] Volume was in turn unable to satisfy an original margin call reported at approximately fourteen million dollars,[31] an amount which exceeded the firm's own assets,

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Complaint at ¶¶ 23-26, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985). *See* CFTC v. Commodity Fluctuations Systems, Inc., 583 F. Supp. 1382 (S.D.N.Y. 1985), *aff'd without opinion* (2d Cir. Feb. 28, 1986). In addition, the CFTC's complaint alleged that COMEX breached its duty under Section 5a(8) of the CEA, 7 U.S.C. § 7a(8), to enforce its rules and regulations, by, among other things, failing to enforce its position limits in respect of the Westheimer and Paruch accounts. Complaint ¶¶ 49-62, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985); *see infra* note 54. The CFTC's administrative claims against COMEX, Volume, Volume's principals, and related charges against COMEX Clearing have been settled. The case remains pending against the Westheimers and Paruch.

26. *Volume Investors Corporation, supra* note 20, at 10-11; *Wohl,* 610 F. Supp. at 53; H.J. Maidenberg, *Concern Over Safety of Funds,* N.Y. Times, July 12, 1985, at D2. The one-day March 19 price move of 11.9 percent and two-day price move of 14.9 percent on March 18 and 19 are relatively modest when compared to the 23 percent price move on the Dow Industrial Average on October 19, 1987.

27. *See Volume Investors Corporation, supra* note 20, at 8.

28. Losses on open positions are collected in the form of variation margin payments payable on a daily basis. These payments are made to the clearing organization, which in turn pays them on a daily basis to the clearing firms on the opposite side of the market whose positions correspondingly have profited. Clearing organizations also generally have authority to issue intra-day margin demands as warranted by market conditions. *See, e.g.,* Board of Trade Clearing Corporation Bylaw 603. By contrast, original margin deposits are required to be deposited by clearing firms with the clearing organization when a position is established, typically by the morning of the business day following the transaction. Although original margin requirements are generally applied uniformly, clearing organizations may call for "super margins" that reflect unusual market risks of particular firms. *See Bankruptcy Act Revision: Hearings on H. R. 31 and 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary,* 94th Cong., 2d Sess. 2377, 2379-82 (1977) (testimony of William T. Bagley, former Commodity Futures Trading Commission Chairman) [hereinafter "Bagley Testimony"]; T. Russo, Regulation of the Commodities Futures and Options Markets at §§ 2.03-2.04 (1983). By COMEX Clearing rule, option margin mark-to-market payments must be held at the clearing organization and are not, as a practical matter, passed to the other side of the market as are similar futures payments, and thus are not characterized as variation margin by the exchange. *See* COMEX Clearing Rule 45.

29. Verified Complaint at ¶¶ 17-18, *Wohl,* 610 F. Supp. at 56; *Westheimer v. Commodity Exchange, Inc.,* [1986-87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,571 at 33,491 (S.D.N.Y. 1987).

30. *Id.*

31. Szala, *supra* note 18 at 68.

issued by COMEX Clearing and payable the morning of March 20, 1985.[32] Volume consequently defaulted to COMEX Clearing.[33] The clearing margin demand which Volume failed to meet was primarily based on losses on Volume's large net short position in gold options, which in turn principally reflected the Westheimer and Paruch positions.[34] On the following day, March 21, 1985, COMEX Clearing issued two new margin calls to Volume, one for original margin with respect to options positions and one for variation margin on its futures positions.[35] Volume was unable to meet either call.[36]

As the omnibus exchange counterparty, the clearing organization guarantees that the parties on the profitable side of a transaction will receive their profit and that the parties on the losing side will pay their losses.[37] Thus, in the event of a clearing firm default, the clearing organization must answer for the firm's margin obligations to the clearing firms on the opposite side of the market. Consequently, following Volume's failure to satisfy COMEX Clearing's margin calls, COMEX Clearing itself, as the "buyer to every seller" and the "seller to every buyer," became immediately obligated to satisfy Volume's obligations to the counterparties to Volume's transactions. To pay the other side of the market for the losses on Volume's customer positions on the COMEX, COMEX Clearing drew upon: (1) the full amount of the original clearing margin deposits of Volume in respect of open customer positions ($9,800,000); (2) Volume's proprietary account at COMEX Clearing ($661,395); and (3) Volume's contribution to the COMEX Clearing guarantee fund ($29,787.35).[38] Volume's original margin account at COMEX Clearing represented deposits by all Volume customers, including not only the three

32. *Wohl,* 610 F. Supp. at 53.

33. *Id.; Volume Investors Corporation, supra* note 20, at 19.

34. *Wohl,* 610 F. Supp. at 53; *Volume Investors Corporation, supra* note 20, at 19.

35. *Volume Investors Corporation, supra* note 20, at 25.

36. *Id.* at 25-26.

37. All futures contracts made on a commodity futures exchange are submitted for clearance to a clearing organization that matches the purchase and sale sides of each futures transaction prior to accepting the trade for clearance. When the clearing organization accepts a trade for clearance, it becomes substituted as the principal party to each side of the contract, becoming "the seller to every buyer and the buyer to every seller." As the counterparty to every futures transaction, the clearing organization guarantees the performance of each trade accepted for clearance. *See* 1 P. Johnson, Commodities Regulation § 2.50 (1982). In practice, in most instances this guarantee applies to the net position of a clearing member; the clearing member itself guarantees payments between its customers with offsetting positions. T. Russo, Regulation of the Commodities Futures and Options Markets, § 2.06 (1983). The clearing organization guarantee comes into operation if a clearing member firm is unable to satisfy demands for variation margin, representing losses on its open positions, issued by the clearing organization, which in turn must make corresponding variation margin payments to clearing member firms holding profitable open positions. *Id.* In such a case, the clearing firm's default does not result in a default to the clearing firms on the opposite side of that firm's open contracts because the clearing organization guarantee assures the uninterrupted payment of variation margin to the clearing firms owed such payments. *See* T. Russo, Regulation of the Commodities Futures and Options Markets (1983) §§ 2.01-2.09; 1 P. Johnson, Commodities Regulation § 2.50 (1982).

38. *Volume Investors Corporation, supra* note 20 at 27.

defaulting traders but also all nondefaulting customers.[39] COMEX Clearing's action, therefore, affected customers of Volume generally, including customers who did not have positions at COMEX, by depleting funds available at Volume to pay customer equity claims based on futures and commodity options positions irrespective of the contract market where the claim arose.[40]

To the extent that the large Westheimer and Paruch positions remained open after their default, adverse price movements would result in additional margin demands which neither those customers nor, as a consequence, Volume could satisfy. As the guarantor of losses generated by those positions,[41] COMEX Clearing, therefore, stood at risk, interposed between Volume and the counterparties to its positions for as long as those positions remained open.[42] In addition, although the firm's nondefaulting customers could be expected to meet margin demands incurred on their own positions and issued in the ordinary course of business, it is questionable whether such customers would, if fully informed, respond to margin demands issued by a firm known to be insolvent. Consequently, COMEX Clearing theoretically could sustain at least short-term losses generated by all open positions at the defaulting firm.[43] Similarly, Volume's customers would bear the aggregate risk of adverse price movements affecting customer as well as proprietary positions overall because such losses would diminish the assets ultimately available for distribution in a bankruptcy or receivership proceeding.

Despite the risks created by the firm's open positions, beginning on March 20, 1985, Volume's customers apparently were unable, as a general matter, to liquidate or otherwise to control the disposition of even their own positions. Certain of the firm's customers, however, were allegedly given favored treat-

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39. *Id.* Volume also subsequently failed to pay a variation margin call issued on March 22 that reflected the previous day's trading. As COMEX Clearing had employed all available funds that were attributable to Volume in satisfying the variation call of the previous day, it drew upon its own resources to satisfy this demand, employing an advance from its operating surplus. *Id.* at 31.

40. *See Volume Investors Corporation, supra* note 20, at 22; *cf.* H.J. Maidenberg, *Brokerage Fall Hurts 'Innocents'*, N.Y. Times, April 22, 1985, at D14 (funds of customers who opened accounts at Volume to hedge crop purchases in Chicago Board of Trade grain and soybean futures were frozen by COMEX Clearing); *see* CFTC Interpretative Letter No. 85-4, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,505 (Division of Trading and Markets, Feb. 28, 1985) (segregated funds subject to *pro rata* allocation, regardless of location).

41. *See supra* note 37.

42. In the event the financial viability of the clearing organization were itself jeopardized, the continued existence of the positions would pose a different issue. As the clearing organization merely passes losses from losers to gainers on a zero sum basis and has no independent stake in the positions, as long as margin payments sufficient to cover losses are made to the clearing association or are coverable by the clearing organization guarantee, the transfer of such payments to collecting firms should be automatic. If, however, such losses cannot be paid by the obligated clearing firm or by the clearing organization, an argument can be made that the open positions at that point cannot continue to exist.

43. To the extent that COMEX Clearing sustained such losses, it would be entitled to seek recovery from available assets of the firm in a later bankruptcy or receivership proceeding.

ment. Some floor trader customers allegedly succeeded in effecting trades designed to reduce the equity in their Volume accounts before the firm's membership and trading privileges were effectively suspended.[44] Further, the CFTC's administrative complaint in the *Volume Investors* litigation charges that early on March 20, 1985, a principal of Volume and one of its employees advised certain Volume customers to transfer their open positions and margin funds from the firm.[45] According to the CFTC's complaint, as a result of this advice and with the assistance of Volume employees, transactions were effected that resulted in the transfer of approximately $3.9 million from one Volume account alone.[46] The CFTC's complaint alleges that such advice was not afforded all Volume customers[47] and that such selective advice to transfer positions and funds violates Section 4b of the CEA,[48] which proscribes fraudulent conduct in connection with transactions in futures contracts.[49] If accurate, these allegations suggest that uninformed customers may have suffered the worst of both effects of an insolvency: their accounts were frozen while insiders privy to special relationships with the exchange or the firm effected transfers that potentially diminished the pool of assets available for distribution.[50]

On March 21, 1985, the CFTC filed a complaint in the United States District Court for the Southern District of New York alleging that Volume

44. *Volume Investors Corporation, supra* note 20, at 23.

45. Complaint ¶¶ 35-39, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985).

46. *Id.* at 37.

47. *Id.* at 38.

48. 7 U.S.C. § 6b (1982).

49. Complaint ¶ 39, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985). In other Volume-related litigation, a Volume customer that allegedly was not timely advised of Volume's financial difficulties. Flo-Arb Partners (Flo-Arb), contends that it contacted Volume on March 20, 1985 to request that its account be transferred but was advised that it was too late to effect such transfers as COMEX had frozen the firm's assets and accounts. Complaint ¶¶ 49-53, Flo-Arb Partners v. Volume Investors Corporation, No. 85 Civ. 3562 (S.D.N.Y. 1985). Flo-Arb contends, however, that Volume's accounts were not in fact frozen until a receiver was appointed for Volume on March 21, that at least two customers of Volume who subsequently sought transfers of their accounts were permitted to do so, and that transactions made by Volume continued to be cleared through COMEX Clearing until mid-day on March 21. *Id.* Flo-Arb alleges that it was, at all times, "prepared to take any action necessary to accomplish the transfer of its positions to another clearing member, including, without limitation, the posting of additional cash margin." *Id.* at ¶ 52.

Apparent self-help measures by certain Volume customers who were COMEX members also are detailed in the CFTC's staff report on the Volume episode. According to that account, during trading on March 20, certain floor trader-customers opened new accounts or reactivated accounts with other FCMs. They then conducted trades and assigned those with losses to be cleared through Volume and those with gains to other FCMs. In effect, these traders received a beneficial transfer of their Volume account equity without seeking a formal transfer. According to the Division of Trading and Markets' report, trading records indicate that such techniques were employed by at least seven Volume customers on March 20. *Volume Investors Corporation, supra* note 20, at 23. The CFTC's staff report observes that these transactions do not "appear to be improper from the trader's perspective" but could have been refused by Volume. *Id.* at n.23.

50. *Volume Investors Corporation, supra* note 20, at 23.

was in violation of applicable minimum capital and segregation of funds requirements under the CEA and CFTC regulations.[51] This complaint sought appointment of a receiver and injunctive relief.[52] The same morning, the court issued an order enjoining Volume against further violations of minimum capital and segregation requirements and appointing a receiver to, *inter alia,* take immediate possession and control of the firm's assets, supervise the firm, and assure that no further trades were conducted by Volume except to liquidate open customer positions or to secure a transfer of Volume's customer equity and open positions to another FCM.[53]

Also on March 21, the COMEX and COMEX Clearing took action to declare Volume in default and to suspend Volume's clearing membership.[54] Although after the close of trading on March 20, the COMEX Board of Governors had adopted a resolution which "ordered, instructed, and directed" Volume to liquidate the Westheimer and Paruch positions in an orderly manner and not to accept or execute transactions for other accounts except to liquidate existing positions, that action would not take practical effect until the opening of trading on March 21.[55] Shortly before 9:00 a.m. on March 21, COMEX President Alan Brody announced from the COMEX floor that Volume had been suspended.[56] Following a COMEX Clearing Board of Directors meeting, between 10:45 a.m. and 11:45 a.m. on March 21, notices were distributed to traders on the COMEX floor stating that Volume had been "suspended," that its open futures and option positions would be liquidated by COMEX Clearing, that no trades could be submitted for clearance through Volume after 12:00 noon "except liquidating trades specifically authorized by the Clearing Association," and that trades executed by floor brokers to be cleared through Volume would only be accepted if executed prior to 11:45 a.m. that morning and presented for clearance before 12:00 noon.[57]

According to COMEX Clearing, it determined not to commence an organized liquidation of Volume's positions on March 21 because, due to the

51. Complaint, CFTC v. Volume Investors Corporation, No. 85 Civ. 2213 (S.D.N.Y. 1985).

52. *Id.*

53. Order of Preliminary Injunction and Order Appointing Receiver, CFTC v. Volume Investors Corporation, No. 85 Civ. 2213 (S.D.N.Y. 1985).

54. The CFTC's administrative complaint charged both COMEX and COMEX Clearing with failing to enforce their own rules, in violation of Sections 5a(8) and 5a(9) of the CEA, 7 U.S.C. §§ 7a(8) and 7a(9), in that Volume was allegedly in default and unable to meet COMEX Clearings minimum financial requirements for clearing members by no later than 11:00 a.m. on March 20, 1985 but was not declared in default at that time nor was liquidation commenced until at least 11:45 a.m. on March 21, 1985. Complaint ¶¶ 40-48, *In re* Volume Investors Corp., CFTC Docket No. 85-25 (1985).

55. *Volume Investors Corporation, supra* note 20, at 24, 58.

56. *Id.* at 26, 62. In COMEX's version of the facts, because of a malfunctioning public address system, Volume's suspension was apparently not effectively communicated to COMEX traders. *See id.* and Affidavit of Edmund R. Schroeder in Support of Motion to Allow in Part and Disallow in Part the Claims of Daniel L. Shak and Nicholas Caricato ¶ 6, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

57. *Volume Investors Corporation, supra* note 20, at 27-28.

morning's trading, it allegedly could not calculate the firm's remaining net positions.[58] COMEX Clearing, however, had apparently decided upon and assumed responsibility for the liquidation of Volume's positions, subject to the liability of customers for losses in their accounts, at the time of the COMEX Clearing Board action reflected in the notices distributed on the COMEX floor that morning.[59] Volume's receiver reported that when he arrived at Volume's premises on the morning of March 21, 1985, he learned that COMEX Clearing had suspended Volume as a clearing member and "had taken over the liquidation of all Volume's positions (including positions carried by Volume for its customers) on the COMEX."[60] COMEX Clearing's determination to liquidate apparently rested upon the conclusion that it was "not practical" to attempt to transfer customer positions from Volume to other FCMs because Volume had insufficient funds to transfer as margin for those positions.[61] According to the CFTC staff report on Volume, during the afternoon of March 21 COMEX Clearing began making arrangements for the liquidation of Volume's accounts through selected brokers.[62]

It was not, however, until March 22, 1985 that COMEX Clearing actually commenced the liquidation of Volume's open positions.[63] Trades submitted for clearance after noon on March 21, 1985 and trades effected on and after March 22 to liquidate the net open positions carried by Volume for its customers were assigned to a single omnibus Volume liquidation account.[64] According to information developed in the CFTC's staff report as well as allegations by certain Volume customers, the principal broker in charge of liquidating Volume's positions was not aware of the nature of individual customer positions comprising the account but instead was given the net Volume position in each contract and expiration for liquidation at the best possible price.[65] COMEX Clearing rules, however, seem to contemplate that

58. *Id.* at 29; Comment Letter from COMEX Clearing to CFTC Re: Advance Notice of Proposed Rulemaking on Need for Regulations Addressing Default Situations, November 4, 1985 (hereinafter, "COMEX Clearing Comment") at 6.

59. *Volume Investors Corporation, supra* note 20, at 29. *See supra* note 57 and accompanying text.

60. First Report of Receiver ¶ 8, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

61. *Volume Investors Corporation, supra* note 20, at 29. COMEX Clearing By-Law 6.1(f)(iv) provides that if the clearing member whose clearing privileges are terminated is an FCM, the clearing organization shall endeavor to transfer the open contracts of the FCM's customers to one or more other clearing members in lieu of closing them out.

62. *Volume Investors Corporation, supra* note 20, at 29.

63. *Id.* at 31; Receiver's Application for an Order Authorizing a Partial and Interim Distribution ¶ 6, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

64. Receiver's Application for an Order Authorizing a Partial and Interim Distribution ¶¶ 5-9, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

65. *See Volume Investors Corporation, supra* note 20, at 31; Receiver's Application for an Order Authorizing a Partial and Interim Distribution, CFTC v. Volume Investors Corp., NO. 85 Civ. 2213 (S.D.N.Y. 1985). *See also* Letter from John S. Kinzey to Eileen Berkman, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985); Affidavit of John L. Wyer in Support of Motion to Allow in Part and Disallow in Part the Claims of Daniel L.

the clearing organization would assume the clearing firm's responsibility to liquidate positions on behalf of individual customers, or at least to assign liquidation prices that reflected individual positions with, for example, separate treatment for straddle positions.[66] According to claims by certain Volume customers, the result of failing to differentiate straddle and other complex positions in the liquidation process was that in some instances the manner of liquidating positions itself caused customer losses because the legs of conversions, reverse conversions and other theoretically risk-free positions were liquidated at different times and without regard to the composition of the overall position.[67] The liquidation of Volume's positions was completed on March 27, 1985, and net equity claims of customers were calculated based on average prices received for positions liquidated.[68]

During and following the liquidation of Volume's market positions, exchange and clearing association officials, together with Volume's receiver, sought to develop a plan for compensation of Volume's customers.[69] As of March 25, when the bulk of Volume's positions had been liquidated, it appeared that approximately $18 million was owed Volume's nondefaulting customers, against which Volume had available approximately $11.5 million in segregated funds and $3 million in firm capital, leaving a shortfall of approximately $3.5 million.[70] At this time the receivership also had claims against Volume customers whose accounts were in deficit totalling approximately $16 million, $14 million of which was attributable to the Westheimer and Paruch accounts.[71] In addition to Volume's customers, the other principal claimant against Volume's assets was COMEX Clearing, which had

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Shak and Nicholas Caricato, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985) ("[w]hen [COMEX Clearing] liquidates a clearing member's open positions, it does not know the positions of any individual customers of the clearing member").

66. *Volume Investors Corporation, supra* note 20, at 32; COMEX Clearing By-Law 6.1(g). *But see* COMEX Clearing Comment, *supra* note 58, at 6-7 (a clearing organization has no knowledge of individual positions of customers of an FCM and has no obligations to such customers except to the extent set forth in rules adopted pursuant to the Commission's bankruptcy regulations).

67. *See* Objections of Flo-Arb Partners to Receiver's Disallowance of Its Claims, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

68. *Volume Investors Corporation, supra* note 20, at 30-35; First Report of Receiver ¶ 9; Receiver's Application for an Order Authorizing a Partial and Interim Distribution ¶¶ 8-9, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985). Certain Volume customers claim that the use of average prices that did not reflect the relationships between legs of straddle positions violated COMEX Clearing rules and improperly diminished the valuation of their recoverable account equity. *E.g.*, Objection of Daniel L. Shak to Receiver's Application for an Order Determining Certain Creditor Claims, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

69. First Report of Receiver ¶ 20, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985); *Volume Investors Corporation, supra* note 20, at 33-36.

70. *See, e.g., Volume Investors Corporation, supra* note 20, at 33.

71. First Report of Receiver ¶ 21, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985); Complaint, Wohl v. Westheimer, No. 85 Civ. 2230 (S.D.N.Y. 1985); Complaint, Wohl v. Flo-Arb Partners, No. 85 Civ. 3662 (S.D.N.Y. 1985).

infused in excess of $9 million to make variation margin payments on behalf of Volume.[72] This $9 million was paid by the clearing organization in variation margin on open positions carried by Volume, including those of customers who had not defaulted. Interestingly, as the market reversed itself, the losses on the Westheimer and Paruch positions would have been moderated to the extent those positions had not been hedged against future losses.[73]

In October, 1985, pending agreement upon a final settlement with respect to Volume's customers, Volume's receiver made a court-approved partial distribution to the firm's nondefaulting customers of approximately $7 million from Volume's segregated funds, about one-half of the funds then available to pay customer claims.[74] A final distribution to Volume's customers was made in February, 1986, pursuant to a settlement agreement among Volume's receiver, COMEX, COMEX Clearing and Volume principal Charles Federbush.[75] With this distribution, Volume's customers received the full balance of their net equity claims. The key feature of the settlement agreement was a $4.1 million bridge loan by COMEX and Federbush to the receivership which supplied the shortfall between funds remaining in Volume's segregated account and the unsatisfied portion of Volume's nondefaulting customer claims. This bridge loan was conditioned upon court approval of a settlement of the receivership's claims against the Westheimers and Paruch for not less than $5 million in cash and of the receiver's agreement to repay COMEX the funds advanced upon approval of the Westheimer settlement and before making any other distributions, except in payment of certain receivership expenses such as accounting and legal fees.[76]

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72. First Report of Receiver ¶ 19, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1985).

73. This scenario indicates one useful aspect of price limits, which existed on the Comex silver future, but not on the related option, at that time. Price limits restrict the amount by which the price of a commodity may fluctuate up or down before a trading halt is required.

74. A previous settlement agreement pursuant to which Volume principals Charles Federbush and Owen Morrissey had deposited $4.1 million in escrow had been reached in August, 1985. This agreement was terminable at the option of Federbush and Morrissey if releases in favor of Morrissey, Federbush and others in connection with claims arising out of the Volume default were not obtained from all nondefaulting customers of the firm. In November, 1985, Morrissey and Federbush withdrew from the agreement based upon the failure of Volume's customers to execute sufficient releases, but Federbush offered to reinstate his obligation upon certain conditions. *See* Receiver's Application For An Order Authorizing Him to Enter into a Certain Amended and Restated Agreement, to Amend Certain Releases Held by the Receiver, and to make a Second Distribution, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1986).

75. Amended and Restated Agreement Relating to Volume Investors Corporation, dated as of August 2, 1985, among Charles E. Federbush, Commodity Exchange, Inc., COMEX Clearing Association, Inc. and John F.X. Peloso, as Receiver for Volume Investors Corp., Exhibit 1 to Order Authorizing the Receiver to Enter Into A Certain Amended and Restated Agreement, CFTC v. Volume Investors Corporation, No. 85 Civ. 2213 (S.D.N.Y. 1985).

76. *Id.*

B. Customer Protection Issues Raised By The Volume Default

The Volume Investors default may be seen as a case in which the interests of the firm's customers and of the marketplace as a whole were, in the largest sense, effectively protected. Indeed, from the perspective of the marketplace, the most salient fact about Volume's default may well have been its lack of impact. The clearing organization guarantee operated effectively, such that the counterparties to Volume's open futures and option positions, the clearing firms on the opposite side of the market, were unaffected by that firm's default. The episode thus confirmed the ability of the clearing system to maintain an unimpeded flow of variation margin and thereby preserve the financial integrity of a contract market[77] despite the insolvency and consequent inability of a single clearing firm to continue to meet its commitments. The assumption by the clearing organization of counterparty risk is an essential attribute of the exchange markets for commodity futures and options trading in this country.[78]

From the perspective of the nondefaulting customers of the defaulting firm, however, the Volume experience did not establish, and in fact raised questions concerning, the efficacy of current legal protections.[79] Although Volume's customers were eventually compensated for their losses, this compensation occurred only after a lengthy period during which their funds were frozen and depended upon a settlement arrangement negotiated months after the failure that entailed voluntary action by the COMEX and a Volume principal to supply an interim source of funds. This outcome also followed extensive Volume-related litigation which threatened still further delays and fueled press reports of "finger pointing" and disavowals of responsibility for the firm's losses.[80]

The delay and uncertainty that preceded the compensation of Volume's nondefaulting customers generated widespread public concern over the scope of the protections afforded by current law to customers of defaulting clearing firms, such as Volume, and of insolvent FCMs in general. Despite the stringent statutory requirement that funds deposited with FCMs be maintained in segregated accounts for the exclusive benefit of the depositing customer,[81] innocent customers had apparently lost money, not through theft by their FCM or its employees, but from the lack of creditworthiness

77. *See supra* note 37 and accompanying text.

78. *See, e.g.,* 41 Fed. Reg. 40093 (1976) ("the essence of the integrity of a futures contract and, hence, of the contract market itself, is the clearing organization which secures that contract").

79. *E.g.,* Kerwin, *supra* note 20 at 13; Maidenberg, *supra* note 40, at D14; O'Dea, *The Guarantee That Wasn't There,* Intermarket, July, 1985 at 38 *et seq.*

80. *E.g.,* Kerwin, *supra* note 20, at 32 (quoting New York futures attorney's description of "a giant circle of fingers pointing at each other," as both COMEX and COMEX Clearing asserted that customers would receive their funds from Volume; Volume's receiver sought recovery from the Westheimers and Paruch; and the Westheimers and Paruch sued COMEX and Volume Investors).

81. CEA § 4(d)(2), 7 U.S.C. § 6d(2) (1982).

of other customers and seemingly lawful actions of the clearing organization. Even if strictly honored, the requirement of segregation of funds apparently was not a foolproof safeguard.[82] This result contrasted with the previously widespread assumption that with the benefit of complete compliance with the CEA's segregation requirements, customers of a bankrupt firm "should receive 100 cents on the dollar for each dollar claimed, notwithstanding the bankruptcy of the firm which holds their accounts."[83] Had this assumption proved accurate, Volume's customers need not have suffered significant harm as a result of the default because transfers of their positions could have occurred and "[b]usiness, albeit through another broker, could proceed as usual."[84]

Consequently, despite the eventual compensation of Volume's customers, the case revived previous contentions that the futures industry could not provide sufficient security to its customers in the absence of a government-sponsored insurance fund or other industry-wide compensation mechanism similar to that afforded securities customers by the Securities Investor Protection Corporation (SIPC).[85] Although the futures industry has a record of fewer broker insolvencies and far smaller customer losses than the securities industry,[86] customer losses have been forestalled and public confidence in the futures markets maintained, in significant measure, by the voluntary contributions of futures exchanges to the compensation of customers of failed clearing members. Such efforts may not only have partially

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82. Kerwin, *supra* note 20, at 32.

83. *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary,* 97th Cong., 1st Sess. 51. (Response of the Commodity Futures Trading Commission to Certain Written Questions Submitted by the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary) (hereinafter, "Response of the CFTC to Certain Written Questions").

84. *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary,* 97th Cong., 1st Sess. 10 (1981) (statement of former CFTC Chairman Philip F. Johnson) (hereinafter "Johnson Statement")

85. SIPC, a non-profit corporation subject to Securities and Exchange Commission and Congressional oversight, administers securities firm insolvencies, receiverships and bankruptcies and maintains an insurance fund which provides reimbursement of customer losses of up to $500,000 per customer, not more than $100,000 of which may represent satisfaction of claims based on cash. SIPC's enabling legislation, the Securities Investor Protection Act (SIPA), is "in essence, the public conduit for the insurance of broker-dealer customers," originally funded by assessments of SIPC members but now principally supported by interest received on investments in government securities. S. Cheston, *Investor Protection Under the SIPA: A Reassessment and Recommendations for Future Change,* 19 COLUM. J. L. & SOC. PROBS. 69, 72 (1985).

86. *See* National Futures Association, *supra* note 2, at 13-36. 114. NFA's analysis reflects that FCM insolvency losses from 1938 through 1985 totalled less than $10 million. By contrast, during the first fourteen years of SIPC's existence, 1971 through 1984, it disbursed an average of approximately $10 million per year, or a total of approximately $153 million, to securities customers.

dispelled the impact of previous insolvencies[87] but also prevented general awareness of the limits of the clearing house guarantee.[88]

During the period following Volume's default and prior to the final distribution to the firm's customers, it became clear that reliance upon a record of voluntary industry efforts to achieve customer compensation had the defect of all *ad hoc* approaches. Such an approach did not assure recovery in any given case nor did it eliminate the possibility that futures customers would be required to fend for themselves following a clearing firm default or participate in prolonged receivership or bankruptcy proceedings to obtain their share of whatever funds could be marshalled from an insolvent FCM's assets. In addition, the absence of a pre-established self-regulatory response to compensation of defaulting clearing firm customers deprived the relevant self-regulatory organizations of the security of a clear course of action, permitting individual exchange member firms to cavil over the extent to which the exchange should voluntarily recompense Volume's customers and over potential approaches to follow should it elect to

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87. NFA comments that "[a]lthough [futures] exchanges have not established a formal response structure like SIPC with a public commitment to compensate customers for insolvency losses, exchanges historically have volunteered such assistance when an exchange member has failed." National Futures Association, *supra* note 2, at 114. NFA's report details the futures industry's substantial record of providing compensation to the customers of exchange member firms on a voluntary basis. For example, in the 1969 insolvency of "Q" Commodities Co., the exchanges in which the firm held memberships reimbursed its customers in full. In 1982, the COMEX Clearing Association drew upon a letter of credit held as security to provide some $2 million to assure full reimbursement of the customers of its clearing member, Southern States Trading Company, Inc. NFA's report also relates that both the Chicago Mercantile Exchange and the Chicago Board of Trade maintain trusts which may be used on a discretionary basis to reimburse customer losses. National Futures Association, *supra* note 2, at 22, 34, 114; *infra* note 208.

88. As defined by legal commentators, the clearing organization guarantee actually protects against member firm defaults only to the extent of assuring payment of variation margin to clearing member firms with net gains on their positions but "does not remove all risk of default because the clearing house does not guarantee the obligations of brokers or traders who are not clearing members." T. Russo, Regulation of the Commodities Futures and Options Markets § 2.09 (1983). In the case of Volume, for example, the clearing organization guarantee did not protect Volume's nondefaulting customers against the consequences of a default by other customers of the firm. The clearing organization guarantee thus "indirectly benefits all futures traders" but directly benefits only clearing member firms. *Compare SEC/CFTC Jurisdictional Issues and Oversight—Part 1: Hearings on H.R. 5447, H.R. 5515 and H.R. 6156 Before the Subcomm. on Telecommunications, Consumer Protection and Finance and the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce,* 97th Cong., 2d Sess. 188, 215 (1982) ("[i]f losses occur and the customer does not pay them, it becomes the obligation of the broker to do so" and "if, for any reason, the broker cannot pay those debts, the exchange's clearing house must satisfy them") (CFTC submission, May 20, 1982); *SEC/CFTC Jurisdictional Issues and Oversight—Part 2: Hearings on H.R. 5447, H.R. 5515 and H.R. 6156 Before the Subcomm. on Telecommunications, Consumer Protection and Finance, and the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce,* 97th Cong., 2d Sess. 327, 345 (due to the clearing organization guarantee, "[n]o one in the futures market need worry about the creditworthiness of any other participants") (CFTC submission, June 16, 1982).

do so.[89] The resulting delay and controversy unnecessarily diminished both the economic and public confidence value of any compensation ultimately provided.

In addition, the Volume case engendered controversy because of the apparently unequal treatment of that firm's customers notwithstanding the egalitarian principles of required bankruptcy dispositions. As discussed above, following Volume's default, allegations surfaced that some customers were warned of the impending default and permitted to transfer equity from the firm, while others were not.[90] Such claims suggest unfairness and, if substantiated, illegality in that "insiders" or other customers with special status or access to information may have secured advantageous treatment to the potential detriment, in the event of a delayed or partial recovery, of the firm's other customers. To the extent that such self-help and collusive transfers were allowed to occur unremarked and unremedied, they could encourage efforts to obtain unfair advantage in future insolvencies and call into question the general ability of individual public customers to achieve fair treatment in such cases. Moreover, even if unfounded, charges of collusion and unequal treatment may impair public perception of the *bona fides* of any self-regulatory response to an insolvency and undermine confidence in the integrity of the marketplace generally.

Finally, the Volume episode created controversy because it illustrated that segregated customer funds were not completely sacrosanct and could be diminished following a clearing firm default by virtue of the clearing organization's access to previously deposited clearing margin.[91] In the Vol-

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89. *See, e.g.,* O'Dea, *supra* note 79 at 44-45; Szala, *supra* note 18 at 64, 68 (quoting one clearing firm official's comment that volume's nondefaulting customers weren't "innocent victims" in that they received the benefit of "cheap commissions" available at Volume by electing that firm over larger, better-capitalized firms). Such disagreements among exchange members were fueled by initial uncertainty over the actual amount of the firm's customer losses but persisted even after the relatively small size of the problem became clear.

90. *See supra* notes 44-50 and accompanying text.

91. *See* Kerwin, *supra* note 20. The authority of clearing organizations to employ original margin deposits in a clearing firm's customer account as security for variation margin payments in the manner described in the text is not, however, unlimited. In an opinion issued after Volume's default, the CFTC's General Counsel concluded that clearing organization rules and by-laws authorizing use of customer margin funds to satisfy any margin obligations attributable to a clearing firm's customer account collectively, without regard to the underlying ownership interests of individual customers in such funds, generally are not inconsistent with Section 4d(2) of the CEA. CFTC Interpretative Statement No. 85-3, *Use of Segregated Funds by Clearing Organizations Upon Defaults By Member Firms,* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,703 (Office of the General Counsel, Aug. 12, 1985). This opinion also stated, however, that clearing organizations might be precluded from exercising rights afforded by such rules and by-laws "by reason of . . . knowledge of or participation in a violation of the Act or other provisions of law that preclude it from obtaining rights to such funds superior to those of one or more customers of the defaulting clearing member," for example, in circumstances in which the clearing organization received margin funds with actual knowledge that such funds had been transferred by the clearing firm in breach of its duty under Section 4d(2) of the CEA to segregate and separately account for customer funds. *Id. See also* Complaint ¶¶ 27-30, *In re*

ume case, it became apparent that following a clearing firm default on margin obligations that exceed the available capital of the firm, the clearing organization, as the representative of the market, and the firm's customers apparently held conflicting interests and, indeed, potentially adverse claims to original margin deposits retained by the clearing organization on behalf of the firm's customers collectively.[92] Had such funds and property been required to be used or maintained by the clearing organization solely on behalf of the customer for which they had been deposited rather than the firm's customers generally, each customer should have recovered his full account equity from segregated funds. However, the clearing organization used such funds as security for the payment of Volume's collective customer margin obligations and hence effectively employed funds attributable to nondefaulting customers to satisfy obligations of the defaulters. This action was contended by some to be inconsistent with the intention of the segregation requirements of the CEA.[93] Under these requirements, FCMs are obligated to maintain for the exclusive benefit of each customer all funds deposited to margin, guarantee, or secure that customer's futures contracts.[94] To the extent that such segregated funds were deposited at COMEX Clearing as original margin deposits, however, they ceased to be held exclusively for the specific benefit of the depositing customer and also served as security to the clearing organization for the open contracts of Volume customers considered collectively, a major factor in defraying counterparty risk and in maintaining market integrity. The clearing organization's authority to use such funds as security for a clearing firm's collective customer obligations reflects the fact that the clearing organization is not merely a depository for essentially fungible margin deposits but has a special status as a clearing organization. It also reflects that generally the clearing firm alone, and not its customers, is in contractual privity with the clearing organization. The legal conclusion, based on the CEA and Commission regulations, that the

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Volume Investors Corp., CFTC Docket No. 85-25 (1985) (charging COMEX Clearing with aiding and abetting violations of Section 4d(2) of the CEA and CFTC Regulations 1.20(a), 1.20(c) and 1.22 by requesting and receiving a margin payment from Volume while "aware of facts that should have caused it to believe that in order to satisfy this payment, Volume would have to use, and did use, the money, securities or property of certain customers of Volume to margin the trades or contracts of customers other than the ones for whom such funds were held").

92. A similar issue would arise in the event of the failure of an originating FCM to satisfy margin demands arising from an omnibus customer account combining the transactions of two or more persons and carried by a second FCM in the name of the originating FCM rather than its individual customers. If the margin demand could not be satisfied by the originating FCM, the carrying FCM could claim that the omnibus customer account constituted a single "customer" and that all margin funds deposited in respect of that account could therefore be drawn upon to satisfy variation margin demands attributable to the account as a whole. *See* CFTC Interpretative Statement No. 85-3, *Use of Segregated Funds by Clearing Organizations Upon Defaults by Member Firms, supra* note 91, ¶ 22, 703 at 30, 986-87.

93. *E.g.*, Kerwin, *supra* note 20, at 13-14 (quoting statement of a Volume customer that the clearing organization "really looted the customers' segregated accounts").

94. Section 4d(2) of the CEA, 7 U.S.C. § 6d(2) (1982).

segregation requirements applicable to clearing organizations differ from those that apply to FCMs remains, however, untested.[95]

By drawing on original margin deposits to satisfy Volume's obligations to the opposite side of the market, COMEX Clearing assured that other clearing firms and their customers would not be adversely affected by Volume's failure to the extent that such deposits served as security for the firm's transactions.[96] The necessary effect of this market-oriented action, assuming it were proper upon a final finding of the facts at the disposal of the clearing organization, was to disadvantage, at least temporarily, Volume's "innocent" customers because of the apparently irresponsible trading of the firm's three defaulting custómers.[97] Because of COMEX

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95. The provision of CEA Section 4d(2) specifically applicable to FCMs states that they shall employ the funds and property of a customer as "belonging to such customer." In contrast, the provision of section 4d(2) expressly applicable to clearing organizations, depositories and all other repositories of customer funds precludes the use of monies or property deposited on behalf of customers "as belonging to the depositing [FCM] or any person other than the customers of such [FCM]." Section 4d(2) of the CEA, 7 U.S.C. § 6d(2) (1982). The latter provision has been construed to mean that clearing organizations and other persons that have received customer funds from an FCM may treat them as belonging collectively to the customers on whose behalf they were deposited, without regard to the individual interests of particular customers in such funds. CFTC Interpretave Statement No. 85-3, *Use of Segregated Funds by Clearing Organizations Upon Default by Member Firms, supra* note 91, ¶ 22, 703 at 30,987. The CFTC's regulations are consistent with this view. CFTC Regulation 1.20(b), 17 C.F.R. § 1.20(b) (1987), for example, requires clearing organizations to separately account for and segregate customer funds received from a member of the clearing organization to purchase, margin, guarantee, secure or settle trades, contracts or options and all money accruing as the result of such trades, contracts or options "as belonging to such commodity or option customers" and specifies that clearing organizations shall not use or dispose of such customer funds "except as belonging to such commodity or option customers." By comparison, CFTC Regulation 1.22, 17 C.F.R. § 1.22 (1987), which precludes FCMs from using or permitting the use of "the customer funds of one commodity and/or option customer to purchase, margin, or settle the trades, contracts, or commodity options of, or to secure or extend the credit of, any person other than such customer or option customer," refers only to FCMs and thus, according to the CFTC's staff opinion, "does not govern clearing organizations or other depositories of customer funds." CFTC Interpretative Statement No. 85-3, *Use of Segregated Funds by Clearing Organizations Upon Defaults by Member Firms, supra* note 91, ¶ 22, 703 at 30,988. This construction of Section 4d(2) and CFTC segregation regulations has been said to reflect the fact that "clearing organizations' direct customers are, generally, clearing firms, not the ultimate 'customers' who entered into the futures contracts and options positions accepted for clearance by the clearing organization." *Id. See* Corcoran, *Risk-Avoidance Strategies for Large Market Participants,* 19 REV. OF SEC. AND COMMODITIES REG. 173, 174-75, 178 (Aug. 27, 1986). On the same or similar reasoning, margin funds securing omnibus accounts at carrying FCMs could be claimed to constitute a single customer account available to be drawn upon to satisfy all unsatisfied margin demands in respect of that account. Like clearing organizations, carrying FCMs are likely to disavow contractual privity with the ultimate customers whose positions they carry. *See supra* notes 91-92 and accompanying text.

96. Of course, to the extent those deposits were supplemented by a clearing guarantee, clearing members' obligations to support the guarantee function were drawn upon.

97. The effects of the trading activities of the Westheimers and Paruch were apparently exacerbated by weaknesses in the financial surveillance programs of COMEX and COMEX Clearing. *Volume Investors Corporation, supra* note 20, at 50-52; Letter from Andrea M.

Clearing's use of margin deposited to support the clearing function, open positions of Volume's nondefaulting customers were apparently unsupported by margin sufficient to permit their transfer to solvent FCMs and consequently were liquidated.[98] The inability to transfer positions meant that Volume's nondefaulting customers could be expected to be deprived of the use of their funds pending a bankruptcy or receivership distribution of their *pro rata* portion of available customer property and that some customers could suffer additional losses because of the manner in which their positions were liquidated or assigned liquidation values.[99]

These and other aspects of the Volume Investors default resulted in examinations of commodity customer account protection by both the CFTC and, at the CFTC's request, the National Futures Association (NFA). In a report to Congress mandated by the Commodity Futures Trading Commission Act of 1974,[100] the CFTC previously had determined that conditions in the commodities markets did not warrant the establishment of an insurance fund and that a customer insurance program similar to that administered by SIPC for the benefit of securities investors would not be cost-effective.[101] Following Volume's failure, the CFTC's Division of Trading and Markets took a broader view of customer account insurance and identified a number of possible compensation mechanisms that included, but were not limited to, a federally-sponsored insurance corporation such as SIPC.[102] Although this CFTC staff study did not recommend establishment of an insurance program, it found that, despite widespread regulatory improvements in the decade since the CFTC's previous insurance study, some risks to customer funds and the parties supported thereby remained. It also found that as the result of changes in the character of the commodities markets during that period, the potential consequences of such losses could well have increased.[103] The CFTC staff report recommended that NFA be requested to undertake a further study of the cost-effectiveness of various

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Corcoran, Director, Division of Trading and Markets, CFTC to Alan J. Brody and Thomas O'Hare (April 1, 1985). Depending upon the degree of factual connection between deficiencies in self-regulatory programs and a clearing firm default, the clearing organization's "priority" to original customer margin deposits may have implications for its role as a self-regulatory body as well as that of ultimate guarantor of futures trades accepted for clearance. That is, the clearing organization may have dual and potentially conflicting functions insofar as it has the capacity to employ priority rights to original margin deposits to reduce losses for which it may in part be responsible. *See infra* note 261.

98. *See supra* text at 859; *Volume Investors Corporation, supra* note 20, at 29.

99. *See supra* text at 859-60.

100. Pub. L. No. 463, 88 Stat. 1389 (1974).

101. *See Commodity Account Protection, supra* note 2, at Appendix A.

102. *Commodity Account Protection, supra* note 2, at 63. Alternate compensation mechanisms reviewed by the CFTC's Division of Trading and Markets included surety bonding, fidelity bonding, and the use of clearing organization guarantee funds to create a customer compensation fund.

103. *Id.* at 116.

alternative forms of commodity customer compensation or insurance.[104]

NFA's "Customer Account Protection Study," issued in November, 1986, in response to the CFTC's request, addresses potential steps "to reduce the risk of or to remedy an insolvency loss" and "the direct and indirect costs and benefits of each."[105] That study focuses heavily on current regulatory requirements of a preventive nature, such as segregation of customer funds and FCM internal controls. While specifically declining to make policy choices or recommendations, NFA found that an insurance program would not be cost-effective and stressed the significance of the "substantial and wide-ranging customer account protections" currently in place.[106] With respect to insurance, the NFA report commented that the substantial public commitment to insurance programs in the banking and securities industries was "born out of the importance of the retail customer in those sectors" and threats to investor confidence posed by "widespread failures."[107] NFA observed, however, that in the futures industry "insolvency loss is a rare occurrence," that futures customers "derive their confidence" from "the protections afforded by the industry as a whole and the firm with whom they choose to deal," and that the retail customer, "although important to the futures industry, is not its lifeblood."[108]

Significantly, the NFA study, like the CFTC staff's examination of commodity account protection, identified alternative approaches to reme-

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104. Pursuant to this recommendation, the CFTC subsequently directed its Division of Trading and Markets to request NFA "to undertake a preliminary study of the cost-effectiveness of the various alternatives advanced by the Division and other alternatives NFA itself may develop and report to the Commission whether insurance could play a role in reducing the impact of financial failures and, if so, what further action may be advisable." National Futures Association, *supra* note 2, at 1.

105. *Id.* at 3.

106. *Id.* at 121.

107. *Id.* As banks are depository institutions that are subject to reserve requirements but are not required to maintain customer deposits in segregated accounts, insurance serves to prevent a "run" on the bank that places excessive demands upon reserve funds that are not required to equal the bank's total outstanding obligations to customers. 12 U.S.C. § 461; 12 C.F.R. § 204.1 *et seq.* No equivalent problems of short-term demand on an FCM should exist in the usual case because, if statutory segregation requirements are complied with, funds sufficient to satisfy existing customer claims would at all times be available except, however, after a customer default exceeding the capacity of the firm to restore the deficit. This is because an FCM must at all times have sufficient funds to pay all of its obligations to customers.

108. National Futures Association, *supra* note 2, at 122. Based upon interviews of NFA members, NFA concluded that even retail participation in the futures markets does not depend upon a public commitment to account insurance. *Id.* at 118-20. It would appear, however, that institutional investors such as mutual or pension funds, which represent groups of essentially retail investors, could assess the consistency of commodity futures investments with their fiduciary responsibilities based in part upon the security of those investments in the event of insolvency. *See* Corcoran, *Risk-Avoidance Strategies for Large Market Participants*, 19 REV. OF SEC. & COMMODITIES REG., *supra* note 95, at 175-78. More recently, they might also seek to assure themselves as to the extent of potential clearing risk, although the liquidity of a cleared market may be essential to their trading strategies.

dying the effects of a commodity broker insolvency that are not patterned after the securities industry's SIPC insurance program. In particular, the NFA report stressed the potentially substantial benefits that could accrue from an approach to customer account insurance designed not to compensate customers for lost funds but "to facilitate transfers of positions from an insolvent firm to a solvent one."[109] According to NFA, such an approach could significantly benefit the customers of an insolvent firm in addition to the marketplace as a whole, allowing hedgers to maintain their positions without exposure to adverse price movements in the cash markets and facilitating "the continued orderly operation of the futures markets by eliminating the specter of forced liquidation of positions."[110] Nonetheless, as NFA commented, the "key to any such program would be the *immediate availability* of sufficient funds to accomplish orderly transfers."[111] While identifying position transfers as a possible objective of a customer protection program, NFA's report does not specifically assess the relative costs and benefits of a program designed solely to fund such transfers.[112] Such potential benefits could include reduced clearing organization liability for variation margin payments, the elimination of increased basis risk for hedgers forced to re-establish hedges following a liquidation of their positions, and the enhancement of overall market integrity achieved by protecting customer positions against forced liquidation.[113]

The events of Volume Investors' default and receivership, as well as the post-Volume insurance studies by the CFTC and NFA, raise questions concerning the application of current law to protect customer interests following an FCM insolvency, including the following:

—To what extent do current bankruptcy laws and regulations assure a fair and efficient recovery by customers and facilitate the transfer of customer positions in the event of an FCM insolvency?

—To what extent would application of current bankruptcy provisions in receiverships such as that employed to distribute Volume Investors' assets enhance the protections available to customers of defaulting clearing firms and to customers in the marketplace generally?

109. National Futures Association, *supra* note 2, at 8.

110. *Id.* at 91.

111. *Id.* at 92 (emphasis in original). The NFA states that in addition to financing, such a program would require substantial but unspecified revisions in the *pro rata* distribution sections of the CFTC's bankruptcy regulations. *Id. See infra* note 304 and accompanying text (discussing pro ration adjustments).

112. NFA's report does include an estimate of the annual costs of such a program of approximately $2.4 million. *Id.* at 91; *see infra* note 302.

113. The industry's past willingness to assume financial responsibility for insolvencies suggests that voluntary measures to facilitate position transfers instead of or in conjunction with a program to reimburse customer losses might be undertaken. *See supra* note 87. Possible measures to facilitate transfers are discussed in the text of this article at pages 908-13.

—What measures could be taken to increase the likelihood that positions will be transferred rather than liquidated without diminishing current protections of the clearing system and the overall market in the event of insolvency or materially burdening the industry with unnecessary costs or regulatory requirements?

These issues are discussed below.

## II. Bankruptcy Code Provisions Governing the Liquidation of Commodity Brokers

In the Bankruptcy Reform Act of 1978,[114] Congress enacted the first bankruptcy laws specifically addressed to "the unique problems raised by commodity broker bankruptcies."[115] These new provisions, codified as Subchapter IV of Chapter 7 of the Bankruptcy Code (Code),[116] reflect two paramount legislative objectives: to protect monies of customers deposited with insolvent commodity brokers and to prevent the potential chain reaction or "domino" effects of a commodity broker failure.[117] To facilitate customer protection, these Code provisions accord customer claims the highest priority against the bankrupt's estate, subject only to claims "attributable to the administration of customer property."[118] Congress described this policy as one which "maintains consistency with the Commodity Exchange Act, which establishes customer protection as a primary objective" and is expected to "promote customer confidence in commodity markets generally."[119] In addition, the Code was designed to impose upon the bankruptcy trustee the duty to endeavor to transfer to another commodity broker or brokers open customer commodity contracts and supporting margin in order "to insure that producers who have hedged their production in the commodities market are allowed the opportunity to preserve their positions."[120]

Congress's second principal objective in enacting the commodity broker liquidation provisions of the Code was to protect the stability of the futures markets. The Code provisions formulated to advance this goal reflect

114. Bankruptcy Reform Act of 1978, Pub. L. No. 598, 92 Stat. 2549.

115. S. Rep. No. 989, 95th Cong., 2d Sess. 7 (1978).

116. 11 U.S.C. §§ 761-766 (1982). The CFTC had initially proposed enactment of five separate Bankruptcy Code chapters, to provide separate treatment for FCMs, foreign FCMs, clearing organizations, leverage transaction merchants, and commodity options dealers, respectively. H.R. Rep. No. 595, 95th Cong., 2d Sess. 272 (1978). Congress instead enacted a single commodity broker liquidation subchapter. The legislative history of the Bankruptcy Reform Act's commodity broker liquidation provisions is summarized in White, *The Commodity-Related Provisions of the Bankruptcy Act of 1978*, 34 Record of the Association of the Bar of the City of New York 262 (1979).

117. S. Rep. No. 989, 95th Cong., 2d Sess. 7-8 (1978).

118. 11 U.S.C. § 766(h) (1982). A first priority for administrative claims was believed necessary to assure the availability of professionals willing to administer an estate which could potentially consist entirely of customer property.

119. S. Rep. No. 989, 95th Cong., 2d Sess. 8 (1978).

120. *Id.* at 107.

congressional recognition that preserving market stability following a commodity broker's bankruptcy "is more difficult in the commodities markets than in other markets," because commodity futures and options contracts are of very limited duration and because the clearing system addresses price volatility by requiring that gains and losses on open positions be paid in cash on a daily or intra-day basis in the form of variation margin payments.[121] Consequently, the necessity to meet contractual obligations is virtually continuous and "[d]elay by the trustee can result in default in making the daily variation margin payments, or default on delivery, either of which could have a ripple effect that disrupts the entire market."[122] Conversely, "abrupt action by the trustee could seriously disrupt orderly trading, resulting in substantial losses to the bankrupt, its customers, and other market participants."[123] Accordingly, the Code "strongly encourages the immediate transfer of customer accounts from the bankrupt to a solvent commodity broker" as a means of preserving maximum responsiveness to daily payment demands and minimizing the possibility of default on margin payments and delivery.[124]

In addition, the Code establishes a policy against recapture by a bankruptcy trustee of margin payments made to clearing organizations or other commodity brokers. In securing the clearing organization against liability for margin transferred to clearing firms on the opposite side of the bankrupt's open contracts, the Code in effect grants a priority to the clearing organization on behalf of customers generally as opposed to those directly affected by the financial predicament of their carrying firm and assures the security of futures transactions despite the insolvency and consequent incapacity of one market participant to pay margin owing into the system.

### A. The Bankruptcy Code Customer Priority

The Commodity Exchange Act establishes that all property deposited with FCMs by commodity customers to margin, guarantee or secure commodity contracts, and all funds that accrue due to such contracts, are entrusted to the FCM as a fiduciary and, wherever located, remain the property of the depositing customer. Under CEA Section 4d(2), an FCM must at all times "treat and deal" with each of its customer's deposits "as belonging to such customer," separately account for and maintain such funds in a segregated account and refrain from using such funds or property

121. S. Rep. No. 989, 95th Cong., 2d Sess. 8 (1978). Moreover, in particularly volatile and, hence, financially perilous markets, calls for intra-day margin to address price changes occurring within a trading day and for super-margins addressing the capacity of specific firms to remain in the market may be made. *See* 1 P. Johnson, Commodities Regulation § 2.50 (1982); *The Silver Market of 1979/1980: Actions of the Chicago Board of Trade and the Commodity Exchange, Inc.*, Investigative Report of the Division of Trading and Markets, Commodity Futures Trading Commission at 69, 711-12.

122. S. Rep. No. 989, 95th Cong., 2d Sess. 8 (1978).

123. *Id.*

124. *Id.*

"to margin or guarantee the trades or contracts or to secure or extend the credit, of any customer or person other than the one for whom the same are held."[125] These statutory protections are denominated "segregation" requirements and are designed to prevent the creation of competing security interests in customer funds, to make clear that such funds are not employable to satisfy the operating costs of the FCM or for any other purpose, to deter their theft and to reinforce their status as specially protected property of the depositing customer. To avoid violating the statutory proscription against the use of one customer's funds to margin the trades of another, whenever a given customer account falls into deficit, the FCM must replenish that deficit from its own capital to assure its capability to meet all customer equity claims without using one customer's funds to pay another.[126]

Prior to the enactment of the Bankruptcy Reform Act of 1978, these customer protections of the CEA had no specific counterpart in the bankruptcy laws and the treatment that commodity customers would receive in the event of an FCM bankruptcy consequently stood "open to speculation."[127] Indeed, it was likely that the preferred regulatory response to the imminence of a financial crisis (that is, transfers of positions and collection of augmented margins) could subsequently be undone by a trustee. In the absence of a specific statutory bankruptcy priority for commodity customers, the CFTC and its predecessor agency, the Commodity Exchange Authority, had urged that the bankruptcy courts treat bankrupt FCMs as holding the funds deposited by their customers to margin commodity positions in constructive trust.[128] Under this approach, the FCM would have no access to such funds to satisfy its own obligations, and hence its trustee in bankruptcy as a direct successor in interest, likewise would "ha[ve] no ownership interest in customers' funds deposited as margin in their accounts."[129] Further, under this view, to the extent that such funds could be traced and identified, they would be recoverable by the depositing customer.[130] Although bankruptcy trustees (and bankruptcy courts) generally had recognized the claims of commodity customers to funds in segregation, such decisions had lacked a clear rationale and commonly employed a makeshift extension of traditional trust law or an application of the law

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125. Section 4d(2) of the CEA, 7 U.S.C. § 6d(2) (1982). Under the CEA, open trade equity also constitutes a protected customer interest. Disposition of open commodity contracts other than pursuant to the customer's express or implied consent is a wrong redressible under Section 4b of the CEA, 7 U.S.C. § 6b, the CEA's general antifraud provision, which has been construed to prohibit, *inter alia,* breaches of fiduciary duty by FCMs in connection with the purchase or sale of commodity futures contracts. Sherwood v. Madda Trading Co., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,401 (CFTC, 1977).

126. *See* 17 C.F.R. § 1.22 (1987) (an FCM may not use one customer's funds to margin, guarantee or secure the positions of any other customer); 48 Fed. Reg. 8717 (1983).

127. Bagley Testimony, *supra* note 28, at 2378.

128. *Id.* at 2392.

129. *Id.*

130. *Id.*

governing the bankruptcies of securities broker/dealers prior to 1938.[131] In the CFTC's view at the time bankruptcy reform was being contemplated in the 1970s, the most serious deficiency in these *ad hoc* approaches was that they lacked a definitive legal theory and had not been endorsed by any appellate court.[132]

The treatment accorded customer claims to funds wrongfully diverted from segregation or otherwise required to be, but not actually in, segregated accounts was even less satisfactory. Such claims were likely to be rejected outright, leaving customers without a priority interest in such funds and, therefore, entitled only to the status of general creditors. The CFTC reported that "[w]hile trustees in the bankruptcies of futures commission merchants have generally awarded commodity customers a preference to funds in segregation, they have not generally granted such customers a preference to nonsegregated funds, even where such funds are readily traceable back to customers."[133] Decisions such as that in *In the Matter of Weis Securities, Inc.* [1975-1977 Transfer Binder] Comm. Fut. L. Rep. ¶ 20,108 (S.D.N.Y. 1975) confirmed the CFTC's concerns. That case addressed, *inter alia,* the claims of commodity customers to customer funds held by a debtor, Weis Securities, Inc., which was being liquidated pursuant to SIPA. The court held that to the extent that customer funds had *actually* been maintained in segregation, the depositing commodity customers were entitled to have their claims paid *pro rata* from such segregated funds.[134] As to any unpaid, unsegregated balance, however, such claimants constituted only general creditors of the estate.[135]

The CFTC consequently advocated enactment of a statutory priority for commodity customers that would extend to all money, securities, property, and open trades traceable to the FCM's customers collectively, with authority vested in the CFTC to determine, by rule or regulation, which assets would be deemed traceable to commodity customers.[136] Congress adopted a somewhat simpler version of the CFTC's formulation of a statutory priority for commodity customers.[137]

As enacted, the Code's definition of "customer property" provides a basis for assuring that commodity customers receive priority claims that are coextensive with their ownership interests in funds and property held by the bankrupt FCM as defined by Section 4d(2) of the CEA. Under the Code, "customer property" includes "cash, a security, or other property, or

131. *Id.*
132. *Id.*
133. *Id.*
134. *In re* Weis Securities, Inc. at 20,789-90.
135. *Id.*
136. Bagley Testimony, *supra* note 28, at 2398.
137. As initially proposed by the CFTC, the statutory priorities applicable to FCMs and other categories of commodity brokers would have been set forth separately. When Congress elected to combine treatment of all commodity brokers in a single subchapter, it enacted a single customer priority provision. 11 U.S.C. §§ 761, 766 (1982). *See supra* note 116.

proceeds of such cash, security, or property, received, acquired, or held by or for the account of the debtor from or for the account of a customer."[138] In addition, the Code identifies a number of specific categories of customer property, including "property that was unlawfully converted and that is property of the estate"[139] and "other property of the debtor that any applicable law, rule, or regulation requires to be set aside or held for the benefit of a customer, unless including such property as customer property would not significantly increase customer property."[140]

These provisions establish that an FCM's improper commingling of commodity customer funds, whether with its own trading accounts or other funds, does not deprive customers of priority claims to such funds wherever they can be found, effectively overturning the result in *Weis Securities.* In addition, the Code's customer property definition provides a basis for reaching other assets of the FCM to restore customer funds missing from an estate through diversion or other abuse. In this regard, the Code makes clear that customer property includes assets of the bankrupt FCM to the extent that available segregated funds are inadequate to satisfy the claims of public customers without regard to whether such assets were in fact diverted from the customer segregated account. Since FCMs are obligated under the CEA and CFTC regulations to cover shortfalls in customer segregated accounts with their own funds,[141] an FCM's assets constitute property required to be "held for the benefit of the customer" to the extent that available segregated funds are insufficient to satisfy customer net equity claims. This result is confirmed by regulations promulgated by the CFTC pursuant to its statutory authority to provide by rule or regulation "that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property."[142] Section 190.08(a)(1)(ii)(J) of the Commission's regulations specifies that customer property includes "cash, securities or other property of the debtor's estate, including the debtor's trading or operating accounts and commodities of the debtor held in inventory" to the extent that other enumerated categories of customer property are "insufficient to satisfy in full all claims of public customers."[143] These regulations assure that difficulties in tracing customer funds will not unfairly disadvantage customers to the benefit of the firm's general creditors, establishing by rule a variation on the presumption drawn from English trust law that "where a wrongdoer commingles his own funds in a bank account with those of another person and thereafter makes withdrawals from that account, the wrongdoer withdrew his own funds first."[144]

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138. 11 U.S.C. § 761(10) (1982).
139. 11 U.S.C. § 761(10)(A)(viii) (1982).
140. 11 U.S.C. § 761(10)(A)(ix) (1982).
141. *See supra* text at 873.
142. 7 U.S.C. § 24(a)(1) (1982).
143. 17 C.F.R. § 190.08(a)(1)(ii)(J) (1987).
144. 46 Fed. Reg. 57535, 57553 (1981). The CFTC's potentially all-inclusive definition of

In addition to assuring that customers' priority claims reflect their actual property interests under the CEA, the Code's priority provisions establish an equitable standard for allocating customer property among the FCM's customers. Section 766(h) of the Code requires the bankruptcy trustee to distribute customer property "ratably to customers on the basis and to the extent of such customers' allowed net equity claims" and "in priority to all other claims" except claims attributable to the administration of customer property.[145] This *pro rata* distribution requirement establishes a principle of equal treatment for all customers and effects a proportionate allocation of any shortfall in customer property available for distribution, a standard that accords with established law under the CEA, common law trust

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customer property has been criticized as one which "somewhat trivializes the concept of customer property" under the Bankruptcy Code by essentially subjecting all property of the debtor's estate to the priority claims of public customers despite Bankruptcy Code language that seems to contemplate that customer claims would be recognized as general creditor claims to the extent of a shortfall in customer property. *See* T. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS at §§ 18-72 (1983). However, as Congress contemporaneously afforded the CFTC essentially unlimited authority to define the scope of customer property, its enactment of a statutory provision that apparently contemplates that customer property could fail to encompass the debtor's entire estate appears to be intended to provide a residual protection for customers in the event that the CFTC were to exercise its delegated authority to define customer property to reach less than all available assets. In enacting Code provisions to govern the liquidation of commodity brokers, Congress expressed the intent only to provide a 'framework' for broker liquidations which "[d]ue to the germinal state of regulation of the commodities industry . . . does not provide detailed rules to cover every contingency" and would be supplemented by regulations to be promulgated by the CFTC pursuant to a delegation of general rulemaking authority. S. REP. No. 989, 95th Cong., 2d Sess. 8 (1978). To date, however, no court has addressed the issue of the effect of the CFTC's extension of the definition of customer property to inventory and other putatively proprietary assets of an FCM under circumstances where general creditors would be materially affected. *See* Teuting & King, *Funds Protections: An Overview of What Happens When a Commodity Broker Becomes Insolvent,* 7 JOURNAL OF FUTURES MARKETS 93, 99 (Winter 1987). The basis for that extension is the segregation requirement that an FCM cover customer deficits with its own funds. *See supra* note 126 and accompanying text.

145. 11 U.S.C. § 766(h) (1982). A customer's *pro rata* share of available customer property is calculated in several steps. First, the customer's net equity claim, defined to mean "the total claim of a customer against the estate of the debtor based on the commodity contracts held by the debtor for or on behalf of such customer less any indebtedness of the customer to the debtor," is calculated. 17 C.F.R. § 190.07(b) (1987). The customer's "allowed net equity," essentially equal to the *pro rata* share of the assets available to satisfy his net equity claim, is determined by reference to the "funded balance" of the customer's net equity claim. A customer's funded balance for each of five classes of accounts is calculated by multiplying the ratio of the customer's net equity claim, with certain adjustments, to the total net equity claims for all customers, by the total property allocated for distribution as customer property to the accounts of that class. The customer's allowed net equity is equal to the aggregate of the funded balances of the customer's net equity claims for each account class, modified by certain adjustments specified in CFTC Regulation 190.07(d), 17 C.F.R. § 190.07(d) (1987). The CFTC's regulations provide for reducing the customer's equity by the value of positions transferred on behalf of, or specifically identified property returned to, the customer so that such pre-distribution transfers do not result in a greater than *pro rata* distribution to specific customers.

precepts, and the bankruptcy principle that "equality is equity."[146]

### B. Transfer Provisions of the Bankruptcy Code

As noted above, the legislative history of the Bankruptcy Code reflects congressional recognition that both fundamental purposes of the commodity broker liquidation provisions, customer protection and market protection, would be advanced by transfers of the open positions of an insolvent FCM to solvent firms. The Senate Report describes the trustee's duty to attempt to transfer customer positions and supporting margin to other brokers as an initial and primary duty, based upon the overriding importance of preserving the hedging function of the futures markets:

> This requirement is placed upon the trustee to insure that producers who have hedged their production in the commodities market are allowed the opportunity to preserve their positions.[147]

Similarly, in advocating the enactment of provisions to facilitate transfers, the CFTC had stressed that "in order for the hedging mechanism to work, the integrity of futures contracts must be beyond question, and hedgers must be able to keep their futures positions open as long as their cash positions are open and to close out their futures positions as soon as they close out their cash positions."[148] The CFTC also stressed the importance to the hedging mechanism of "granting statutory recognition to the ability of the various contract markets to take prompt action to protect the commodity customers of their member firms by transferring customers' open trades and margin funds to other futures commission merchants."[149]

The Code's framers also viewed position transfers as a key to market stability in the event of a broker bankruptcy because transfers, by reducing positions under the control of a trustee, would minimize the potential for decisions by the trustee to refuse to make daily margin payments or delivery, events that could have a disruptive effect on the entire marketplace.[150] The House Report commented, for example, that because the securities market is "well established, fluid and generally 'thick,' " the trustee of a bankrupt stock broker "could reject contractual commitments with little impact on the market."[151] By contrast, in the comparatively "thin" commodity markets, "a similar power in the trustee of an insolvent commodity broker could result in a ripple effect disrupting the entire market."[152]

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146. Southeastern Express Co. v. Robertson, 264 U.S. 541 (1924).

147. S. Rep. No. 989, 95th Cong., 2d Sess. 107 (1978). The same reasoning would apply to hedgers of financial instruments or obligations whose effective rate of return depends on maintenance of their hedge positions.

148. Bagley Testimony, *supra* note 28, at 2400.

149. *Id.* at 2404.

150. S. Rep. No. 989, 95th Cong., 2d Sess. 8 (1978).

151. H.R. Rep. No. 595, 95th Cong., 2d Sess. 271-72 (1978).

152. *Id.*

*1. Bulk Transfers Under the Bankruptcy Code and CFTC Regulations*

The Code and Commission regulations consequently contemplate essentially immediate efforts by the trustee to effect transfers of all or a portion of the open positions of the debtor's customers. The principal Code provision, Section 764(b), insulates from the trustee's avoidance power transfers of commodity contracts and funds or property margining or securing such contracts made within five days after the order for relief, if the transfer is approved by the Commission by rule or order, either before or after the transfer.[153] By rule, the Commission has required that it be notified no later than the third business day after the order for relief[154] as to whether a transfer under Section 764(b) of the Code will be made and has provided that, if such transfer is not disapproved by the Commission, it may not be avoided by the trustee.[155]

The Code does not expressly require the trustee to attempt to effect transfers except, as discussed below, in the case of specifically identifiable contracts to the extent that the value of such contracts does not exceed the customer's *pro rata* share of customer property.[156] The Commission's bankruptcy regulations, however, mandate immediate, affirmative efforts by the trustee to effect such transfers. Regulation 190.02(e) requires that the trustee "immediately use its best efforts to effect a transfer" of open customer contracts and equity no later than the fourth business day following the order for relief.[157] In general, all customer accounts with open positions qualify for a bulk transfer, except for accounts which are in deficit.[158] The regulations generally preclude the transfer of funds or property in respect of any account eligible for transfer in excess of a customer's estimated *pro rata* share, *i.e.*, "if the value of such money, securities or property would exceed the funded balance of such account" calculated as of the close of the business day preceding the transfer.[159] In computing a customer's funded balance, which is the measure of equity that may be transferred, the value of any property previously transferred is reflected to assure equivalent treatment to customers as a whole.[160] Although not constrained by the Code to apply a strictly *pro rata* approach to bulk transfers, the Commission's rules contemplate that "in the interests of equity, any bulk transfer should

153. 11 U.S.C. § 764(b) (1978).

154. "Order for relief" is defined to mean "the filing of the petition in bankruptcy in a voluntary case and the adjudication of bankruptcy in an involuntary case." 17 C.F.R. § 190.01(dd) (1987).

155. 17 C.F.R. §§ 190.02(a)(2), 190.06(g) (1987).

156. 11 U.S.C. § 766(c) (1978).

157. 17 C.F.R. § 190.02(e)(1) (1987). The CFTC's regulations provide that clearing organizations and other self-regulatory organizations may not maintain rules that are inconsistent with the regulations applicable to position transfers. 17 C.F.R. § 190.06(a) (1987).

158. 17 C.F.R. § 190.06(e) (1987).

159. 17 C.F.R. § 190.06(e)(2) (1987). *See supra* note 145.

160. 17 C.F.R. § 190.07(b)(4) (1987); 46 Fed. Reg. 57545 (1981); 48 Fed. Reg. 8732 (1983).

approximate, to the extent possible, the distribution which would be made in bankruptcy."[161] A strictly *pro rata* distribution is not, however, a statutory or regulatory prerequisite to insulation of such transfers from avoidance.[162] This flexibility is important because it permits expeditious action to be taken based on estimates, using the shortfall in segregation as a reference point for assessments of the assets available for transfer on a *pro rata* basis, before more complicated calculations of individual net equities can be made.[163]

CFTC regulations expressly contemplate partial transfers if all customer contracts cannot be transferred.[164] Regulation 190.06(f)(3) states that the Commission will not disapprove such a transfer for "the sole reason that it was a partial transfer if it would prefer the transfer of accounts, the liquidation of which could adversely affect the market or the bankrupt estate."[165] Commission regulations also expressly provide for the possibility of the transfer of a portion of a single customer's open commodity contracts if all such contracts cannot be transferred.[166] Such a transfer "may be effected by liquidating that portion of the open commodity contracts held by a customer which represents sufficient equity to permit the transfer of the remainder."[167]

### 2. *Transfer of Hedge Positions Under the Code*

Reflecting the special importance attributed to hedge positions by the Code's framers, the Commission's bankruptcy regulations establish a method for transferring such positions even if a bulk transfer of the debtor's customer accounts cannot be achieved. Although the Code does not expressly address the transfer of hedge positions, it makes special provision for the

161. 46 Fed. Reg. 57545 (1981).

162. 46 Fed. Reg. 57546 (1981).

163. The ability to effect transfers on the basis of estimates without the necessity for completing precise calculations of each customer's funded balance may be critical as a practical matter because of the extremely limited time (as little as one day) that clearing organizations are likely to allow such positions to remain open before exercising contractual authority to liquidate them. *See* 48 Fed. Reg. 8726 (1983); *infra* text at 899-900; 11 U.S.C. § 556 (1984).

164. In discussing the Code provisions for transfer, the Senate Report recognized that "[a]lthough it is preferable for all such accounts to be transferred, exigencies may dictate a partial transfer." S. Rep. No. 989, 95th Cong., 2d Sess. at 107 (1978).

165. 17 C.F.R. § 190.06(f)(3)(i) (1987).

166. 17 C.F.R. § 190.06(f)(3)(ii) (1987). The rule specifies that if any of the contracts to be transferred as part of a partial transfer are parts of a spread or straddle, "both sides of such spread or straddle must be transferred or neither side may be transferred." Implementation of this provision would appear to require the assistance of personnel employed by the debtor FCM in identifying straddle or spread positions.

167. 17 C.F.R. § 190.06(f)(3)(ii) (1987). An election to liquidate a portion of a customer's contracts to facilitate a transfer of the remainder may, however, create the possibility for customer claims contesting the trustee's choice of positions for liquidation or transfer. Although the CFTC's regulations would appear to leave such details in the trustee's discretion, trustees may be reluctant to expose themselves to the risk of controversies over the procedures employed in effecting partial transfers.

disposition of certain "specifically identifiable" property, including commodity contracts, by affording customers a degree of control over the disposition of such property, while property that is not so categorized rests in the exclusive control of the bankruptcy trustee subject to judicial review.[168] The Code provides that the trustee "shall return promptly" to a customer any specifically identifiable security, property, or "commodity contract" or "shall transfer," on such customer's behalf, such security, property, or commodity contract to a commodity broker that is not a debtor under Title 11, subject to CFTC rules or regulations and to the extent that the value of such security, property, or commodity contract does not exceed the customer's *pro rata* share of the debtor's estate if such security, property or commodity contrast were not otherwise returned or transferred.[169] The Code provides that in the event that the value of a customer's specifically identifiable property exceeds his *pro rata* entitlement, the customer may deposit cash with the trustee equal to the difference between the value of such specifically identifiable securities, property, or commodity contracts and his *pro rata* share of the bankruptcy estate.[170] The trustee shall then either return such property to the customer or effect its transfer to another commodity broker, subject to rules or regulations prescribed by the Commission.[171]

Although the Code does not define either "specifically identifiable property" in general or "specifically identifiable commodity contracts" in particular, pursuant to statutorily delegated definitional authority[172] the CFTC has enacted regulations limiting the category of specifically identifiable commodity contracts to properly identified hedge positions.[173] This approach reflects the Bankruptcy Code's legislative history, which suggests "that special treatment of hedge accounts was particularly intended."[174] The Commission's definition of the contracts that may be treated as specifically identifiable also rests upon the practical assessment that while "in general, commodity contracts have no value or existence independent of the equity attributable to them," contracts entered into for hedging purposes "have an intangible value separate and apart from any equity deposited with respect to them which results from their hedging function."[175] The special value imparted to hedge positions by their risk reduction function in respect of cash positions in other markets is the basis for the special burdens

168. *E.g.*, 11 U.S.C. §§ 765, 766 (1978).

169. 11 U.S.C. § 766(c) (1982 & Supp. 1985).

170. 11 U.S.C. § 766(d) (1982 & Supp. 1985).

171. *Id.*

172. 7 U.S.C. § 24(a)(2). Pursuant to this delegated power, the CFTC may provide, "with respect to a commodity broker that is a debtor under Chapter 7 of Title 11 . . . by rule or regulation . . . (2) that certain cash, securities, other property, or commodity contracts are to be specifically identifiable to a particular customer in a specific capacity."

173. 17 C.F.R. § 190.01(kk)(2)(ii) (1987).

174. 48 Fed. Reg. 8726 (1983).

175. 48 Fed. Reg. 8722 (1983).

imposed upon the bankruptcy trustee in disposing of such contracts. Accordingly, Commission regulations provide that the only open contracts eligible for treatment as specifically identifiable contracts are *bona fide* hedge positions as defined in Regulation 1.3(z)[176] or commodity option transactions "determined by the contract market to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[177] To qualify for treatment as specifically identifiable property, such futures and option positions must be "identified on the books and records of the debtor as held for the account of a particular customer" and be held in an account designated as a hedge account in the debtor's records.[178]

Under the CFTC's regulations, such positions are eligible for disposition by the trustee in accordance with customer instructions, provided that the customer first deposits cash with the trustee "in an amount equal to the amount by which the equity to be transferred to margin such contract . . . plus a reasonable reserve in the trustee's sole discretion," exceeds the customer's estimated *pro rata* share of the bankrupt estate, less the value of any previously returned property.[179] The CFTC's regulations also condition such transfers on provision by the customer of "adequate security for the nonrecovery of any overpayments by the trustee,"[180] a requirement that may be satisfied by the trustee's retention of a portion of otherwise transferable equity or by a legally enforceable agreement to return a percentage of the distribution to the debtor's estate in the event of an overpayment.[181]

Within two business days following entry of the order for relief, the trustee must request customer instructions concerning the transfer or liquidation of specifically identifiable open commodity contracts and afford notice that contracts for which transfer instructions are not received prior to the close of business on the fifth business day following entry of the

176. 17 C.F.R. § 1.3(z) (1987).

177. 17 C.F.R. § 190.01(kk)(2) (1987).

178. *Id.* Most large institutional users of the future markets, such as pension funds, are likely to hold positions that would qualify as hedge positions under the CFTC's regulations. In a recent interpretation of the definition of "hedging" in CFTC Regulation 1.3(z), 17 C.F.R. § 1.3(z) (1987), the Commission clarified the applicability of the definition to certain risk-reduction strategies commonly used in portfolio management by institutional investors. 52 Fed. Reg. 27195 (1987).

179. 17 C.F.R. § 190.08(d)(2) (1987). The reserve required to be deposited in the trustee's discretion would be retained to cover administrative expenses. 46 Fed. Reg. 57555 (1981).

180. *Id.*

181. *In re* Incomco, Inc., No. 80-B-11217 (Bankr. Ct., S.D.N.Y. 1980), which was instituted prior to the issuance of the CFTC's bankruptcy regulations, Heritage Commodity Consultants Inc. (Heritage) was permitted to elect between transfer or liquidation of its positions. It elected transfer and its positions were transferred with Heritage's estimated distributive share of the funds available for distribution, after reserving for administrative and other such expenses, based upon Heritage's agreement to return a portion of such funds in the event of an overpayment.

order for relief will be liquidated.[182] The CFTC's regulations also afford the holders of hedge accounts the opportunity to specify at the time their hedge accounts are opened that they desire such accounts to be liquidated by the bankruptcy trustee in the event of bankruptcy, obviating the transfer notice and instruction procedure otherwise required at the time of bankruptcy.[183] Contracts for which instructions have been received but which have not been transferred must be liquidated within ten business days following entry of the order for relief.[184]

These provisions supply a framework for protecting the continuity of open hedge positions that should significantly increase the likelihood that such positions will not be liquidated unless the owner so directs. They may enable the holders of hedge positions to transfer them even if the trustee cannot accomplish a bulk transfer of all or a substantial portion of the FCM's customer accounts. Moreover, in requiring that the trustee request instruction from the owners of designated hedge positions concerning their disposition and the opportunity to supply requisite funds to secure a transfer of such positions, these provisions permit the hedger to make his own assessment of the value of the hedge against the cost of abandoning or reestablishing it. This ability of hedgers under the CFTC's bankruptcy regulations to instruct against the liquidation of their open positions and to supply additional funds as necessary to render such transfers practicable stands in significant contrast to the generally preclusive effect of a segregation shortfall upon the ability to transfer open positions,[185] affording an individual customer the opportunity to advance funds to facilitate transfer of a position that would otherwise be undermargined.

### C. PRE-BANKRUPTCY TRANSFERS

The Commission's regulations also contemplate that transfers of customer positions may occur prior to a bankruptcy filing, on a preventive

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182. 17 C.F.R. § 190.02(b)(2) (1987).

183. *See* 17 C.F.R. § 190.06(d)(1) (1987). CFTC Regulation 190.06(d)(1) states that a commodity broker "must provide an opportunity for each customer to specify when undertaking its first hedging contract whether, in the event of bankruptcy, such customer prefers that open commodity contracts held in a hedging account be liquidated by the trustee without seeking customer instructions." 17 C.F.R. § 190.06(d)(1) (1987). This provision only creates an opportunity to elect in favor of liquidation. To the extent that a hedge customer wishes to preserve the opportunity to elect between liquidation or transfer at the time of bankruptcy, such customer would not avail himself of the pre-bankruptcy liquidation election of CFTC Regulation 190.06(d)(1), but whether a transfer opportunity would in fact be realized in the event of bankruptcy would not be determinable in advance. To the extent that hedge owners specify when opening their positions that they desire liquidation of such positions in the event of bankruptcy, they benefit the firm (and its trustee) by simplifying the disposition of those positions but lose the potential opportunity to maintain those positions through transfers to a solvent firm unless a bulk transfer is achieved. *Id.*

184. 17 C.F.R. § 190.02(b)(2) (1987) In addition, under the CFTC's regulations, the trustee is required to issue margin calls with respect to open contracts and may liquidate accounts which do not maintain requisite margin levels. 17 C.F.R. § 190.02(g)(2) (1987). Accounts which are in deficit must be liquidated. *Id.*

185. *See infra* text at 899-900, 905-07.

basis, when an FCM's capital has become significantly impaired. The Commission's minimum financial rules require that each FCM that knows or should know that its adjusted net capital is less than 150 percent of the minimum fixed by Commission regulation or applicable exchange rule establishing a higher level notify the Commission and the relevant exchange of that fact within twenty-four hours.[186] Further declines in an FCM's capital require that the FCM take action to transfer all customer accounts. Under Regulation 1.17(a)(4), an FCM that cannot demonstrate compliance with applicable minimum financial requirements "must transfer all customer accounts and immediately cease doing business as a futures commission merchant until such time as the firm is able to demonstrate such compliance."[187] These provisions are designed to facilitate transfers "before a firm becomes seriously undersegregated" and thus "to permit ameliorative measures to be taken before customer losses occur."[188]

As previously discussed,[189] the authority vested in the CFTC by Section 764(b)(1) of the Bankruptcy Code to insulate from the trustee's avoidance powers "by rule or order" transfers of commodity contracts and supporting margin made "before five days after the order for relief"[190] permits protection of such pre-bankruptcy transfers against attack in an ensuing bankruptcy proceeding. Pursuant to this authority, the CFTC has provided by rule that pre-bankruptcy transfers made in compliance with Regulation 1.17(a)(4) of the CFTC's minimum financial regulations are not avoidable by the trustee unless disapproved by the Commission.[191] In affording general protection for such pre-bankruptcy transfers, the CFTC stressed that the absence of such a safeguard could diminish the willingness of transferee

186. 17 C.F.R. § 1.12 (1987).

187. 17 C.F.R. § 1.17(a)(4) (1987). The regulation states, however, that if the FCM "immediately demonstrates to the satisfaction of the Commission or the designated self-regulatory organization the ability to achieve compliance, the Commission or the designated self-regulatory organization may in its discretion allow such registrant up to a maximum of 10 business days in which to achieve compliance without having to transfer accounts and cease doing business as required above." *Id.* The Regulation 1.17(a)(4) requirement of cessation of business is thus qualified by the FCM's opportunity to demonstrate "the ability to achieve compliance" and should not be viewed as an automatic termination of the firm's business operations and status as an FCM. *Compare* 17 C.F.R. § 1.17(a)(4) *with* Koci v. Herbert Freehling, Trustee of Bengal Trading Corp., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,231 (Bankr. Ct., S.D. Fla. 1981) (trustee's claim that wire transfer of customer funds should be distributed ratably to all customers in accordance with 11 U.S.C. § 766(h) rejected on the ground that because debtor FCM was not in compliance with CFTC's minimum capital requirements, it was "automatically prohibited from doing business as a futures commission merchant," and hence was "precluded by law from accepting and handling [the depositing customer's] money at the time it was transferred," and the putative customer therefore could not become a "customer" or his funds become "customer property" within the meaning of the Bankruptcy Code).

188. 46 Fed. Reg. 57545 (1981).

189. *See supra* text at 878.

190. 11 U.S.C. § 764(b)(1).

191. 17 C.F.R. § 190.06(g)(i) (1987).

firms to accept transfers and thereby undermine a key protection of customers of failing FCMs and of SROs in addressing such failures. As the "proper functioning of the Commission's minimum financial rules depends to a great extent on the cooperation of regulated firms," if the Commission could not insulate such pre-bankruptcy transfers from avoidance as preferences, they could be recalled at a later date, "potentially jeopardizing the financial stability of the transferee and interfering with the willingness of firms to accept account transfers."[192]

In proposing general protection for transfers made in compliance with Regulation 1.17(a)(4), the Commission observed that "[i]deally, any pre-bankruptcy transfer of assets under the minimum financial rules would approximate a post-bankruptcy distribution scheme, while avoiding the litigation and other administrative expenses commonly associated with bankruptcy proceedings."[193] In addition, transfers under Regulation 1.17(a)(4) may afford substantial practical advantages over those effected in the context of a bankruptcy or receivership proceeding. As noted above, Regulation 1.17(a)(4) transfers "should occur before a firm becomes seriously undersegregated"[194] and, therefore, should avoid the chief obstacle to transfer, the unwillingness of transferee firms to accept undermargined accounts.[195] Moreover, such transfers may be effected without compliance with the specific time limitations and other requirements applicable in bankruptcy. Also, the assistance of personnel of the failing firm to facilitate such transfers may be more readily available outside of a bankruptcy context, and the CFTC's regulations "provide more flexibility in effecting protected transfers prior to bankruptcy than thereafter because the Commission desires to give its current safeguards ample opportunity to work."[196] Consequently, while the CFTC stated its view that pre-bankruptcy transfers should "approximate"[197] post-bankruptcy distributions, it also noted that Regulation 1.17 "does not require transfers to be made *pro rata.*"[198]

### D. Market Protections Afforded by the Bankruptcy Code

As discussed above,[199] the Bankruptcy Code's commodity broker liquidation provisions reflect Congress's intent to mitigate the dangers to the

192. 46 Fed. Reg. 57545 (1981). In addition to fraud, grounds for Commission disapproval of such transfers could include failure to comply with CFTC Regulation 1.17(a)(4) in that fewer than all customer accounts were transferred. *See* 46 Fed. Reg. 57545 (1981); 48 Fed. Reg. 8733 (1983).

193. 46 Fed. Reg. 57545 (1981). Pre-bankruptcy transfers pursuant to CFTC Regulation 1.17(a)(4) hold potential advantages for the FCM as well as for its customers because if all customer accounts are transferred, the firm will no longer constitute a "commodity broker" under the Code, as by definition a commodity broker must have a customer, and will thus be eligible for reorganization under Chapter 11. *See* 11 U.S.C. § 101(5); *supra* note 17.

194. 46 Fed. Reg. 57545 (1981).

195. Bagley Testimony, *supra* note 28, at 2400.

196. 46 Fed. Reg. 57545 (1981).

197. *Id.*

198. *Id.* at n.68.

199. *See supra* text at 872.

stability of the marketplace posed by commodity broker bankruptcies. The transfer of futures positions, pursuant to the provisions discussed above, constituted a key objective of the Code not only because such transfers would preserve the hedging and consequent risk transfer or insurance functions of the futures markets but also because such transfers should support the integrity of the marketplace and of previously undertaken transactions against the impact of an individual firm failure by reducing the potential for related defaults in making margin payments and delivery.[200] Additionally, position transfers are consistent with the concept of an exchange market, where the obligations and credit risk of the counterparty are assumed by a clearing organization rather than individual market participants, and assessments of the creditworthiness of individual contractual counterparties should therefore be unnecessary.[201]

A second critical market safeguard enacted by the Code was a reversal of previous decisions indicating that margin payments made to a clearing organization or other commodity broker prior to a bankruptcy filing might be avoided by a bankruptcy trustee. Protection against recovery of such margin payments was viewed as imperative by the CFTC because if such payments could be recaptured by the trustee, the failure of an FCM could undermine the stability of other brokers and the clearing organization itself.[202] Indeed, the administrative burden alone of retracing and reclaiming margin previously passed through the clearing system to counterparty clearing firms and their customers could threaten the orderly operation of the clearing system.[203]

Liability on the part of a clearing organization for past margin payments, which would not necessarily be recoverable from its transferee clearing firms, would impose financial demands upon the clearing organization at odds with the essential character of the clearing system as historically constituted and operated. The chief function of the clearing system is to ensure the integrity of futures contracts accepted for clearance, an objective accomplished primarily through the daily mark-to-market system by which the clearing organization, as the omnibus exchange counterparty, guarantees that the parties on the profitable side of a transaction will receive their profits and that the parties on the losing side will pay their losses.[204] Demands for variation margin payments are issued on a daily and, at times,

200. *E.g.*, S. Rep. No. 989, 95th Cong., 2d Sess. 8, 107 (1978); *cf.* H.R. Rep. No. 1195, 96th Cong., 2d Sess. 6-7 (1980).

201. *See supra* note 37.

202. Bagley Testimony, *supra* note 28, at 2405-06.

203. *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97th Cong., 1st Sess. 167 (1981) (testimony of Stephen F. Selig) ("If the Trustee of [a major firm that had become insolvent] tried to go out into the system to recover money paid as margin, then the whole system would become paralyzed because nobody would know who was entitled to what.").

204. Bagley Testimony, *supra* note 28, at 2379-82; *see supra* text at 855.

an intra-day basis, and must be met in cash within a time frame that may be as limited as one hour.[205] Clearing organizations operate principally as conduits for the transfer of variation margin funds, which once distributed net to zero, among their members pursuant to the daily mark-to-market system. Original margin is intended as a performance bond against such payments being made. Clearing organizations are thus not regarded as stakeholders and they are not required to maintain independent resources.[206] Although clearing organizations may be partially secured by original margin deposits held on behalf of a defaulting firm and its customers, once such deposits are exhausted, a clearing organization would be obliged to resort to clearing member guarantee deposits,[207] trust funds[208] and, depending on the clearing organization, limited or unlimited assessment powers[209] with respect to its members, sources of funds that do not generally contemplate significant clearing firm losses.[210] Consequently, if the entitlement of the clearing organization to clearing margin received prior to insolvency were successfully contested, a clearing organization could have potential exposure to return variation margin payments made over a period of weeks or months prior to a bankruptcy. The financial viability of the clearing organization and, therefore, of the exchange marketplace as a whole, could then be jeopardized.[211]

These concerns were underscored by the decision in *Seligson v. New York Produce Exchange,* in which the trustee in bankruptcy for Ira Haupt

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205. Bagley Testimony, *supra* note 28 at 2379-82.

206. *See* Response of the CFTC to Certain Written Questions, *supra* note 83, at 45-47.

207. *See, e.g.,* CSC Clearing Corporation Rule 216 (providing, *inter alia,* that each clearing member shall deposit and maintain in the Guaranty Fund an amount equal to the lesser of 10 percent of "working capital" or $500,000, and any additional amount the Board may from time to time prescribe).

208. The Chicago Mercantile Exchange reportedly maintains assets in excess of $30 million which can be applied to purposes determined at the discretion of its Board of Governors. (That the trust is discretionarily as opposed to compulsorily committed appears to be a function of its tax treatment as a grantor trust. *See* 26 C.F.R. §§ 1.671-1.678 (1987)). Similarly, the Chicago Board of Trade maintains an irrevocable trust with assets reported at in excess of $5 million which apparently may be employed at the discretion of the Board of Trustees to supply funds for the transfer of customer positions or to pay customer insolvency losses. *See* National Futures Association, *supra* note 2, at 114.

209. *Compare* CSC Clearing Corporation Rule 302 (establishing a formula for calculating assessments based upon the proportion of contracts cleared for the defaulting clearing member and establishing a maximum assessment within a given period) *with* New York Mercantile Exchange Clearing Rule 9.03(D) (providing that losses to its Guaranty Fund shall be covered from operating surplus to the extent determined by the Board but that "the balance of such loss shall be made up by an assessment in equal shares upon each of the Exchange members").

210. Response of the CFTC to Certain Written Questions, *supra* note 83, at 45-47.

211. *See* Bagley Testimony, *supra* note 28, at 2406. Conversely, to the extent that the clearing organization could recover variation margin payments previously made to clearing firms on the opposite side of the market, that action could jeopardize the financial stability of its transferee firms, which are likely to have transferred any margin payments received from the clearing organization to their own customers. Response of the CFTC To Certain Written Questions, *supra,* note 83 at 45.

& Co., an FCM, sought to set aside over twelve million dollars in variation margin payments made on behalf of the firm's customer account to the New York Produce Exchange Clearing Association during a seven-day period shortly prior to the bankruptcy filing. Although the extent of the clearing organization's liability was not fully resolved in that proceeding, the reasoning adopted by the court in denying the clearing organization's motion for summary judgment indicated that such liability could exist to the extent that the clearing organization had notice of the debtor's "precarious" financial position.[212] In advocating statutory protection against recovery of margin payments in the situation presented in *Seligson,* the CFTC stressed that a clearinghouse "by its very nature, must always have knowledge of the market positions of its clearing members."[213] Consequently, to the extent that such knowledge was viewed as undermining the clearinghouse's good faith in accepting margin payments, the clearing organization "may be forced into a position where it is the guarantor not only of any variation margin payments its clearing members might fail to make between their first such failure and the closing out of their positions, at most a few days, but also of any payments they make over a much longer period of time, perhaps over several months."[214] The CFTC therefore urged enactment of a statutory provision to protect against reversal in bankruptcy of all variation and original margin payments made to any clearing organization or commodity broker prior to bankruptcy "unless made in collusion with such clearinghouse or such futures commission merchant with the intent of defrauding other creditors of the bankrupt futures commission merchant."[215]

Responding to the CFTC's concerns, the Code established a policy against reversal of variation margin payments and other deposits except in cases of fraud,[216] a measure that "facilitates pre-petition transfers and protects the ordinary course of business in the market."[217] The legislative

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212. Seligson v. New York Produce Exchange, 394 F. Supp. 125, 133 (S.D.N.Y. 1975). In *Seligson,* the bankruptcy trustee alleged that the margin payments were transferred without fair consideration at a time when Ira Haupt & Co. was insolvent and therefore constituted fraudulent transfers under the New York Debtor and Creditor Law. *Id.* In denying the clearing association's motion for summary judgment, the court held that there were genuine issues of material fact as to whether Haupt received fair consideration, a standard requiring that the consideration have been given in good faith and constitute a fair equivalent for the transfer such that "the bankrupt's estate is not depleted as a result of the transfer." *Id.* The court found that issues of fact existed as to the clearing association's good faith because of evidence of the association's awareness of the firm's "precarious position in the market" and because it was questionable whether considerations such as "the promise of the Association to clear Haupt's contracts or its forbearance to liquidate Haupt's positions in any way offset the depletion of the estate caused by the transfer of $12 million in margin." *Id.*

213. Bagley Testimony, *supra* note 28, at 2406.

214. *Id.* The CFTC commented that "[e]ven the financial stability of the clearing houses, with often millions of dollars at their disposal, would be severely threatened by such exposure." *Id.*

215. *Id.*

216. H.R. REP. No. 595, 95th Cong., 2d Sess. 392 (1978).

217. *Id.*

history reflects an intention specifically to overrule *Seligson v. New York Produce Exchange*,[218] and thereby to "protect all margin payments in the customer-broker-clearinghouse chain" and "substantially reduc[e] the likelihood that the bankruptcy of one customer or broker will lead to the bankruptcy of another broker or clearinghouse."[219]

As currently in effect, Section 546(e) of the Code[220] provides that a trustee may not avoid and recover margin payments and settlement payments except pursuant to Section 548(a)(1),[221] which provides for recovery of certain pre-petition fraudulent transfers. Under the latter provision, the trustee may avoid a transfer made within one year prior to the filing of the petition that was made by the debtor "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made . . . indebted. . . ."[222] Further, Section 548(d)(2)(B) makes clear that a commodity broker, including a clearing organization, that receives a margin payment or settlement payment "takes for value to the extent of such payment," resolving in favor of the clearing organization a key issue raised in the *Seligson* case and providing a further assurance against the recovery of payments from good faith transferees.[223] Thus, margin payments generally are not voidable as preferences. This result follows from the preclusion by Section 546(e) of recovery of margin or settlement payments except pursuant to the fraudulent transfer provision of Section 548(a)(1) and because such payments would constitute contemporaneous exchanges for equivalent value under Section 547(c)(2).[224]

A third important market protection was added to the Bankruptcy Code in 1982 to prevent interference with contractual rights of clearing organizations and other commodity brokers to liquidate a bankrupt firm's open contracts.[225] The CFTC had advocated enactment of a provision that would protect rights to liquidate futures contracts and to receive margin payments

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218. S. Rep. No. 989, 95th Cong., 2d Sess. 106 (1978).

219. *See* 124 Cong. Reg. 517,433 at 764-5 (daily ed. Oct. 6, 1978) (remarks of Senator Mathias) (quoted in 4 Collier on Bankruptcy ¶ 764.01[3] n.9 (15th ed. 1987)).

220. 11 U.S.C. § 546(e) (1982 & Supp. III 1985). Section 546(e), which was previously designated Section 546(d), was enacted in 1982 to replace the original margin avoidance provision of the Bankruptcy Reform Act, Section 764(c). 1 A. Herzog & L. King, Bankruptcy Code (Collier Pamphlet Edition 1987) at 373.

221. 11 U.S.C. § 548(a)(1) (1982 & Supp. III 1985).

222. *Id.*

223. The fact that margin payments are deemed to have been made for full consideration does not, however, protect against reversal of such payments in cases of fraud or collusion, as provided in Section 548(a)(1), or prevent clearing organizations or FCMs from being held in breach of the CEA by reason of accepting or paying margin funds in circumstances in which such action entails participation in or furtherance of unlawful conduct. *See supra* note 91.

224. 11 U.S.C. § 547(c)(2) (1982 & Supp. III 1985). *See generally* 4 Collier on Bankruptcy §§ 546.05, 548.09[2], 764.01[3] (15th ed. 1987).

225. 11 U.S.C. § 556 (1982). This provision was incorporated into the Bankruptcy Code in 1982 by Public Law No. 97-222, "Technical and Substantive Changes in Bankruptcy with Respect to Securities and Commodities." 4 Collier on Bankruptcy ¶ 556.01 (15th ed. 1987).

notwithstanding the Code's provision for an automatic stay of creditors' remedies[226] and its prohibition against treatment of the bankruptcy of a customer as an event of default.[227] In supporting the enactment of such protections, the CFTC observed that it was standard business practice for commodity customer agreements to permit the liquidation of a customer's positions "where the futures commission merchant maintaining a customer account believes that a customer may not be able to meet its obligations without an actual default."[228] Additionally, clearing organization rules commonly provide for suspension or termination of the clearing privileges of a clearing member, if other remedial measures are not effective, upon specified events including insolvency or the filing of a bankruptcy petition, and for the liquidation or transfer of the firm's positions as rapidly as possible following such suspension or termination.[229] According to the CFTC, "it is standard practice" for such clearing organization rules to be incorporated in every contract purchased or sold on or subject to the rules of the exchange; consequently "it would . . . be correct to say that the right of the applicable clearing organization to liquidate a contract upon its member's insolvency becomes a part of each commodity contract it clears."[230]

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226. 11 U.S.C. § 362 (1982 & Supp. III 1985).

227. 11 U.S.C. § 365(e) (1982); Johnson Statement, *supra* note 84, at 24.

228. Response of the CFTC to Certain Written Questions, *supra* note 83, at 66.

229. *Id.* at 67. *See, e.g.,* Board of Trade Clearing Corporation By-Law 804 (upon default Clearing Corporation may cause all open trades with such member to be closed in the open market); COMEX Clearing By-Law 6.1(f) (upon termination of clearing privileges, all open contracts to be closed out "as expeditiously as is practicable but not later than the close of trading on the Exchange on the business day following such termination" unless open contracts are transferred; if the clearing member is an FCM, COMEX Clearing shall endeavor to transfer such open contracts in lieu of liquidation).

230. Response of the CFTC to Certain Written Questions, *supra* note 83, at 67-68. The Commission described the right of clearing organizations to liquidate contracts of insolvent member firms as one that "may be exercised unilaterally without the consent of the customer for which such contracts are being liquidated." *Id.* at 69. *But see* 17 C.F.R. § 190.02(b)(1) (1987) (no later than two business days after order for relief, trustee must request customer instructions concerning the transfer or liquidation of specifically identifiable contracts not required to be liquidated under regulation 190.02(f)(1), 17 C.F.R. § 190.02(f)(1) (1987). The Commission also stressed, however, that "[t]here are some circumstances . . . in which the immediate closing of contracts might not be required or even desirable and the rules of the clearing organizations which permit liquidations recognize this fact." Response of the CFTC to Certain Written Questions, *supra* note 83, at 69. To the extent that the liquidation authority of clearing organizations is recognized to be "contractual" and is defined as such by Section 556, that authority would appear to be modifiable by contract. However, as a practical matter, such a result would be unlikely to be achievable by individual clearing firms or their customers. As between the clearing organization and the clearing firm, by-laws are established by the vote of the clearing organization's member clearing firms and would not be modifiable by a single firm. With regard to clearing firm customers, clearing organizations generally disavow contractual privity on the ground that their only "customers" are their clearing member firms. COMEX Clearing By-Law 6.19(f) provides, for example, that "in no event shall [the clearing organization], any other Clearing Member, or any director, officer, employee, or agent of the Corporation or any other Clearing Member" be liable to a defaulting FCM, its customers or

Enactment of Section 556 of the Code reflected specific concerns that Section 365(e), which prohibits the termination or modification of executory contracts by reason of the commencement of a bankruptcy case, could be construed to preclude enforcement of "close-out" provisions for the liquidation of open market positions (arguably otherwise executory contracts subject to affirmance) of bankrupt FCMs by clearing organizations or of open market positions of a bankrupt customer by an FCM until an actual default on such contracts occurred.[231] The Commission observed that "the volatility of the commodities market is ordinarily such that to require a firm to await a default before liquidating open positions could be particularly damaging."[232] Not only might millions of dollars be saved by the ability of a trustee, clearing member, or clearing organization "to close out positions rapidly in a customer bankruptcy" but prompt liquidation could be imperative "to stabilize the market."[233] Statutory protection of contractual liquidation rights also was sought "to allay concerns that the commodity broker carrying the positions of a bankrupt customer or firm would have to petition a court to vacate or modify the automatic stay to allow the broker to close out . . . positions," a requirement that would expose the broker to "the risk of sustaining substantial losses" before a court order could be obtained.[234]

The CFTC stressed "the special necessity for not restricting the normal workings of the commodities futures clearing system which will liquidate open positions if other alternatives do not appear sound."[235] In the Commission's view, "it would be very difficult for the judgment of a court to be better than that of the clearing organization in determining when contracts should not be liquidated and . . . any court proceedings would inevitably take time during which there could be a substantial loss to the bankrupt estate as the result of price changes."[236] Consequently, even "to permit the appropriateness of a contract's liquidation to be debated before a court is to risk not only the rapid mooting of the question in the marketplace, but

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any other person because its open contracts were not transferred." By-law 515 of the Board of Trade Clearing Corporation provides that the liability of the Clearing Corporation "shall be limited to losses resulting from the substitution of the Clearing Corporation upon contracts between clearing members" and that the Clearing Corporation will not be liable for, *inter alia,* "obligations to a customer by a clearing member." In addition, any assumption by clearing organizations of direct contractual privity with clearing firm customers could be viewed as jeopardizing the generally accepted authority of clearing organizations to maintain and employ customer margin funds posted by a clearing firm as a common fund securing the collective margin obligations of all customers of the depositing firm without regard to the individual positions or interests of specific customers. *See supra* notes 91-95 and accompanying text; *infra* text at 896-901.

231. Johnson Statement, *supra* note 84, at 24-25.

232. *Id.* at 25.

233. *Id.* at 25-26.

234. *Id.* at 26.

235. Response of the CFTC To Certain Written Questions, *supra* note 83, at 72.

236. *Id.* at 72-73.

also . . . significant injury to other market participants."[237] Moreover, a court-ordered stay would create the danger that in the event of a price movement against open positions protected against liquidation, the clearing organization or FCM would be forced to use its own funds to satisfy demands for variation margin on those positions.[238] In extreme cases where the frozen positions were large and the adverse market movement severe, the financial stability of the clearing organization itself could be jeopardized, creating a "potential threat to the stability of the entire market."[239]

As enacted, Section 556 provides, in part, that "[t]he contractual right of a commodity broker . . . to cause the liquidation of a commodity contract" because of conditions of the kind specified in Section 365(e)(1), as well as the right to variation or maintenance margin payments from a trustee with respect to open contracts "shall not be stayed, avoided, or otherwise limited by operation of any provision of this Title or by the order of a court in any proceeding under this Title."[240] Section 556 also states that the term "contractual right" includes "a right set forth in a rule or bylaw of [a] clearing organization or contract market or in a resolution of the governing board thereof."[241]

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237. *Id.* at 77-78.

238. Response of the CFTC to Certain Written Questions, *supra* note 83, at 46-47.

239. *Id.* at 44-47.

240. 11 U.S.C. § 556 (1982).

241. *Id.* The Code's specific prohibition in Section 556 against stays or other interference with contractual rights to liquidate commodity contracts should be compared to the parallel Code provision with respect to contractual rights to liquidate securities contracts, Section 555 of the Code, 11 U.S.C. § 555 (1982 and Supp. IV 1986). The latter provision precludes the stay, avoidance or other interference with the exercise of contractual rights of stockbrokers, financial institutions or securities clearing agencies to liquidate securities contracts because of conditions of the kind specified in Section 365(e)(1) "by operation of this Title or by order of a court or administrative agency in any proceeding under this Title *unless such order is authorized* under the provisions of the Securities Investor Protection Act of 1970 (15 U.S.C. § 78aaa *et seq.)* or any statute administered by the Securities and Exchange Commission." (Emphasis added). The ability of SIPC to secure a stay of the exercise of contractual liquidation rights in respect of securities contracts, in contrast to the across-the-board preclusion of such stays in respect of futures contracts, reflects fundamental differences in the insolvency frameworks applicable to securities brokers and to commodity brokers. These include the facts, that SIPC insures securities customer accounts; that, for purposes of SIPC recoveries, net equity is determined as of the bankruptcy filing date while for futures customers, net equity fluctuates until all open positions have left the debtor's estate; and that SIPC has general power to transfer open securities commitments throughout a bankruptcy proceeding whereas "the transferability of commodity positions becomes impracticable as a matter of law on the fifth day subsequent to a bankruptcy filing," except in the limited circumstances in which positions may be transferred pursuant to customer instruction. Response of the CFTC to Certain Written Questions, *supra* note 83, at 71-72.

In precluding interference with contractual liquidation rights, the Code affords seemingly unreviewable discretion to clearing organizations to liquidate open futures contracts, effectively requiring that a representative of a defaulting firm's customers or of the firm itself secure the forebearance of the clearing organization from liquidating open positions in order to assure an opportunity to transfer open futures positions. In promulgating its bankruptcy regulations,

## III. Customer Protection Implications of the Volume Default

Although Volume Investors was placed in receivership rather than in bankruptcy,[242] the Bankruptcy Code provisions formulated to protect customers of an insolvent commodity broker nonetheless should serve as an appropriate substantive measure of the extent to which the interests of the firm's customers were effectively protected.[243] As these provisions were

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the CFTC observed that "as a practical matter, [it] would not expect a clearing organization to wait more than one business day before closing out the open positions of an insolvent commodity broker unless the trustee or customers holding large positions provided sufficient assurances that variation margin payments would be met or of other security until such time as a transfer of those positions could be effected." 48 Fed. Reg. 8726 (1983). The exercise of liquidation authority by clearing organizations may, however, be limited in particular factual circumstances by reason of the clearing organization's complicity in wrongdoing or its knowledge of facts that could render it chargeable with abetting a wrong by exercising otherwise lawful authority. *See supra* note 91.

242. Following the appointment of Volume's receiver, two of the firm's defaulting customers, Gerald Westheimer and Valerie Westheimer, filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. *In re* Gerald Westheimer, No. 85 Bkcy. 10479 (1985) and *In re* Valerie Westheimer, No. 85 Bkcy. 10480 (1985). Volume's receiver applied to the receivership court for withdrawal of these matters from the Bankruptcy Court, based upon 28 U.S.C. § 157 (which provides for withdrawal of a bankruptcy proceeding "if the court determines that resolution of the proceeding requires consideration of both Title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce"), contending that resolution of the bankruptcy petitions would require consideration of the CEA. The receiver also applied for dismissal of the bankruptcy petitions pursuant to 11 U.S.C. § 1112(b) on the ground that they were allegedly filed in bad faith to avoid a warrant of attachment issued against the Westheimers' assets in an action brought against them by the Volume receiver. *See* Memorandum of Law in Support of Receiver's Motion for Withdrawal and Dismissal of the Westheimer's Bankruptcy Cases, Wohl v. Westheimer, 610 F. Supp. 52 (S.D.N.Y. 1985). The receivership court granted the receiver's application. CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. April 16, 1985 hearing).

243. Conversely, the extent to which receiverships such as the *Volume* proceeding depart from substantive bankruptcy protections and thus fall short of achieving the objectives of the Bankruptcy Code may also reflect on the Code itself as a remedial mechanism designed to respond to the special problems presented by the bankruptcy of commodity brokers. The relatively greater incidence of use of receivership proceedings for the liquidation of commodity brokers over bankruptcy proceedings renders the choice of law to be applied in receiverships particularly significant. The predominance of receiverships over bankruptcy proceedings in the liquidation of insolvent commodity brokers may be attributable in part to the absence of express statutory authority on the part of the CFTC to initiate bankruptcy proceedings in respect of insolvent commodity brokers. However, when a clearing firm or other FCM fails, immediate action is necessary to preserve the assets of the firm and to protect its customers' interests, actions for which the CFTC is generally far better situated than the firm's customers. In the absence of authority to institute a bankruptcy proceeding, the CFTC's most effective means of protecting the interests of the customers of a failing firm for which it is impossible to transfer accounts is likely to be institution of a judicial receivership proceeding that, like a bankruptcy filing, places the assets of the firm under the protection of a court-appointed representative with responsibility for safeguarding the interests of the firm and its customers, thus preventing *de facto* differential treatment of customers. Such action does not preclude a bankruptcy filing but affords the receiver an opportunity to assess the available assets and claims and determine whether a bankruptcy filing would best serve the interests of the firm's

formulated specifically to address the unique problems posed by commodity broker insolvencies, the Code's commodity broker liquidation provisions would appear to supply the most relevant legal standards for receiverships that operate to liquidate an FCM's business, at least as to distributional issues such as the priority of customer claims.[244] Since receiverships are remedial mechanisms generally governed by flexible equitable principles,[245] their use should not materially diminish pre-existing protections or entitlements of commodity customers and other interested parties conferred by the CEA or other applicable law. A contrary result would be inequitable and could undermine the very procedural economies sought to be advanced by receiverships. If Bankruptcy Code customer protections are not observed at least in principle when a receivership proceeding is used to distribute the assets of an insolvent commodity broker, customers thereby disadvantaged, if fully informed, would presumably seek the protection of the bankruptcy laws.[246] Moreover, a significant departure from the tenets of the Bankruptcy Code in this context would enable the form of the proceeding to materially alter substantive rights, a result disfavored in the law and evidence of unfairness in practice.

A further reason why the receivership form of the proceeding should not result in departures from the substantive protections afforded by the Bankruptcy Code is that those protections essentially derive from and parallel the treatment of property and customers under the Commodity Exchange Act. Consequently, to the extent that the Bankruptcy Code is not honored in receivership proceedings, these CEA precepts nonetheless should secure an approximately equivalent result for an insolvent firm's customers.[247] For example, the Bankruptcy Code customer priority provides specific statutory recognition in bankruptcy of customer interests defined by Section 4d(2) of the CEA.[248]

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customers and other creditors. In addition, the greater procedural flexibility of receiverships, which can accommodate functions ranging from protective custody of customer funds to liquidation and distribution of a firm's assets under procedures tailored to the case and modifiable to meet changed circumstances, may render receiverships particularly useful remedies in conjunction with CFTC enforcement proceedings against firms in apparent violation of the CFTC's financial regulations or other legal requirements. *See generally* Teuting & King, *Funds Protection: An Overview of What Happens When a Commodity Broker Becomes Insolvent,* 7 J. OF FUTURES MARKETS at 99-101 (Winter, 1987).

244. *But see* Johnson v. Studholme, 619 F. Supp. 1347, 1348-49 (D. Colo. 1985) (avoidance provisions of Bankruptcy Code do not apply in non-bankruptcy receiverships).

245. 1B J. MOORE, J. LUCAS & T. CURRIER, MOORE'S FEDERAL PRACTICE ¶ 0.419[2] (2d ed. 1984).

246. An involuntary bankruptcy petition may be filed by three creditors having a total of at least $5000 in unsecured claims. 11 U.S.C. § 303(b). Although commodity customers hold a statutory first priority (subject to certain administrative expense claims), their claims are not "secured" by customer property in the conventional sense.

247. The Volume receiver's application for withdrawal of the bankruptcy petitions filed by the Westheimers rested in part upon the contention that disposition of the bankruptcy petitions would require application of the CEA. *See supra* note 242.

248. *See supra* text at 872-876. At least as to matters such as the scope of customer

Nonetheless, the Volume receivership demonstrated the extent to which seemingly clear bankruptcy principles might be disputed or even, potentially, disregarded in receiverships. For example, in the Volume receivership the view was advanced that the priority claims of the firm's nondefaulting customers did not extend beyond segregated funds, an anachronistic view recalling the decision in *In the Matter of Weis Securities,* which was explicitly reversed by the Code.[249] To the extent that such basic customer protections remain open to dispute in receiverships, the protection of commodity customers affected by commodity broker insolvencies retains the uncertainty that impelled enactment of the express statutory protections of commodity customers provided by the Bankruptcy Reform Act.[250]

In key respects, however, the Volume receivership eventually achieved the ultimate objectives of the Bankruptcy Code's provisions for the protection of commodity customers. For the most part, these results were obtained by compromise and without producing clear judicial precedent to guide future cases. However, despite the fact that Volume's customers received full compensation by means of consensual arrangements rather than judicial enforcement of priority claims, it is reasonable to infer that assessments of the respective legal rights of the parties shaped the compromises eventually achieved and that as the governing legal principles are further defined and clarified, similar controversies can be resolved more expeditiously in the future.

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interests in property entrusted to an FCM, the CEA and the Bankruptcy Code should provide essentially congruent and overlapping legal standards. The extent to which state law may provide supplemental rules of decision on matters for which the CEA or Bankruptcy Code provides no directly relevant rule is less clear. *See, e.g.,* Teuting & King, *supra* note 243, at 100-01 (noting paucity of authority governing the proper scope of an equity receiver's powers in the context of an FCM liquidation and that "[m]atters are further complicated by [uncertainty as to] the extent to which state law will govern the receivership, an issue which is largely unresolved").

249. *In re* Weis Securities, Inc., [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,108 (S.D.N.Y. 1975). *See supra* text at 874-876. The extent to which the Volume receivership proceeding engendered controversies readily resolvable under the Bankruptcy Code is discussed more fully in Corcoran, *Lessons of the Volume Investors Corporation Default,* Eighth Annual ALI-ABA Course of Study on Broker-Dealer Regulation (1986) at 11-13.

250. *See supra* text at 873-74. The uncertainty surrounding the applicability of Bankruptcy Code provisions and policies in commodity broker receiverships such as Volume's reflects, as counsel for Volume's receiver stressed in filings with the receivership court, that the Volume proceeding was the first "major receivership of a futures commission merchant that was a member of a commodity clearing organization" since the CFTC's establishment in 1975. Consequently, the case "presented numerous legal issues for which there is at present no definitive precedent, including the proper interpretation of the segregation requirements of the Commodity Exchange Act and CFTC Regulations, the correct application of provisions of the new Bankruptcy Code, and the new CFTC Regulations thereunder, the correct meaning and application of [COMEX Clearing's] rules, the proper basis for determining customer equities in a forced liquidation of a clearing member, and the priorities as among different categories of claimants." Reply of Receiver's Attorneys to CCA Objections to Fee Applications, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1986).

*Priority of Customer Claims.* To the extent that Volume's customers received compensation for the liquidation value of their positions, that result can be seen as a reflection of the special status of commodity customers under both the CEA and the Bankruptcy Code. As discussed above, the "bridge" loan that facilitated a full distribution to Volume's customers represented an extension of credit conditioned upon the availability to recompense the COMEX of certain funds owed by the firm's defaulting customers in settlement of their liability to the receivership. The Code's customer priority provisions apparently made clear or reinforced basic equitable assessments that such funds should be subject to the first claim of Volume's nondefaulting customers and that customer claims preceded claims of the clearinghouse for the recovery of margin funds advanced to the other side of the market or of general creditors.[251]

If assessments of available recoverable customer property were made promptly and such anticipated recoveries employed as the basis for bridge loans such as eventually occurred in *Volume,* distributions to a defaulting firm's customers could be greatly expedited in many cases.[252] The Bankruptcy Code customer priority provisions and pertinent CEA provisions thus should facilitate settlements such as that in *Volume* that recognize the primary entitlement of customers in a brokerage insolvency to all funds that actually were or should have been in segregation.

*Pro Rata Distribution of Customer Property.* In addition to the priority of customer claims, the Bankruptcy Code generally is intended to assure customers of equality in the distribution of customer property and to prevent a race among creditors to recover their funds. The events following Volume's default raised questions concerning equality of distribution of the firm's assets which, in the absence of a settlement affording full customer compensation, could have been resolved by reference to the Bankruptcy Code's *pro rata* distribution standard.[253] To the extent that collusive transfers allegedly were made by Volume or Volume representatives in anticipation of or immediately following the firm's default by which certain customers

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251. Contentions that clearing organization claims for funds advanced as payment of variation margin on Volume's customer positions constituted customer claims surfaced in the *Volume* case but were not litigated. However, the settlement eventually achieved effectively subordinated such claims to those of Volume's customers. *See supra* text at 860-62; Reply of Receiver's Attorneys to CCA Objections to Fee Applications, CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1986) at 7, 37-38.

252. Comments by Judge Kevin T. Duffy, who presided over the *Volume* receivership, are instructive in this regard. At a May, 1986 hearing on the receiver's fee application, Judge Duffy recalled that Volume's first receiver, John Peloso, had suggested at the outset of the proceeding "that perhaps the best thing would be a fast receivership in and out, with [COMEX Clearing Association] covering the losses for all the public and being assigned all of the claims that Volume might have. I am quite sure that that solution was suggested by Mr. Peloso to those in charge. Yet after all of this time, that basically is the solution." CFTC v. Volume Investors Corp., No. 85 Civ. 2213 (S.D.N.Y. 1986) (transcript of hearing held on May 29, 1986).

253. *See supra* text at 876-77.

attempted to obtain property exceeding their *pro rata* share of assets available for distribution, such transfers may have constituted fraudulent transfers at odds with the fundamentally egalitarian purposes of the Code and voidable by a bankruptcy trustee. The CFTC's administrative charge that such transfers violated Section 4b of the CEA, which proscribes fraud in connection with the making of futures contracts, is further evidence that, in establishing the reversibility of such transfers, the Bankruptcy Code advances otherwise applicable policies of the CEA.[254] Consequently, had Volume's customers not been afforded full compensation for their losses, recovery of such transfers would have been appropriate to protect the interests of Volume customers whose *pro rata* distributions were diminished by such transfers. To facilitate such recovery, the receivership court would likely have endowed the receiver with avoidance powers patterned after those of a bankruptcy trustee.[255]

*Clearing Organization Priority.* A third aspect of the Volume episode with immediate implications for the firm's customers, the actions of COMEX Clearing, also should be assessed against the relevant provisions and policies of the Bankruptcy Code. Most controversially, Volume illustrated that, in practice, the interests of the clearing organization as the principal agency for preserving the integrity of futures contracts and the stability of the marketplace[256] potentially may conflict with the interests of an insolvent firm's innocent customers during the highly compressed time frames within

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254. *See supra* text at 857.

255. In *Johnson v. Studholme, supra* note 244, the court dismissed claims based upon voidable transfer provisions of the Bankruptcy Code brought by a receiver to recover certain distributions made to investors in an alleged Ponzi scheme on the basis that such causes of action were not available outside of bankruptcy proceedings. Johnson v. Studholme, 619 F. Supp. 1347, 1349 (D. Colo. 1985). The court also dismissed claims for the same relief based upon state law causes of action for money had and received and for unjust enrichment, but on the ground that it would not be inequitable for the recipients to retain such distributions rather than the inapplicability of such state law causes of action to the receivership. *Id.* at 1350. In rejecting the receiver's attempt to employ Bankruptcy Code preference provisions, *Johnson* would not appear to address the applicability of federal causes of action in receiverships. For example, it would not appear to address claims under Section 4b of the CEA for recovery of funds fraudulently transferred, which do not depend upon the distributive provisions of the Bankruptcy Code, which are designed to effect a fair allocation of the debtor's assets rather than to redress a wrong and which would support a cause of action without regard to the firm's insolvency or the filing of a bankruptcy petition. The court stressed, for example, that Section 548 of the Bankruptcy Code, "a strict liability provision that permits a trustee to avoid transfers made for less than equivalent value within one year preceding the filing of bankruptcy," creates a power to be "exercised for the benefit of the creditors of the bankruptcy estate whose claims are filed and allowed according to other statutory requirements." *Id.* at 1349. The court concluded that to "extract this authority from the Bankruptcy Act, and apply it . . . for the benefit of any persons to whom distribution may ultimately be ordered in the receivership, would be such an expansion of the law as to be judicial legislation beyond the authority of this court." *Id.* By contrast, recognition of federal causes of action that exist without regard to the Bankruptcy Code would appear to be not only within the authority of a receivership court but required in the absence of a countervailing federal statute or policy.

256. *See supra* text at 865-68.

which the disposition of a defaulting firm's margin funds and open contracts is determined. Specifically, the *Volume* case raised the possibility that a shortfall in segregated funds could be created in this context without theft or other affirmative malfeasance by the FCM but through apparently lawful action of the clearing organization following a customer default. This could occur, for example, if following a clearing firm's default on a variation margin call of ten million dollars that principally represents losses on the positions of one customer who has defaulted on a margin demand issued by the firm, the clearing organization satisfies the ten million dollar margin demand by using the firm's total original margin deposits of ten million dollars, consisting of five million dollars attributable to the defaulting customer and five million dollars attributable to the firm's nondefaulting customers. In that event, the segregated funds of nondefaulting customers are depleted by the clearing organization to effect the payment of variation margin pursuant to its function as guarantor of the defaulting firm's open futures positions. As mentioned previously, such an event occurred following Volume Investor's default when COMEX Clearing applied original margin deposits of approximately $9.8 million held in segregated accounts on behalf of Volume's customers collectively toward satisfaction of margin obligations primarily attributable to the firm's three defaulting customers. In so employing Volume's original customer margin deposits, COMEX Clearing acted in a manner that appears to be consistent with, although not compelled by, its by-laws[257] and, in the absence of knowledge of or participation in

257. *See* COMEX Clearing By-Law 9.3 (all cash deposits and collateral deposited by clearing members as security for the performance of any obligation to the Corporation may be "applied by the Corporation to any indebtedness or obligation of the defaulting Clearing Member to the Corporation"). Clearing organization rules and by-laws generally authorize use of original margin deposits to satisfy obligations of defaulting clearing firms. Such rules range from broad provisions authorizing the clearing organization to employ all assets of a defaulting clearing member firm to satisfy the firm's losses to more specific rules that expressly confine use of customer margin deposits to the satisfaction of obligations arising from the clearing organization's customer account. *Compare* Chicago Mercantile Exchange Rule 802(A) (if clearing member "fails promptly to discharge any obligation to the Clearing House, its security deposit . . . , its margins on deposit with the Clearing House, and any of its other assets available to the Exchange shall be applied by the Clearing House manager to discharge the obligations") *with* CSC Clearing Corporation Rule 302 (if the default is in the customer account of the clearing member, all of the member's assets under the control of the Clearing Corporation, whether held for the proprietary or customer account, shall be available to discharge the obligation; if the default is in the proprietary account, "only that portion of such assets as are held for the proprietary account shall be available to discharge the obligation"). Regardless of their precise formulation, however, the operation of such rules is limited by Section 4d(2) of the CEA so as to preclude the use of customer funds to satisfy a proprietary obligation of the defaulting firm. *See* CFTC Interpretative Statement No. 85-3, *Use of Segregated Funds By Clearing Organizations Upon Defaults By Member Firms, supra* note 91. Clearing organization rules and by-laws also commonly provide that the clearing organization does not assume or incur liability by reason of the obligations of its clearing firms to their customers. Chicago Mercantile Exchange Rule 803 (liability of the Clearing House shall be limited to losses resulting from the substitution of the Clearing House upon

otherwise wrongful conduct, apparently permitted by the CEA and CFTC regulations.[258]

The apparent priority of clearing organizations to original margin funds at the clearing level is justified principally on the policy ground that such deposits constitute security for the clearing organization's responsibility to satisfy demands for variation margin owed on the net positions of its customer, the defaulting firm, and thus to customers on the opposite side of the defaulting firm's contracts. As the risk of nonperformance on its member's positions is finally borne by the clearing organization, the clearing organization constitutes the "ultimate risk-bearer."[259] The priority of the clearing organization to security for the discharge of its obligations as "guarantor of last resort"[260] therefore serves to assure the integrity of futures transactions, protects clearing firms and the customers of such firms on the opposite side of the market, and fosters market stability. In this respect, the first claim against original margin deposits can be said to be that of overall market stability, a principal objective of the Bankruptcy Code, while the other primary Code objective, the protection of customers, is addressed to customers of the marketplace generally and the protection of customers of a specific financially impaired firm is correspondingly subordinated.[261]

contracts between clearing members; Clearing House shall not be liable for, *inter alia,* obligations to a customer by a clearing member); Intermarket Clearing Corporation Rule 404 (liability of the Corporation shall extend only to losses resulting from the nonperformance of contracts cleared by it and specifically excludes "obligations of a Clearing Member to a customer or to another Clearing Member"). *See supra* notes 91-95 and accompanying text.

258. CFTC Interpretative Statement No. 85-3, *Use of Segregated Funds Upon Default by Member Firms, supra* note 91; *supra* text at 865-67.

259. 1 P. Johnson, Commodities Regulation § 2.50 (1982).

260. *Id.*

261. The clearing organization priority may have a dual character in that it secures the clearing organization in its role as guarantor of market stability in the event of a clearing firm default but also mitigates losses to the clearing organization that may arise from conditions for which the clearing organization, as a self-regulatory body, may in part be responsible. Indeed, the principal safeguards of market stability are preventive requirements and programs, for example, minimum financial requirements and margin requirements, for which clearing organizations and exchanges possess substantial enforcement responsibilities and which are intended to assure that occasions for assertion of the clearing organization priority do not arise. *See* Response of the CFTC to Certain Written Questions, *supra* note 83, at 50-60. The financial surveillance programs of clearing organizations and their affiliated exchanges, for example, are required to entail monitoring of large price movements and assessment of the impact of such price movements on member firms, responsibilities which the CFTC's staff concluded were insufficiently discharged in the case of Volume Investors. *Volume Investors Corporation, supra* note 20, at 50-51; Response of the CFTC to Certain Written Questions *supra* note 83 at 51-53. *See* Financial and Segregation Interpretation No. 4-1 (Advisory Interpretation for Self-Regulatory Organization Surveillance Over Members' Compliance with Minimal Financial, Segregation, Reporting, and Related Recordkeeping Requirements), Division of Trading and Markets, CFTC, (July 29, 1985), 1 Comm. Fut. L. Rep. (CCH) ¶ 7114A. The CFTC staff report on the Volume default notes that the emergency situation created by the firm's highly concentrated short gold option positions and extreme adverse price movements

The consequence of a shortfall in an FCM's segregated customer funds, such as would follow use by a clearing organization of original margin deposits comprised of segregated funds, coupled with a customer margin default resulting in an unsecured debit balance, is to place an immediate obligation upon the firm to restore the fund to its required balance, that is, to cover its obligations to its customers.[262] If the amount of the shortfall exceeds the FCM's available capital, however, as was true in the case of Volume Investors, the shortfall in segregated funds is effectively allocated *pro rata* among the firm's customers with the likely result that customer positions will be unsupported by adequate margin. As position transfers then may be a practical impossibility, a direct consequence of such a shortfall is likely to be the immediate liquidation of the open positions of the defaulting firm.[263]

In the case of Volume, liquidation of the firm's positions, while not immediate, followed directly once the full extent of the shortfall in segregated funds created by a customer default exceeding the firm's capital and

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on March 18 and March 19 "was worsened by weaknesses in the financial surveillance programs of COMEX and COMEX Clearing," which "were apparently not aware of the developing crisis at Volume until most of the damage had already been done. . . ." *Volume Investors Corporation, supra* note 20, at 50. As a result of its review of the Volume Investors events, the CFTC's staff recommended improvements in COMEX and COMEX Clearing financial surveillance programs, including development of systems to assure better identification of FCMs carrying high risk positions relative to their capitalization, issuance of intra-day margin calls for options, and sharing of position data among clearing organizations. *Volume Investors Corporation, supra* note 20, at 50-52.

Similarly, one reason for assuming that exchanges will exercise their authority to set margin requirements at appropriate levels is that since exchange clearing organizations stand as "the ultimate guarantor of every futures contract," "their own finances would be in jeopardy" were they to set margins at a level insufficient to cover market risk. *SEC/CFTC Jurisdictional Issues and Oversight—Part 1: Hearings on H.R. 5447, H.R. 5515 and H.R. 6156 Before the Subcomm. on Telecommunications, Consumer Protection and Finance and the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce,* 97th Cong., 2d Sess. 188, 260 (CFTC Submission, May 20, 1982). In its review of the Volume Investors default, the CFTC's Division of Trading and Markets expressed concern that "weaknesses in margin policy at the exchange level may have significantly contributed to the Volume default." *Volume Investors Corporation, supra* note 20, at 46-49. To the extent that deficiencies in clearing organization financial surveillance and other self-regulatory programs contribute to a clearing firm default or fail to prevent or mitigate losses that should have been avoided, the clearing organization priority, although exercised in behest of the greater good, may permit "self-help" by an interested, and arguably partially responsible, participant in the financial crisis.

262. *See supra* text at 873.

263. *See, e.g.,* Bagley Testimony, *supra* note 28, at 2500 (transfers "are generally made only with respect to customer trades which are adequately margined with both the clearing house and the failing futures commission merchant"); Response of the CFTC to Certain Written Questions, *supra* note 83, at 70-71 (CFTC's 1982 assessment of bankruptcies since Code's effective date indicates that when funds held in segregation for customers are substantially less than the customer claims to such funds, the likelihood of securing willing transferees for such accounts during the limited time available to effect transfers that are not reversible by a trustee is small).

COMEX Clearing's use of original margin deposits deposited in respect of customers of that firm was comprehended.[264] COMEX Clearing by-laws provide that upon the termination of the clearing privileges of a member firm, action required in the event of a failure to satisfy margin obligations to the clearing organization, all open contracts carried on behalf of such clearing member must be liquidated by the close of trading on the day following such termination, except to the extent that such contracts are transferred to other clearing members.[265] However, if the terminated clearing member is an FCM, "the corporation shall endeavor to transfer to one or more other clearing Members the open contracts of customers of such futures commission merchant in lieu of closing out the same. . . ."[266] Although the extent of a clearing organization's duty to attempt to effect transfers of open positions pursuant to such provisions has not been adjudicated, the improbability that a transferee firm could be located to accept open positions unsupported by adequate margin funds, a firm commitment to provide such funds, or security for their nonreceipt, would render such a duty largely unperformable in cases such as Volume. If positions cannot be transferred, a failure to liquidate them creates the risk of market losses for the clearing organization, which would be obligated to fund variation margin payments due to adverse price movements. This exposure is commonly expected to induce virtually immediate liquidation of all open positions at the defaulting firm.[267] Ultimately, the defaulting firm's customers remain at risk if untransferable positions are not liquidated as price changes, the direction of which cannot be anticipated, can erode the equity eventually available for distribution. Prompt action to liquidate open commodity contracts that cannot be transferred is therefore necessary to protect customer as well as market interests.[268]

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264. *See supra* text at 859.

265. COMEX Clearing By-Law 6.1(f).

266. *Id.*

267. The clearing organization's own potential exposure by reason of its guarantee function has been recognized to provide such an incentive for liquidation that "[e]ven where the rules of a particular clearing house merely authorize rather than require liquidation of a defaulting clearing member's positions, the potential for losses to the clearing house caused by price movements adverse to such positions will usually dictate immediate liquidation of any positions which cannot be transferred." T. Russo, *supra* note 37, § 2.10 at 2-19.

268. The CFTC's staff review of the Volume Investors default reports that although the firm should have been declared in default or insolvent by COMEX and COMEX Clearing as of no later than the morning of March 20, 1985, when the firm defaulted on an original margin call from COMEX Clearing, the bulk of the firm's customer positions on COMEX were not liquidated until March 22 and March 25. *Volume Investors Corporation, supra* note 20, at 53. The staff report commented that "by allowing Volume's market exposure in gold and gold options to remain for several days following the Wednesday morning default, the Exchange and clearing house left open the possibility that further adverse price movements could generate newer and bigger losses for the firm and the clearing organization." *Id.* Why, in view of such risks, the clearing organization would delay liquidation of positions it had apparently already determined could not be transferred (see *supra* text at 858) remains a matter of debate. The CFTC's staff report commented that "[t]o the extent that COMEX or COMEX

In employing customer margin deposits to satisfy Volume's margin obligations, assuming it did not have knowledge of, participate in or aid unlawful conduct, COMEX Clearing thus acted in a manner consistent with protection of the overall market, advancing a major Bankruptcy Code objective and the interests of futures customers generally. However, such action was not without cost. It caused customers at the insolvent firm in effect to insure the marketplace against their carrying firm's default, reduced funds available for distribution and effectively dictated the liquidation of their open positions. In effect, this action imposed upon Volume's customers on at least an interim basis losses properly assessable against but not immediately recoverable from the firm's defaulting customers and, secondarily, from the defaulting firm.[269] To avert that result, COMEX Clearing would have had to assume such losses itself or shifted them to other market participants, action that would affect not only its clearing firms on the opposite side of Volume's open contracts, but also, potentially, the customers of such firms.

The Volume result, however, as we suggest below, may not be compelled in every case. In the event of a true conflict between the interests of the relatively small number of customers of a defaulting firm and the stability of the marketplace, the public interest undoubtedly dictates the compromise of the interests of a few in favor of protection of the many. This does not, however, mean that other concerns must be ignored. Measures short of undermining the security of the market, which may advance the interests of clearing firm customers as well as those of the clearing organization and the marketplace as a whole, may exist to respond to a clearing firm default. In particular, despite the overall consistency of the outcomes achieved in Volume with the objectives of the Bankruptcy Code, it is evident that a central Code policy, the transfer of open positions, was not achieved. This was so despite the general recognition that such transfers protect both individual customer interests and the stability of the marketplace and despite the fact that, depending on the time of intervention, the cost of such transfers could have been relatively small in the Volume case.[270]

## IV. Methods of Facilitating Transfers of Customer Positions

From a customer protection perspective, a principal lesson of the Volume episode may be the simple proposition that in the event of a clearing firm

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Clearing officials hoped to limit Volume losses by anticipating that gold prices would recede from their Tuesday night peaks, they were inappropriately removing their self-regulatory hats and becoming traders themselves." *Id.* COMEX Clearing states that it could not commence liquidation prior to March 22 because it did not know the net open positions in Volume's account until the close of business on March 21 and that by the close of business on March 22 the unliquidated positions were "basically balanced (i.e., risk free)." COMEX Clearing Comment, *supra* note 58, at 6. COMEX Clearing's view that open positions were essentially balanced means that long futures positions were taken to offset short options positions pending the liquidation of those options positions.

269. *See supra* text at 873.

270. *See supra* text at 860-61.

default, protection of the many is more readily achievable than protection of the few. Thus, for customers at the affected firm, compensation over time based upon liquidation values is far easier to achieve than continuity of open market positions. To the extent that a clearing organization's needed use of original margin deposits to meet its obligations to counterparties effectively precludes position transfers, this result reflects the conflict between market stability, which serves broad-based customer protection objectives, and customer interests implicated at the immediately affected firm.[271] However, the failure to effect position transfers also may reflect the narrow time frame within which transfers typically must be effected, as little as one day in most cases,[272] and the absence of pre-established procedures to organize and effectuate transfers within such time constraints. As time is of the essence because of the market risks of open positions, a failure to have a predetermined course of action to maximize the potential for transfers is likely to dictate that the opportunity to effect them will be lost. Moreover, the conclusion that such transfers cannot be achieved when a segregation short fall exists because no transferee would be likely to accept undermargined accounts may be self-perpetuating, inasmuch as no meaningful attempt has yet been made to provide a systematic approach toward maximizing the potential to achieve such transfers.[273]

Claims that position transfers cannot be achieved thus may reflect the fact that, historically, little attempt has been made to achieve them rather than the actual impossibility of doing so. If the potential for position transfers were to be maximized, advance planning would be necessary to provide an expeditious method of assessing available segregated funds to margin open customer positions, to identify potential transferees, and to secure such additional funds or alternate security as may be necessary to induce the acceptance of such positions by a transferee firm. Such funding could be obtained by using, for example, established credit facilities of the clearing organization,[274] clearing organization trust funds[275] or clearing organization guarantee funds,[276] on a temporary basis. As discussed below, to

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271. *See supra* text at 865-68, 896-901.

272. In adopting its bankruptcy regulations, the CFTC stated that it "would not expect a clearing organization to wait more than one business day before closing out the open positions of an insolvent commodity broker" unless the bankruptcy trustee or customers holding large positions afforded security that variation margin payments would be met." 48 Fed. Reg. 8726 (1983).

273. As noted below, however, position transfers have occurred in isolated cases. *See infra* notes 293 and 294.

274. Following the Volume Investors default, COMEX Clearing reportedly initially employed a loan from Chemical Bank to cover some $9 million in variation payments rather than call upon its guaranty fund. *See* O'Dea, *supra* note 79, at 44. COMEX Clearing's guaranty fund at the time was reported at approximately $80 million, of which approximately 80 per cent was letters of credit, some of which were unsecured. *Volume Investors Corporation, supra* note 20, at 27; Kerwin, *supra* note 20.

275. *See supra* note 208.

276. *See supra* note 207.

the extent that such advance planning may significantly increase the likelihood of position transfers, substantial economies to the clearing organization and other market participants as well as significant benefits to commodity customers may accrue.

### A. Customer and Market Benefits of Position Transfers

The Bankruptcy Code's commodity broker provisions reflect the conclusion that the preservation of open positions following a clearing firm default may, in many cases, provide superior benefits to individual commodity customers and to the overall market than the liquidation of such positions.[277] This assessment is supported by the National Futures Association's recent study of customer account protection which stressed that, in addition to customer compensation, "[a]nother potentially important goal of an account protection program would be to provide the ability to immediately effectuate the orderly transfer of customers' open positions from an insolvent FCM to a financially stable FCM."[278] Benefits to customers accrue from position transfers because customer interests in open positions may not be fully recouped by recovery of the liquidation value of those positions. The liquidation of an open market position may disrupt an ongoing hedge or other risk-reduction strategy, the essential value of which lies in the continuation of the open futures or option position.[279] NFA's report observes that the ability of hedgers to maintain their futures or option positions, and thereby insure against exposure to price movements adverse to their cash market positions despite a broker's insolvency, would constitute "a substantial benefit" and that small hedgers as well as many commercial and institutional customers might prefer to retain their positions rather than receive even a complete return of margin funds.[280] Moreover, to the extent that the expeditious transfer of positions from an insolvent to a solvent firm enables business to "proceed as usual" through another broker, the danger of positions becoming effectively "frozen" pending liquidation or transfer, with the prospect of substantial interim losses, is diminished.[281]

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277. *See supra* text at 872, 877-78.

278. National Futures Association, *supra* note 2, at 91.

279. As noted above, hedge positions possess "an intangible value separate and apart from any equity deposited with respect to them which results from their hedging function." 48 Fed. Reg. 8722 (1983); *see supra* text at 880-81.

280. National Futures Association, *supra* note 2, at 91. In addition to destruction of the special value of hedge positions or other risk-reduction strategies, forced liquidations may also disproportionately impair the value of complex, theoretically risk-neutral positions if, as allegedly occurred following the Volume default, liquidation occurs or liquidation values are assigned as of different dates without regard to the overall composition of the position. *See supra* text at 860.

281. Johnson Statement, *supra* note 84, at 9-10; Andrews & Sender, *Off-Balance Sheet Risk: Where Is It Leading the Banks?*, INSTITUTIONAL INVESTOR, (January 1986), at 75 (if a bank's open futures position is frozen, "by the time it could be liquidated or transferred, the market might have cost the bank hundreds of thousands of dollars").

In addition, as the framers of the Bankruptcy Code recognized, preservation of open positions enhances the likelihood of continuity of margin payments and thereby increases the stability of the market as a whole.[282] The NFA's study is in accord, observing that position transfers from insolvent firms "would also facilitate the continued orderly operation of the futures markets by eliminating the specter of forced liquidation of positions."[283] Moreover, by increasing the probability that customers will continue to satisfy margin demands on their open positions, transfers should diminish the likelihood that the clearing organization will be required to do so, potentially creating significant economies for the clearing organization in its role as guarantor.

The events following Volume's default illustrate the potential economic benefits to customers, the clearing organization, and other market participants from preservation of the open positions of a defaulting clearing firm. As recounted above, certain Volume customers claimed to have suffered substantial losses because the liquidation of the firm's positions or the assignment of liquidation values did not reflect the composition of complex, putatively risk-neutral positions.[284] In addition, had positions been transferred rather than liquidated, the clearing organization's liability for variation margin payments would likely have been significantly reduced by enabling the firm's nondefaulting customers to continue to fund margin payments on their own positions.[285] Subsequent receivership proceedings and related litigation also entailed costs for the clearing organization, the exchange, and Volume's customers. Further, the ultimate price of impairment of public confidence in the futures markets, particularly given the growth of competing risk-reduction and speculative products sold outside of exchange markets, may be significant.[286] The fact that concerns over customer protection aroused by the Volume default have persisted for months and, indeed, years after the firm's failure[287] suggests the fragility of public confidence in markets that lack a systematic method for minimizing the

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282. *See supra* text at 872, 877-78.

283. National Futures Association, *supra* note 2, at 91.

284. *See supra* text at 860. Losses that flow from a failure to consider the overall composition of complex positions also could be occasioned in cases where offsetting positions are maintained in different markets. For example, during the October 1987 market break, the liquidation of positions in either the securities or futures market could have increased rather than reduced risk in the other market.

285. As discussed previously, after COMEX Clearing undertook liquidation of Volume's positions, it made a total of over $9 million in variation margin payments on the firm's open positions. *See supra* text at 861.

286. *See* 52 Fed. Reg. 47022 (1987) ("Regulation of Certain Hybrid and Related Instruments") (CFTC advance notice of proposed rulemaking concerning proposed regulatory framework for various commodity-related products sold other than on designated contract markets).

287. *E.g.*, Hiltzig, *A Matter of Confidence*, FIN. WORLD (Jan. 20, 1987) ("Volume's collapse demonstrated that the industry's existing 'segregation' rules . . . were inadequate to protect customers from one another" and "that, in times of crisis, exchange and clearinghouse officials . . . could not be relied on to act exclusively in the interest of the marketplace").

dislocations of a default or insolvency, notwithstanding the relatively low incidence of customer loss. Had Volume carried accounts for pension plans or mutual funds, rather than floor traders and a relatively small group of public customers, it is fair to assume that public confidence would have been affected even more profoundly.

### B. Impediments to Position Transfers

Despite the evident advantages to affected customers and to the marketplace that may accrue from the transfer of open customer positions, the events following Volume's default reflected the absence of any established procedure or institutional mechanism, other than the Bankruptcy Code and CFTC bankruptcy regulations, to effectuate transfers. As a result, customers, even if willing to supply additional margin funds, apparently were not afforded an opportunity to effect transfers. The clearing organization and exchange were equally unable to bring about that result, despite the fact that the exchange eventually advanced funds in an amount that would have enabled transfers to occur had such funds been provided at the time of the default.[288] These results reflect the reality that transfers of positions for which sufficient margin is lacking are impracticable unless a more formal procedure is implemented to compensate temporarily for a shortage of transferable margin funds.

Practically speaking, a transferee firm stands immediately liable to supply any difference between required margin funds and the funds transferred from the defaulting firm, in addition to satisfying variation margin demands as they accrue, by drawing upon its own capital. Such funds may ultimately be recoverable, as occurred in the Volume receivership, through prosecution of claims against defaulting customers or others answerable for the deficit. However, the transferee, which may have no interest in accepting transferred positions other than altruistic loyalty to the exchange, may be unwilling to assume the risk that recovery of the shortfall will not occur, commit resources to litigation necessary to effect such recovery, or be deprived of the use of its own funds pending such recovery.[289] Consequently, in cases such as Volume where segregated funds are significantly depleted, the clearing organization or, in the case of a non-member firm, another SRO, may determine that no likelihood of locating a transferee exists and

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288. *See supra* text at 860-61.

289. Additional obstacles to transfers of open positions may be presented by a transferee firm's unwillingness to accept accounts of customers it would not otherwise service and the inadequacy of available records of the insolvent FCM. If the FCM's records do not appear to be complete or reliable, a transferee may have cause for concern that in a subsequent bankruptcy proceeding the bankruptcy trustee or the Commission may be reluctant to approve transfers of the estimated *pro rata* share of a customer's equity because of the possibility that the records may not support an accurate calculation of *pro rata* distributions or may omit some customer claims entirely. *See Commodity Account Protection, supra* note 2, at 58.

that liquidation therefore must occur.[290] As the CFTC reported in 1978 in advocating bankruptcy protection of account transfers, "where the amount of undersegregation has amounted to only a few thousand dollars, some of the larger futures commission merchants have occasionally accepted a failing futures commission merchant's customers trades and absorbed any resulting loss themselves for the 'good of the industry.' "[291] However, no provisions for mitigating losses associated with the acceptance of such trades existed and, as a practical matter, it could be "assumed that no futures commission merchant would be willing to accept such customers' trades where the amount of undersegregation is tens or hundreds of thousands of dollars."[292]

Consequently, although transfers of adequately margined open positions pursuant to the CFTC's provisions for the transfer of customer accounts of FCMs suffering impaired capital have occurred with some frequency,[293] transfers from insolvent FCMs or where a significant segregation shortfall exists have little precedent.[294] To the limited extent that transfers of accounts

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290. *See supra* note 241; Bagley Testimony, *supra* note 28, at 2500. The improbability of locating a willing transferee in the absence of a mechanism to restore or otherwise mitigate the effects of a segregation shortfall was reflected in the CFTC's review in 1981 of the bankruptcies of several non-member FCMs that had occurred following the enactment of the Bankruptcy Code. The Commission reported that by the time of the relevant bankruptcy filings, the segregated funds held for each firm's customers were substantially less than the customer claims to such funds, with shortfalls ranging from 2 to 3.8 million. The CFTC stated that "[a]lthough additional money was recovered by the trustee for the benefit of customers subsequent to the bankruptcy filing, it is easy to see why there were no willing transferees during the few days transfers which are not reversible by a trustee could have been made." The CFTC contrasted the problems created in these cases by undersegregation with the "Silver Crisis" events of 1979-80, when the solvency of a COMEX Clearing member was jeopardized but, because its segregated funds were not impaired, "a transfer of open customer positions might have been possible." Response of the CFTC to Certain Written Questions, *supra* note 83, at 70-71.

291. Bagley Testimony, *supra* note 28, at 2500-01.

292. *Id.*

293. As discussed above, the CFTC's regulations require the transfer of customer accounts carried by an FCM in violation of the minimum capital requirement of CFTC Regulation 1.17(a). *See supra* text 883-85. Such transfers have occurred in a number of cases. In the case of two firms, Maduff & Sons and First LaSalle, Inc., such transfers were effected, although neither firm was technically in violation of applicable financial requirements, based upon business decisions reached by the firm and the relevant exchange. In the case of a third firm, ContiCommodity Services, Inc., the firm's capital impairment was remedied by an infusion of funds from its parent, Continental Grain, which enabled the firm to continue in operation. An exchange-supervised transfer of accounts was nonetheless agreed upon and effected. In these cases, there was no apparent shortfall in customer segregated funds available to margin open customer positions. *Commodity Account Protection, supra* note 2, at 12-13, 55.

294. In November, 1986, some one hundred customer accounts, representing nearly $2 million in equity including open positions, at Paris Securities Corporation ("Paris"), a New York Mercantile Exchange (NYMEX) clearing member which apparently suffered from impairment of capital below the required minimum as well as a shortage of segregated funds, were transferred under the supervision of the exchange. Although Paris' principals agreed to supply the funds necessary to restore the deficiency in segregated customer funds prior to the transfer, the transfer was facilitated by NYMEX actions to assure the transferee firm, Geldermann Incorporated, against the risks of accepting the transferred accounts, including a

unsupported by sufficient segregated funds have occurred, they have depended, in the absence of an institutional framework or procedure, upon *ad hoc,* negotiated arrangements with interested parties to secure additional funds to permit transfers. Such measures, while available to the initiated, do not afford either commodity customers or the marketplace generally a realistic option for preserving the continuity of positions. Moreover, in the absence of clearly defined procedures, even in the rare instances in which transfers are effected, the potential for unfair results and costly controversies concerning the mechanics and valuation of transfers may be created.[295] Flexible procedures established in advance which would provide immediate access to a source of funds to cover shortfalls in a failed firm's segregated customer account are apparently necessary if the statutory expectation that open positions can be transferable in such cases[296] is to be meaningfully fulfilled.

### C. Potential Methods of Facilitating Transfers

In constructing procedures to facilitate both individual and bulk position transfers, the CFTC's bankruptcy regulations, while not directly applicable

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NYMEX Board of Director's resolution stating the exchange's guarantee to all Paris customers of "the full and prompt payment of any deficiency" in the equity required to be on deposit in each such customer's account and a NYMEX guarantee to Geldermann that in the event of a failure by Paris "to transfer [customer] positions with full, lawfully required positions and equities computed as of the close of business on November 11, 1986," it would make "full and prompt payment of the difference between the value of the transferred accounts" and their equities computed as of November 11, 1986. *See* Siconolfi & Sullivan, *Clearing Firm Closes Amid Accusations It Misappropriated Funds of Customers,* Wall St. J., Nov. 14, 1986 at 6, col. 4.

295. For example, in *In re Incomco,* No. 80-B-11217 (Bankr. Ct. S.D.N.Y. 1984), a bankruptcy which was instituted following the enactment of the Bankruptcy Code's commodity liquidation provisions but prior to the promulgation of the CFTC's bankruptcy regulations, Heritage Commodity Consultants Inc., a registered commodity pool operator and trading advisor, was given the option, pursuant to court approval, of liquidating or transferring its positions. Heritage elected to transfer its open futures contracts to another FCM and those positions were so transferred several days after the bankruptcy filing with 20 percent of the applicable equity, representing an estimate of the firm's *pro rata* share of funds available for distribution. Heritage subsequently submitted a claim for the depreciation in the value of its open contracts between the date of filing of the bankruptcy petition and the transfer of those positions. This claim conflicted with the Bankruptcy Code's requirement that a customer's "net equity" with respect to positions that the customer elects to transfer be determined by valuing such positions "as of the date of the transfer", 11 U.S.C. § 761(17)(c) (1982), as well as with the more specific requirement of the CFTC's regulations that the net equity of customers who elect to hold their positions open following filing of the petition must be adjusted by crediting or debiting their accounts for losses or gains accrued after the filing date. 17 C.F.R. § 190.07(b)(6) (1987). Although the CFTC argued that Heritage's claim should be rejected as contrary to express Code provisions and as an attempt to shift the risk of voluntarily assumed trading losses to the firm's other customers, the court approved a compromise of Heritage's claims, apparently to avoid potentially costly litigation at the estate's expense. *See* Opposition of the Commodity Futures Trading Commission to Application of the Trustee for Order Approving Compromise of Claims, In re Incomco, Inc., 80-B-11217 (Bankr. Ct. S.D.N.Y. March 22, 1984).

296. S. Rep. No. 989, 95th Cong., 2d Sess. at 106-07 (1978).

outside of bankruptcy proceedings, suggest that the potential for effecting transfers may yet to be fully explored in other contexts. For example, these regulations suggest that procedures to permit infusions of additional funds by individual customers as necessary to assure that such transfers do not result in a greater than *pro rata* distribution can be created to facilitate position transfers on a systematic basis.[297] Although the CFTC's bankruptcy regulations do not govern when a bankruptcy petition has not been filed,[298] they may serve as a model on which other approaches, including voluntary measures by self-regulatory organizations to provide relief to customers directly affected by a default, might be fashioned. Such measures could parallel or expand upon the CFTC's regulations with respect to hedge accounts,[299] employing customer account agreements that would simplify transfer issues by allowing account holders to specify when opening their accounts whether they wished to have their accounts liquidated in the event of the suspension from trading of a carrying firm, insolvency, or a bankruptcy filing. Similarly, also drawing upon the CFTC's bankruptcy regulations, in such cases contingency plans could be made for notifying customers that liquidation of open positions would ensue if an election to transfer and a statement of willingness to supply additional funds as needed to make up any shortfall between the customer's *pro rata* share of customer property and funds sufficient to permit transfer were not received within a specified period. At a minimum, such procedures could be established for hedge positions, or for particular types of customers, achieving parity outside of bankruptcy proceedings with the transfer opportunity afforded by the CFTC's bankruptcy regulations.

Although the creation of procedures to facilitate preservation of hedge positions may satisfy the clearest need for position transfers, procedures that entail customer-by-customer notice, election to transfer or liquidate, and calculation of *pro rata* distributive shares may impose upon a clearing organization or other intermediary impracticable administrative burdens. Moreover, while helpful in avoiding the likely disorganization attendant

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297. In the wake of the Volume failure, notably, even customers who allegedly were ready, willing and able to supply additional margin funds to obtain a transfer of their positions were unable to do so, while others sought to preserve their assets from the debacle through questionable self-help techniques and the "race to the till" which bankruptcy law was intended to prevent. *See, e.g.,* 11 U.S.C. § 547(b)2-4 (1982), defining a trustee's right to avoid as preferences certain transfers made within 90 days prior to the bankruptcy filing (or, if made to insiders, within a year prior to the filing) for or on account of an antecedent debt and while the debtor was insolvent that enable the creditor to receive a greater percentage of his claim than he would receive in a bankruptcy distribution. *Id.*

298. The absence of procedures, such as those provided under the CFTC's bankruptcy regulations, to provide hedgers the opportunity to preserve open positions to facilitate transfers outside of bankruptcy, creates a disparity in position protection that, to the extent generally understood, would increase the likelihood that customers with large hedge positions and knowledge of a failing firm's financial condition would elect to place the firm in bankruptcy to protect their open positions.

299. 17 C.F.R. § 190.06(d)(1)-(2) (1987); *see supra* text at 880-83.

upon a financial emergency and the consequent preference for the swift and the easy, such procedures would fall short of assuring the routine continuity of open positions and margin payments that a mechanism for the transfer of all customer positions would afford. A pre-existing or even merely pre-identified source of funds to replenish shortfalls in segregated funds, together with an institutional procedure of general application to effectuate transfers, could expedite transfers and thereby minimize the market risks of open positions, reduce the liability of the clearing organization to make variation margin payments, and limit the potential for inequitable self-help measures. Indeed, an established source of funds to facilitate transfers and a systematic procedure for effectuating them could significantly enhance the ability of bankruptcy trustees to fulfill existing Bankruptcy Code and CFTC bankruptcy transfer policies by affording security to the clearing organization that transfers can be achieved and that the exercise of contractual liquidation authority is therefore neither inevitable nor desirable, notwithstanding the exercise of the clearing priority.[300]

The key to such a transfer program, as the NFA's study stressed, would be the immediate availability of funds sufficient to margin positions to be transferred.[301] NFA's study estimated that approximately $2.4 million would be required on an annual basis to provide for the transfer of positions from failed firms.[302] NFA's review of the historical record of FCM insolvencies also reflected, however, that as much as one-half of the average shortfall in segregated funds is eventually recovered and thus that "the annual drain on the resources of a transfer mechanism" would likely be "somewhat less" than the estimated 2.4 million dollars.[303]

Even based upon NFA's calculations, which address the estimated fund required to restore segregated funds to the amount necessary to satisfy customer equity claims in full, it appears that a modest fund would be sufficient to permit transfers of positions in most cases. NFA apparently calculated an amount sufficient to restore funds sufficient to satisfy customer claims in full. However, a funding mechanism designed to supply a temporary extension of credit to facilitate transfers rather than providing permanent compensation to clearing firm customers could be structured. Using this approach, the total funds required to replenish the shortfall in

300. *See* 11 U.S.C. § 556 (1982); *supra* text at 896-901.

301. *See supra* text at 905-07.

302. This figure is based upon NFA's calculation of average maintenance margin requirements for FCMs, as of September 30, 1985, of approximately $9.5 million. NFA's review of failed FCMs reflected that such firms typically have held considerably less customer funds than the average FCM. Based upon a conservative analysis of the historical record of FCM insolvencies, NFA assumed for the purposes of its calculations that the average failed firm has a margin requirement of one-half of the $9.5 million average and that the shortfall in segregated funds would amount to less than 50% of the funds required to be in segregation. Based upon these conservative assumptions, NFA estimated that approximately $2.4 million would be required to be readily available on an annual basis to fund the transfer of positions from failed FCMs. National Futures Association, supra note 2, at 42-46.

303. *Id.* at 43, 46.

segregated funds would be measured by the prevailing rate of interest multiplied by the period required to recover collectible obligations to the debtor's estate, an amount which could be significantly less than that estimated by NFA as necessary to establish and to secure a transfer program. Such a mechanism would recognize that, while open positions can be maintained only if supported by immediately available funds, subsequent recovery of funds from defaulting customers, the firm itself, or others responsible for the segregation deficit may substantially restore the initial shortfall in segregated funds. Such a program would depart from previous conceptions of customer account insurance by stressing short-term availability of funds to facilitate transfers rather than commodity account insurance or a compensation fund to shift losses permanently from a defaulting firm's customers to other market participants or the industry as a whole.

If a mechanism based upon an extension of credit to bridge the gap between eventual recovery of equity in a receivership or bankruptcy proceeding and funds immediately necessary to supply transferable margin were established, the clearing organization and/or exchange could draw upon a number of alternative sources. For example, the clearing organization or exchange could draw from guarantee funds, trust funds, surplus operating funds, or credit lines to supply the difference between available segregated funds and the total margin immediately required to transfer positions to solvent firms. To the extent funds advanced to effect transfers constituted borrowings, the clearing organization and/or exchange supplying such funds should be subrogated to the rights of the defaulting firm and its customers to distributions in a subsequent receivership or bankruptcy distribution. In cases in which such recoveries did not equal the amount of credit extended to facilitate transfers plus interest, customers receiving the benefits of the transfer could be called upon to pay their *pro rata* share of the shortfall.[304] In effect, the exchange or clearing organization would assume the distributive and recoupment authority of a bankruptcy trustee, a function that could be clarified by the adoption of appropriate clearing organization and exchange rules and implemented by specific provisions in customer agreements.

Such a procedure would result in shifting the initial impact of a segregation shortfall, by consent of the parties, to the clearing organization or exchange rather than the customers of the defaulting firm, with potential benefits extending far beyond those customers' ability to maintain their positions and accruing to the market as a whole. However, a procedure

304. This proposal would also contemplate that to the extent that holders of transferred accounts received distributions in excess of their *pro rata* share of the assets eventually available for distribution, they would be required to refund the excess distribution. This would eliminate the concerns expressed in NFA's report that infusion of funds to permit transfers would not result in *pro rata* transfers. National Futures Association, *supra* note 2, at 92. Moreover, the Code permits transfers which do not result in strict *pro ration* if accomplished prior to five days after the bankruptcy order of relief and approved by the CFTC. 11 U.S.C. § 764(b) (1984). *See supra* text at 878. Transfers would not be expected to occur where the FCM's records are so materially deficient that even approximate calculations of *pro rata* distributions cannot be made.

that entails the use of exchange or clearing organization funds to supply a source of margin would contemplate that the relevant clearing organization assess its ability to guarantee market integrity without the use of resources earmarked as a temporary source of funding for transfers. This would assure that such transfers could generate the customer and market benefits discussed previously without impairing the clearing organization's ability to assure market stability. Had the clearing organization facilitated transfers of Volume customer positions by forbearing the use of original margin deposits as security for the firm's variation margin obligations in favor of eventual recovery in the receivership distribution, it voluntarily would have achieved the effects outlined above.

A critical premise of any such transfer program would be the availability of sufficient resources to assure the clearing organization's ability to continue to guarantee payment of variation margin to the opposite side of the market on open positions of the defaulting firm prior to a transfer. However, since clearing organization guarantee funds in fact exist for the purpose of securing the payment of variation margin, the extent to which such funds also could facilitate funding of a modest pre-approved transfer program without jeopardizing the integrity of the market should be explored. It is possible that if such guarantee funds were employed directly to fund transfers, or indirectly to facilitate transfers by supporting an extension of credit, they could substantially advance the purposes for which they exist by reducing the exposure of clearing organizations to demands for variation margin that could be expected to be satisfied by customers if their positions were transferred to solvent firms. Consequently, the benefits of such a program for clearing organizations could exceed its costs, even without regard to the salutary effects of transfers upon affected customers and the overall marketplace.

A transfer program of the nature proposed here would, of necessity, entail discretionary action by a clearing organization or exchange. If the shortfall in available segregated funds exceeded or even approached the resources designated to fund transfers, the clearing organization or exchange could reasonably be expected to forego transfers rather than incur the risk of nonrecovery of overpayments due to poor or incomplete records or disputes over account valuations. Moreover, even if resources sufficient to fund transfers were available but the failed FCM's records were deficient, court approval might be considered necessary to afford protection against subsequent recalculations and attendant customer claims.

In addition to allowing the exercise of discretion on the part of the exchange or clearing organization to determine the feasibility of transfers on a case-by-case basis, a program for the transfer of positions could entail significant administrative burdens that substantially replicate those assumed by a bankruptcy trustee or non-bankruptcy receiver. For example, a method to safeguard the firm's assets against dissipation pending the transfer of its funds and positions could be important.[305] In addition, computation of

305. The collusive transfers alleged to have occurred on March 20, 1985 when the Volume

available segregated funds and of the balance necessary to be covered to permit transfers would necessitate access to the failed firm's books and records[306] and, potentially, the assistance of firm employees and access to its computer systems. These tasks would require the prompt availability of exchange or clearing personnel, the cooperation of the firm itself or recourse to the courts, and an advance of expenses by the clearing organization or exchange that eventually would have to be taxed against any existing compensation fund.[307]

For these practical and legal reasons, existing procedures under the CFTC's bankruptcy regulations or court-appointed receiverships such as that employed in *Volume* may provide the most practical framework in which to administer a pre-established exchange or clearing organization transfer fund if the transfer occurs after an actual default and there is a shortfall in segregated funds. Such an approach would provide the protections of the court, retain the administrative assistance of the SRO, and tap the resources of a receiver or trustee, while substantially increasing the likelihood of transfers by affording a basis for deferral by clearing organizations of their contractual authority to liquidate open positions and an established, although limited, fund to permit transfers.

Ultimately, of course, the best protection against the dislocations of an FCM's insolvency is prevention of the insolvency and the most expedient and economical method of effecting transfers of open positions despite an insolvency is to prevent shortfalls in segregated funds, through insufficient capital or otherwise, that create the necessity for extraordinary efforts to secure additional margin funds to facilitate transfers. An institutional framework to facilitate position transfers such as that outlined above would constitute a substantial self-regulatory response to customer and market protection problems that ensue when measures to prevent impairment of FCM capital and depletion of segregated funds have failed. Such a remedial mechanism should be advanced, however, with a recognition that a formal transfer program is necessary only to the extent that existing regulatory and self-regulatory safeguards have not fully achieved their objective. Indeed, Volume's default and concomitant disruptions have been attributed at least in part to weaknesses in relevant SRO financial surveillance and other self-regulatory programs.[308] In this regard, the pre-bankruptcy account transfers

default was imminent or had occurred and prior to appointment of a receiver for the firm on March 21, 1985, suggest the necessity for such protective measures. *See supra* text at 857.

306. Exchanges and clearing organizations should have access to clearing members' books and records in the ordinary course of business in order to fulfill their responsibilities to enforce minimum financial requirements and other rules applicable to their members. *See* 17 C.F.R. §§ 1.51-52 (1987). Potentially, both entities would need to cooperate in the event of a transfer.

307. The NFA, as an industry-wide, self-regulatory organization which discharges a variety of audit and oversight functions and maintains a staff of qualified auditors, could potentially provide a source of interim staff assistance to discharge the administrative and audit functions necessary to effectuate transfers.

308. *See supra* note 261.

that have been effected pursuant to CFTC Regulation 1.17(a)(4)[309] can be viewed as instances in which bankruptcy dislocations and Volume-like controversies over competing clearing system and customer demands were avoided by self-regulatory and regulatory actions to achieve consensual transfers based upon effective financial surveillance prior to an actual insolvency or depletion of segregated funds.

Consequently, any concerted effort to improve the industry's self-regulatory response to FCM insolvencies should first assure the efficacy of existing self-regulatory programs of a preventive nature. In this connection, the relative economy and simplicity of transfers pursuant to Regulation 1.17(a)(4) suggest that such transfers should be preferred to later intervention and should be viewed as a key adjunct to self-regulatory financial surveillance programs to identify FCMs that may be in jeopardy of significant capital impairment. If employed as prophylactic measures before any significant capital impairment actually occurs and, thus, prior to any depletion of segregated funds, such pre-bankruptcy transfers may frequently obviate crisis situations in which the integrity of the futures positions of a failing firm's customers or of the firm's obligations to the clearing system and the marketplace as a whole are directly threatened.[310]

## CONCLUSION

The futures industry has a record of remarkably few insolvencies and low customer losses. As a consequence, establishment of a government-sponsored insurance fund has been found unwarranted for the futures markets, whereas the significantly greater frequency of securities broker/dealer insolvencies and higher securities customer losses have been addressed by legislation creating a customer insurance system subject to federal oversight. Nonetheless, as discussed above, the potential exists for substantial dislocation, of at least a temporary nature, in the event of a futures firm failure.

Nearly three years after the event and despite full reimbursement of the firm's customers, the Volume episode lives on in the public mind as a lesson in the potential consequences of a futures broker failure. That case reflected that even full compliance with the Commodity Exchange Act's stringent segregation requirements could not assure the firm's customers against loss and that once such losses had occurred, no formal governmental or self-regulatory program was in place to restore such losses. Moreover, the positions of the firm's customers were liquidated without any serious attempt to transfer them, reflecting the current absence of any mechanism to replenish available segregated funds to provide margin sufficient to permit transfers. Most importantly, however, the stability of the market remained undisrupted throughout, the clearing organization stepped forward to pay

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309. *See supra* note 293.
310. *See supra* text at 883-84.

the counterparties opposite Volume for the losses accrued on its positions, and nearly one year after the firm's default, Volume's nondefaulting customers received full reimbursement. Thus, while FCM failures are rare, cases such as Volume illustrate potential hardships that could be ameliorated through a more systematic approach to position transfers than is afforded by current regulatory and self-regulatory programs. Existing regulatory and self-regulatory frameworks, which provide a basis for assuring customer recovery of account equity subject to *pro rata* allocation of losses and for safeguarding overall market stability against the impact of a firm failure.

The Bankruptcy Code's commodity broker liquidation provisions advance two paramount objectives, customer protection and market stability. These objectives are reflected in specific statutory provisions that should assure customers fundamental fairness in the event of a commodity broker's insolvency and prevent "domino" effects that could jeopardize the solvency of other market participants. The Code's legislative history also reflects Congress' intention to foster a third objective, the transfer of open commodity positions from insolvent to solvent commodity brokers, which could provide a means for advancing and harmonizing the statute's overriding customer and market protection purposes.

Unlike the protection of customer and market interests, however, the intent of the Bankruptcy Code's framers to foster position transfers could not be effectuated through enactment of statutory provisions, such as the customer priority, proscriptions against the reversal of pre-bankruptcy margin payments, or preclusion against interference with contractual liquidation rights, that achieve their statutory purposes by mandating particular actions or precluding others. Rather, as the Code's framers recognized, position transfers could be protected against avoidance by a bankruptcy trustee and encouraged as a matter of policy, but could not be required in all cases. Indeed, no regulatory framework that does not supply a source of funds to restore full margin to positions that have become undermargined could guarantee that such transfers would occur. However, to enable holders of properly identified hedge positions to preserve their positions despite a broker's insolvency, the CFTC's bankruptcy regulations provide a detailed procedure that permits individual position holders to supply such additional funds as may be necessary to preserve their positions and an administrative framework for organizing transfer efforts. Although the logistical burdens entailed in effecting even this limited category of transfers may appear onerous, the CFTC's hedge transfer procedures constitute the only method yet envisioned, much less established, to respond to the otherwise generally preclusive effect of segregation shortfalls upon position transfers. Although position transfers have occurred in isolated cases even when a shortage of segregated funds existed, such events have been extremely rare and have depended upon *ad hoc,* negotiated arrangements that afford no general assurance that transfers of even hedge positions will occur. Moreover, to the extent that the CFTC's bankruptcy regulations provide hedgers with a means of maintaining their positions in the event of an insolvency, they cannot assure that result even for hedgers except in the limited category of cases in which an insolvent broker is placed in bankruptcy.

Historically, concerns that the futures industry fails to afford sufficient security to its customers, in the absence of account insurance or other customer compensation mechanisms, have been answered by reference to the industry record of relatively infrequent insolvencies and low customer losses, an impressive record improved in significant measure by the past willingness of commodity exchanges to afford customers compensation on a voluntary basis. Public debate on such issues, however, has failed until recently to address the importance of preserving open futures and options positions, as opposed to funding customer reimbursement, or to explore the relative costs and benefits of a customer protection program designed exclusively to preserve the continuity of open positions. Potentially significant benefits to the self-regulators as well as to commodity customers from a systematic procedure for effecting position transfers therefore have been ignored. Recent studies suggest, however, as the Code's framers recognized, that maintaining open positions may afford substantial benefits to commodity customers as well as to the market as a whole and that position transfers are an important protection of the hedging function of the futures markets.

Viewed against the potential benefits of preserving open positions of an insolvent broker, the industry's historically low customer losses may be more probative of the practicability of a program to facilitate transfers than of the acceptability of the *status quo*. Consequently, although no inflexible procedure or unlimited source of funds that will ensure the transfer of positions in every case can reasonably be contemplated, we suggest that a modicum of advance planning and a modest credit facility or other source of funds could increase significantly the likelihood of effecting transfers in many insolvencies. Such a program could prove to be substantially self-funding over time in that recoveries in the course of receivership or bankruptcy proceedings may significantly restore initial outlays to effect transfers and expeditious transfers potentially could secure significant reductions in clearing organization guarantee obligations. In addition, such a program would afford the self-regulators and commodity customers increased certainty and security, reduce the potential for costly and disruptive litigation, enhance the hedging function of the futures markets, and provide a firm foundation for public confidence in the futures industry's ability to respond to a broker insolvency in a manner that evenhandedly advances the interests of commodity customers and of the marketplace as a whole.

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