UNCERTAIN FUTURES IN EVOLVING FINANCIAL MARKETS

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ABSTRACT

Today's publicly offered investment funds, including mutual funds, have ever more diverse investment strategies, as they increasingly invest in financial instruments that, in earlier years, had been the province of only the most sophisticated investors. Although the new landscape of investment possibilities may substantially benefit retail investors, one financial instrument attracting increasing amounts of retail investors' assets is acutely troublesome: the commodity futures contract. Futures originated as a means for farmers and other producers of agricultural commodities to ensure that their products could be sold at reasonable prices. Early on, the goals of futures regulation centered on one particular risk facing futures market participants—manipulative trading that destabilizes futures markets—with little emphasis on other risks, including risks to futures traders' assets. Over the years, that goal has remained largely static.

As this Article argues, that is the problem. The many retail investors that now participate (indirectly) in the futures markets are at risk as a result of the inadequate regulation of futures commission merchants ("FCMs"), the brokerage firms that are essential for futures transactions. "Inadequate" regulation in this context, moreover, means inadequate procedural regulation—regulation aimed at protecting assets that a brokerage customer deposits with a broker for purposes of carrying out her trading activities. The weaknesses of the procedural regulation of FCMs are evident in rules governing both FCMs' operations and the

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liquidation of insolvent FCMs. And the deficiencies are more than theoretical, having become all-too-evident in the wake of two recent FCM bankruptcies. Proposing tailored policymaking solutions, this Article further contends that futures regulation can become substantially more effective—and do so in a cost-effective manner that need not excessively disrupt existing regulatory approaches. These proposals would not only help protect retail investors as they navigate new investment options; they would also help fortify the promising role that futures trading has begun to play in twenty-first century financial markets.

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I. INTRODUCTION

Investment opportunities are all around us. There are thousands upon thousands of mutual funds and other publicly offered investment funds,[1] which, as the dominant investment repositories of retail investors' retirement capital and other assets, have come to play a crucial role in the securities markets.[2] Although one might wonder how any particular fund might distinguish itself from all others, at least one answer to that question has, in recent years, become apparent: Today's funds have ever more diverse investment strategies, as they increasingly invest in assets and financial instruments that in earlier eras had been the province of only the most sophisticated investors.[3] Indeed, funds focusing on, for example, international "small cap" stocks, so-called emerging economy stocks, and moderate-risk corporate bonds are now among the more staid investment programs,[4] particularly when one considers the recent emergence of funds focusing on, for example, real estate, fine art, gold, and oil.[5] It is no exaggeration to say that, at least in terms of the *types* of investments in

1. *See, e.g.*, *Mutual Funds*, FINRA, http://www.finra.org/Investors/SmartInvesting/Choosing Investments/MutualFunds/ (last visited Mar. 29, 2016), *archived at* https://perma.cc/GRG9-X55U; *cf.* DAVE KANSAS, THE WALL STREET JOURNAL COMPLETE MONEY AND INVESTING GUIDEBOOK 137 (2005) ("From small beginnings early in the twentieth century, mutual funds have become a giant part of the financial landscape.").

2. *See, e.g.*, KANSAS, *supra* note 1, at 137 ("Mutual funds have become the most popular way for investors to participate in the financial markets.").

3. *See, e.g.*, Sam Diedrich, *'Alternative' or 'Hedged' Mutual Funds: What Are They, How Do They Work, and Should You Invest?*, FORBES (Feb. 28, 2014, 10:29 AM), http://www.forbes.com/sites/samdiedrich/2014/02/28/alternative-or-hedged-mutual-funds-what-are-they-how-do-they-work-and-should-you-invest/ (discussing the growth of mutual funds that "allow . . . investors to gain access to a wide range of traditionally exclusive hedge fund strategies including merger arbitrage, convertible arbitrage, long/short equity, macro trading, etc." as well as "use of leverage, derivatives, and short selling"); Matt Levine, *Hedge Fund Investors Aren't as Dumb as They Look*, BLOOMBERG VIEW (May 30, 2014, 4:24 PM), http://www.bloombergview.com/articles/2014-05-30/hedge-fund-investors-aren-t-as-dumb-as-they-look, *archived at* http://perma.cc/5Y9T-2738 (observing that hedge fund investment strategies are becoming "ever more diverse").

4. *See* Diedrich, *supra* note 3 (observing that the new mutual fund investment strategies are "far afield from traditional, 'long-only' mutual funds which limit themselves to buying and holding assets, most typically public equities or bonds").

5. *See* KANSAS, *supra* note 1, at 143 (observing that "[m]utual funds have blossomed to cater to nearly every thinkable investing idea" and that "[t]here are funds focused on socially responsible investing; funds that invest [in] . . . gold, silver, wheat and oil; . . . [and] funds that invest only in specific sectors of the market").

which retail investors[6] may participate, there is no longer a sharp division between the banker, on one hand, and the baker, on the other.

The developments in the range of investment possibilities open to retail investors are not a product of legal and regulatory developments, however. Rather, they are a product of the same factors that led to the first use of stock options in the United States in the nineteenth century and the first modern hedge fund—the privately offered counterpart to mutual funds—in the 1940s. Those factors are entrepreneurial activity and human creativity.[7] Of course, the emergence of new products within existing regulatory boundaries raises the question of whether policymakers sufficiently considered those products' development at the time they formulated applicable regulatory strictures. After all, hedge funds are an investment product that arguably were not within Congress's realm of consideration as it drafted exclusions to the application of the Investment Company Act of 1940, the statute that defines and regulates mutual funds. And if there is any doubt about policymakers' foresight, then—given retail investors' typically more modest asset accumulation and relative lack of investment expertise, as compared with more sophisticated investors' assets and expertise[8]—there arises the further question of whether retail investors are sufficiently protected as they traverse the new investment landscape.

In that regard, one financial instrument attracting increasing amounts of retail investors' assets is troublesome: the commodity futures contract. Commodity futures contracts—also known as "futures contracts," or merely "futures"—are, in simplest terms, agreements to buy or sell a particular commodity at a later time.[9] Futures were created to help farmers and other producers of agricultural commodities ensure that their corn,

6. As used in this Article, "retail investor" refers to an individual investor who transacts in securities and other financial instruments for her own account but who does not qualify as a "sophisticated investor"—that is, an investor who meets specified wealth or income tests.

7. That is, there are no new laws or regulations that expressly permit funds' broadening investment strategies. Rather, in pursuing the new strategies, fund managers are working within existing laws and rules. Alfred Winslow Jones, who began the first hedge fund in 1949, provides an apt historical comparison, as he launched his new product by working within longstanding regulatory exemptions and exclusions. *See generally* Carol J. Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, Apr. 1966 (describing Jones's creation of the first hedge fund).

8. *See* Jennifer O'Hare, *Retail Investor Remedies Under Rule 10B-5*, 76 U. CIN. L. REV. 521, 537 (2008) (observing that "retail investors are typically less sophisticated than institutional investors").

9. *See Commodity Futures Contract*, INVESTOPEDIA, http://www.investopedia.com/terms/c/commodityfuturescontract.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/R42K-HN7F (defining a "commodity futures contract" as "[a]n agreement to buy or sell a set amount of a commodity at a predetermined price and date").

cattle, cotton, or other products could be sold at reasonable prices.[10] Such protection is desirable because the market price of a commodity fluctuates throughout the year, based on both the supply and the demand for the commodity at any particular time.[11] For example, the June price of wheat in a given year may be substantially lower than the February price if June is the month in which wheat is harvested, resulting in a significant increase in supply that month. Accordingly, a wheat farmer who desires to secure a good price at harvest time may desire to "hedge" against such price fluctuations by locking in a particular price. She may do so by entering into a futures contract, pursuant to which the contract counterparty agrees to buy a certain amount of the farmer's wheat in June at a specified price per bushel.

Despite the origins of futures contracts, trading in futures, without ever receiving or delivering an actual commodity, may have value in its own right. As is the case with contracts that contemplate physical delivery, the value of a contract traded for "speculative" purposes derives from changes in the price of the commodity that the contract references. For example, if a trader expects that the price of oil will increase in the near term, she might initiate a futures contract on, say, 3000 barrels of oil. If the value of oil at the time the contract is initiated is $70 per barrel, then the value of the contract is $210,000. However, the trader will be able to trade in the contract by posting an initial margin (effectively collateral) of only a small portion of the value of the contract—say, $14,000. If, during the term of the contract, oil prices increase to $80 per barrel, then the value of the contract will increase to $240,000, meaning that the trader will be entitled to the amount of that increase, $30,000 (payable by the counterparty), assuming that the trader terminates the contract before the price falls again. From the earliest days of futures, not surprisingly, the prospect of using futures as a means of generating profit, rather than hedging against commodity price risk, did not escape financial market participants.[12]

It is also not surprising, then, that federal regulation of futures and the futures markets, which dates back to the 1920s, came to reflect that futures are used for purposes other than hedging, that some futures contracts are

10. *See* JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 3–6 (1987) (describing the initial uses of futures contracts in the United States).

11. *See Issue 1: What Drives Commodity Prices?*, COMMODITYFACT.ORG, http://www. commodity fact.org/issues/what-drives-commodity-prices/ (last visited Mar. 29, 2016) (citing G-20 Study Group on Commodities Report stating that "changes in physical demand and supply, rather than growing financial investments, have been the main drivers of commodity prices").

12. *See* MARKHAM, *supra* note 10, at 9–10 (describing the 1880s practice of betting on commodity prices).

based on assets other than agricultural commodities, and that the label "futures market participants" encompasses more than just farmers.[13] This evolution is perhaps evidenced most starkly by the fact that the Grain Futures Act of 1922, which governed futures activities until 1936, was replaced by a statute with a rather more generic title: the Commodity Exchange Act.[14] Still, despite regulation's ostensible recognition of the breadth of futures market participation, the professed goal of futures regulation—prohibiting and punishing manipulative trading that destabilizes markets—has remained largely static.[15]

That is the problem, given the mammoth expansion of participants in the futures markets in recent years. Almost anyone is able to trade in futures simply by, for example, investing in one of the growing number of mutual funds that does so, including as a core strategy.[16] It is appropriate, moreover, that they are able to: Participation in the futures markets serves as a hedge of sorts even for the average investor because of the portfolio diversification it can provide.[17] As this Article argues, however, those investors are at risk, at least in comparison to their counterparts in the securities markets. That risk arises from the inadequate regulation of futures commission merchants ("FCMs")—that is, firms that act as brokers in the futures markets, executing orders through the relevant exchanges on behalf of their customers,[18] whether those customers be

13. *See id.* at 12–47 (summarizing the evolution of early commodity futures regulation).

14. *See id.* at 14–25 (describing Congress's enactment of the Grain Futures Act and, subsequently, the Commodity Exchange Act).

15. *See id.* at 25–28 (detailing the political context in which Congress passed the Commodity Exchange Act).

16. *See Commodity Markets and Commodity Mutual Funds*, ICI RES. PERSP. (Inv. Co. Inst., Wash., D.C.), May 2012, at 4 ("[Commodity mutual funds] allow investors, especially retail investors, to obtain the diversification benefits of commodity investments, benefits that were historically much harder to achieve."); David Evans, *How Investors Lose 89 Percent of Gains from Futures Funds*, BLOOMBERG MKTS. (Oct. 7, 2013, 6:00 PM), http://www.bloomberg.com/news/2013-10-07/how-investors-lose-89-percent-of-gains-from-futures-funds.html, *archived at* http://perma.cc/9FSS-4N4A (discussing the increasing popularity of futures-focused mutual funds).

17. *See Commodity Mutual Funds*, MONEY-ZINE, http://www.money-zine.com/investing/mutual-funds/commodity-mutual-funds/ (last visited Mar. 29, 2016), *archived at* http://perma.cc/3YS9-E5LW ("Commodity mutual funds offer an interesting, and potentially rewarding, way to diversify an investment portfolio beyond stocks and bonds."); Zacks Equity Research, *5 Commodity Mutual Funds to Watch in 2014-Best of Funds*, NASDAQ (Apr. 8, 2014, 1:15 PM), http://www.nasdaq.com/article/5-commodity-mutual-funds-to-watch-in-2014-best-of-funds-cm342390, *archived at* http://perma.cc/NFD9-HDSZ ("The truth remains—commodities are among the best tools for hedging.").

18. Although the early futures markets thrived outside of organized exchanges, *see* MARKHAM, *supra* note 10, at 3–12 (describing "the beginnings" of futures trading), today futures contracts may be traded only on CFTC-designated "contract markets," *see* 7 U.S.C. § 6(a) (2012), such as the Chicago Board of Trade, the Intercontinental Exchange, and the Chicago Mercantile Exchange. *See Trading Organizations—Designated Contract Markets (DCM)*, U.S. COMMODITY FUTURES TRADING COMM'N, http://sirt.cftc.gov/sirt/sirt.aspx?Topic=TradingOrganizations (last visited Mar. 29, 2016).

Exchange-Traded Funds or mutual funds or whether they be individual investors or their advisors.

Importantly, "inadequate" regulation in this context means inadequate *procedural* regulation, a term that this Article uses to refer to regulation aimed at protecting cash and other assets that a participant in the financial markets deposits with a brokerage firm, such as an FCM or a securities broker, for purposes of carrying out her investment and trading activities.[19] Procedural regulation is to be distinguished from its (predictably labelled) counterpart, substantive regulation, which refers to the regulation that governs a broker's performance of its services for its customers. Whereas substantive regulation is directed at ensuring that financial firms competently do what customers are paying them to do, procedural regulation seeks to ensure that customers' deposits do not diminish solely as a result of actions by a broker that are unrelated to the services that the firm provides to customers. In other words, procedural regulation seeks to prevent the firm's unauthorized use of customer deposits either for its own benefit or for the benefit of other customers. It is "procedural" in nature simply by virtue of its role of ensuring that customers have the procedural means (their deposits) to achieve their substantive ends (trading in futures or other financial instruments).

That the procedural regulation of FCMs is problematic is evident from some key differences between that regulation and the regulation of firms that act as brokers in the securities markets (known formally as broker-dealers).[20] For example, a securities broker cannot use a customer's deposits for its own investment or trading purposes without the customer's consent, unless the customer has borrowed funds or securities from the firm—which she might do, for example, to pursue her trading activities on a leveraged basis or to effect "short" sales of securities.[21] In that event, at least a portion of the customer's deposited assets would be pledged to the firm as collateral and, therefore, available for the firm to use in its own trading activities.[22] In addition, in the event that a deficiency, or "shortfall," of customer assets exists at the time of a securities broker's insolvency—the primary condition giving rise to concerns about protection of customer deposits—if those assets cannot be "traced" and

19. *See infra* notes 42–48 and accompanying text (elaborating on the concept of procedural regulation).

20. *See infra* Part II (detailing the procedural regulation applicable to securities brokers, on the one hand, and FCMs, on the other).

21. *See infra* notes 55–65 and accompanying text (describing the circumstances under which a broker might use customer funds).

22. *See infra* notes 60–61 and accompanying text.

retrieved, customers will be made whole (up to a monetary limit) by a securities-specific insurance program established and administered under a federal statute, the Securities Investor Protection Act of 1970 ("SIPA").[23]

These provisions, among others, have the effect of assuring securities brokerage customers that they need not fear for the safety of their brokerage deposits. Put another way, although most securities brokers are not federally regulated banking institutions insured by the Federal Deposit Insurance Corporation ("FDIC"), other types of procedural regulation fill that void,[24] thereby promoting investor confidence in the securities markets. However, customers of an FCM cannot take such comfort in the safety of their deposited funds, thanks in part to the deficiencies of the Commodity Exchange Act ("CEA")—which remains the governing statute—and the rules of the Commodity Futures Trading Commission ("CFTC"), the regulatory agency responsible for administering the CEA. That is the case even though, under the CEA, customer deposits are required to be segregated at all times from the FCM's own assets.[25]

As an initial matter, an FCM may invest customer assets—including through so-called repurchase agreements, or "repos"—regardless of whether the customer has borrowed from the FCM and effectively pledged its assets to the FCM as collateral.[26] In addition, although there are special provisions of the Bankruptcy Code governing the liquidation of insolvent FCMs, they are fraught with difficulties.[27] On the positive side, these bankruptcy provisions parallel provisions that apply to insolvent securities brokers, and the CFTC has adopted rules that are more protective still, providing that, if a deficiency of customer assets exists after all efforts to recover them have been exhausted, customers will be compensated from the general assets of the FCM's estate, with priority over the estate's unsecured creditors.[28] However, the provisions will likely be stayed in most FCM liquidations.[29] Additionally, even if they are not, the protective CFTC rules prioritizing customers over the estate's unsecured creditors may not be enforceable. If that is the case, customers would have to line

23. 15 U.S.C. §§ 78aaa–78*lll* (2012). For additional details about SIPA, see *infra* notes 80–91 and accompanying text.

24. *See infra* notes 49–91 (describing the regulatory mechanisms that help protect the assets of securities brokerage customers).

25. *See infra* Part II.B (summarizing the procedural regulation governing FCMs, including the "segregation" requirements).

26. *See infra* notes 114–19 and accompanying text.

27. *See infra* Part III.B.

28. *See infra* notes 120–31 and accompanying text.

29. *See infra* notes 210–17 and accompanying text.

up with the FCM's unsecured creditors to share in the remnants of the FCM's estate.[30] And, even if the special rules were to apply and even if they are enforceable, the estate's assets may be insufficient, thanks to the fact that FCMs are typically structured as discrete components of larger groups of affiliated entities.[31] On top of all of this is the fact that there is no insurance regime to be a last-resort aid to futures customers in the return of their assets.

The concerns arising from the inadequate procedural regulation of FCMs are more than theoretical. The deficiences of rules that ostensibly protect futures customers have meant that, in the wake of two calamitous FCM bankruptcies in recent years—both of which involved losses of customer assets—customers were placed in a state of limbo, uncertain what laws and rules would apply and what effect those laws and rules might have.[32] Indeed, in one of those bankruptcies, that of MF Global, Inc. in 2011, the firm's creditors rushed to court to protect their interests while their counsel and advisors likewise leapt into action, as though the bankruptcy proceedings involved only the usual players: trustees and administrators, advisors, and, of course, creditors.[33] In the flurry of activity, customers and their interests were all but forgotten,[34] as though an FCM's declaration of bankruptcy entails that customers no longer have any interests in the estate at all.

Those circumstances are all the more alarming when one considers that, *ex ante*, customers and creditors are in substantially different positions. After all, creditors presumably understand the inherent risk associated with entering into a credit arrangement with a financial firm and can negotiate terms that help protect their interests.[35] By contrast, customers simply entrust their hard-earned dollars with the firm, depositing them into an account, with the entirely appropriate expectation that those funds will be as safe as funds they might deposit with their

30. *See infra* notes 218–40 and accompanying text.

31. *See infra* notes 252–57 and accompanying text.

32. *See infra* notes 166–71 and accompanying text (describing the regulatory failures associated with the two bankruptcies).

33. *See* Leah McGrath Goodman, *The Boy Wonder of the MF Global Nightmare*, FORTUNE (Dec. 2, 2011, 3:34 PM), http://fortune.com/2011/12/02/the-boy-wonder-of-the-mf-global-nightmare/, *archived at* http://perma.cc/9AUT-XRXE (reporting on the exasperation of MF Global customers, who, at the outset of the bankruptcy proceedings, felt that "there was absolutely nobody looking out for" their interests and that they "were being ignored, even as their assets dwindled or were returned in sloppy fashion").

34. *See id.*

35. *See* Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 569 (2011) (observing that creditors that understand relevant risks generally should seek to protect their interests through ex ante negotiations).

banking institutions—and that they will be available for the customers' exclusive use.[36] Practically since the beginning of futures regulation, moreover, those expectations have been amply supported by a frequent refrain in the futures industry: Customer funds are safe and secure.[37]

MF Global is not the only example. From the earliest days of FCMs onward, there have been segregation problems, producing substantial and devastating losses for customers.[38] Some losses have arisen from FCMs' failure to separate customer assets from the FCMs' own assets;[39] others have been a product of customer defaults—meaning an FCM's inappropriate use of (most) customers' deposits to support trades of other customers who have exhausted, and failed to replenish, their deposited funds.[40] Although these losses may not be apparent while an FCM is in good health, the firm's insolvency—and the associated need to return deposited assets to customers—make any such shortfalls glaringly evident.

Beyond contending that futures customers' deposits are not, in fact, safe and secure, this Article shows why that is the case and posits that the problems can be corrected in a manner that need not excessively disrupt the existing futures regulatory regime or create excessive costs or other externalities for creditors or other third parties. Accordingly, Congress and the CFTC should act now. Waiting to take action will only create further risks—for customers, for the futures markets, and for the promising new era of near-universal participation in those markets.

Addressing the formidable concerns this Article identifies is more than simply a matter of achieving better customer protection. It is also a matter

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36. *See* Paul Sullivan, *In Commodities World, Safe and Secure Sometimes Isn't*, N.Y. TIMES (Nov. 25, 2011), http://www.nytimes.com/2011/11/26/your-money/in-commodities-world-safe-and-secure-sometimes-isnt.html?pagewanted=all&_r=0 (reporting that, before MF Global's collapse, "segregated accounts had been seen as stronger than the deposit insurance offered by banks that are members of the Federal Deposit Insurance Corporation and the protection on securities, like stocks and bonds, given by the Securities Investor Protection Corporation").

37. *See* Peter Elkind & Doris Burke, *The Last Days of MF Global*, FORTUNE (June 4, 2012, 7:17 PM), http://fortune.com/2012/06/04/the-last-days-of-mf-global/, *archived at* http://perma.cc/BM8Z-328W ("Industry groups routinely boasted that no customer had ever lost a penny because of a bankruptcy."); Marc Nagel, *MF Global Bankruptcy Files a "Disgraceful Disconnect,"* FUTURES (Dec. 19, 2011), http://www.futuresmag.com/2011/12/18/mf-global-bankruptcy-files-disgraceful-disconnect, *archived at* https://perma.cc/8BKA-RNN8 ("We in the futures industry are guilty in repeating the phrase that no one has ever lost money because of the failure of an FCM.").

38. *See* MARKHAM, *supra* note 10, at 30 (noting that the national commodity futures regulator at the time, the Commodity Exchange Authority, in its examination of 654 FCMs between September 1937 and August 1938, found that over 100 of them were "undersegregated" and that one such firm was placed in bankruptcy, resulting in losses to its customers of 54% of their account balances).

39. *See id.*

40. *See id.* at 88–89 (describing one such bankruptcy, that of Volume Investors, Inc., which occurred in 1985).

of bringing futures regulation into the twenty-first century, situating it in the same sphere as securities regulation.[41] Perhaps because the regulation of securities and other financial markets traditionally has emphasized the goal of investor protection in addition to (or perhaps ahead of) the traditional futures regulatory goal of mitigating market manipulation, Congress and regulators have been more vigilant in ensuring commensurately broad procedural protections in those other arenas. If the futures markets are the up-and-coming "securities markets" of this era, albeit on a lesser scale, procedural regulation of them and the brokerage firms that facilitate them needs to rise to the occasion. That is, it must create a more certain future for retail investors and other futures market participants.

Focusing on procedural regulation in both the securities brokerage and futures brokerage contexts, Part II shows that, although customer protections in the two realms are in many ways similar, critical differences nonetheless exist. Part III delves more deeply into the procedural protections of futures customers, highlighting the ways in which they are deficient, particularly in comparison to the protections afforded customers transacting in securities. Part IV turns to regulatory reform, proposing policymaking solutions that can readily be incorporated into the existing procedural regulatory regime governing futures brokers. In addition, it argues that such reform is critical not only for maintaining customer confidence in the futures markets, but also for making futures regulation compatible with the role that futures trading has assumed in modern financial markets. Part V concludes by addressing why the concerns this Article tackles have not heretofore received significant attention, either in the academy or elsewhere.

II. PROCEDURAL REGULATION

Statutory provisions and rules governing brokerage firms may be divided into two categories, depending on the objective of any particular provision or rule. These categories are, first, the regulation of the activities or steps that are preconditions to a broker's provision of its services and, second, the regulation of the substance of those services. For example, securities laws and rules require that a securities broker that has "custody" of customer assets—that, in other words, is the entity with which a customer deposits her funds—designate those assets as belonging to the

41. *See infra* Part IV.B.

customer and ensure that the assets may be used only for particular purposes.[42] Those custody-related requirements are distinctly procedural, in that they have nothing to do with the objective behind the customer's placement of the assets with the broker, which, one might suppose, is to use them to effect securities transactions. Relevant laws and rules also regulate how a broker fulfills that objective—how it carries out its services of effecting transactions for the customer.[43] The requirements that this second type of regulation imposes are substantive, in that they pertain to the substance of the services that the broker provides to its customers. Both regulatory purposes are critical, however, in that substantive regulation becomes relevant only if procedural regulation does its job: ensuring the integrity of customer deposits so that they may be deployed for customers' investment and other financial activities.

In the procedural sphere, the regulation that governs brokers presently relies on three dominant regulatory mechanisms. First, regulation uses what might be called operational requirements. These are requirements that a broker, as it carries out its operations, follow certain procedures designed to protect customer deposits.[44] The efficacy of operational requirements, moreover, may be readily evaluated upon the occurrence of one signal event: insolvency. Typically, only when a broker becomes insolvent can it be known whether operational requirements have adequately protected customer deposits, as there will either be a deficiency of those assets—fewer assets than customers' aggregate claims on them—or there will not be. Before the firm becomes insolvent, after all, should a customer wish to withdraw all of her assets, she will almost certainly be able to do so. For the firm, even if there are insufficient customer assets overall, satisfying a single customer's request in full is simply a matter of robbing Peter to pay Paul, as it were. That is, pre-insolvency, if a deficiency of customer assets exists, no one need know, since funding a sporadic withdrawal is merely a matter of having sufficient assets *somewhere* within the firm that can be drawn upon.[45]

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42. *See infra* notes 70–74 and accompanying text (describing the custody requirements that apply to securities brokers).

43. *See* 15 U.S.C. § 78o(c) (2012) (prohibiting securities brokers' use of deceptive, fraudulent, or manipulative devices); 17 C.F.R. § 240.15c1-7 (2016) (providing that a securities broker that has discretionary investment authority as to a customer's account may not effect purchases or sales "which are excessive in size or frequency in view of the financial resources and character of such account").

44. For a discussion of operational requirements in the securities and futures brokerage contexts, see *infra* notes 49–74, 93–119 and accompanying text. Although some operational requirements serve the ends of procedural regulation, many others pertain to the substantive ends of regulation, namely the services a firm provides to its customers.

45. *See* Complaint at 14–15, U.S. Commodity Futures Trading Comm'n v. MF Global Inc., No.

Second, procedural regulation uses bankruptcy laws and rules in order to help mitigate the effects of insolvency. In particular, in 1978, Congress enacted special provisions of the Bankruptcy Code to apply to brokerage firm insolvencies, and the relevant regulatory agencies (the Securities and Exchange Commission ("SEC") and the CFTC) adopted associated rules pursuant to their authority under those provisions.[46] These provisions and rules prioritize brokerage customers over creditors in the liquidation process.[47] Third, procedural regulation relies on insurance, in the form of pools of funds that may be tapped for purposes of compensating customers of bankrupt firms under appropriate circumstances.[48]

The remainder of this Part discusses the core procedural laws and rules used in the securities and futures brokerage contexts. Focusing on the securities brokerage context, Part II.A provides a comparative perspective that sets the stage for Part II.B's discussion of the procedural regulation of futures brokerage firms. Although differences between the securities markets, on the one hand, and the futures markets, on the other, clearly account for part of the discrepancy in customer protection in the two contexts, they cannot account for all of it.

A. Securities Brokers

To protect customer assets, the regulatory regime governing securities brokers relies to some extent on each of the three tools noted above. Arguably, however, its specialized insurance regime provides more robust protection than do its operational requirements or the provisions of the

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13-cv-4463 (S.D.N.Y. June 27, 2013), *available at* http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfmfglobalcomplaint062713.pdf [hereinafter CFTC Complaint] (detailing MF Global's use of customer funds to "meet the liquidity needs of [the firm's] proprietary trading activities"); *see also infra* Part III (discussing the phenomenon of inappropriately drawing on certain accounts to cover obligations of other, depleted accounts in the days prior to MF Global's bankruptcy).

46. *See infra* notes 75–79, 120–31 and accompanying text (describing the Bankruptcy Code provisions in the securities and futures brokerage contexts).

47. *See infra* notes 75–79, 120–31 and accompanying text.

48. *See infra* notes 80–90 and accompanying text (describing insurance protection in the securities brokerage context).

Meaningful civil and criminal penalties might, of course, constitute a fourth tool of regulation. However, past experience has demonstrated that penalties are not particularly strong deterrents in the procedural regulatory context. Indeed, the enforcement mechanisms available to the CFTC and the SEC are far from toothless, yet troublesome events continue to emerge, as the financial crisis demonstrated on a large scale and as ongoing FCM bankruptcies—and the customer losses they often produce—have demonstrated on a smaller scale. *See supra* notes 38–40, *infra* notes 151–61 and accompanying text (detailing historical and current FCM bankruptcies that have produced customer losses). Accordingly, this Article does not include penalties among the other tools.

Bankruptcy Code that apply to securities broker insolvencies. Nonetheless, the latter two tools support the insurance regime and, presumably, reduce the likelihood that the insurance pool will need to be tapped. This Subpart describes each of the tools and the role that each plays in protecting the deposits of securities brokerage customers.

Operational requirements governing securities brokers are set forth in four sources—namely, the Securities Exchange Act of 1934 ("Exchange Act"),[49] the SEC's rules under the Exchange Act,[50] the Federal Reserve's Regulation T,[51] and the rules of the Financial Industry Regulatory Authority ("FINRA"), which is the self-regulatory organization for the securities industry.[52] To understand these requirements, it is necessary to understand the nature of the relationship between securities brokers and their customers: Most securities brokerage customers are investors or traders—be they individuals, businesses, endowments, hedge funds, or mutual funds—that wish to transact in securities. Toward that end, these investors establish accounts with one or more brokers and use the funds they deposit in those accounts to buy and sell securities.[53] The broker typically acts as the intermediary, procuring a seller or a buyer for each of the investors' securities transactions.[54] At any given time, then, an investor's brokerage account will typically hold a certain mix of cash and securities.

This picture is complicated, however, by one critical factor. The Exchange Act provides that securities brokerage account arrangements may authorize an investor—a brokerage customer—to borrow "on margin."[55] With such an arrangement, the customer may borrow additional funds from the broker to use for her securities trading and investment activities.[56] Alternatively, she may borrow securities from the broker that

49. 15 U.S.C. §§ 78o–78o-3 (2012).

50. 17 C.F.R. pt. 240 (2016).

51. 12 C.F.R. pt. 220 (2016).

52. *See FINRA Rules*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=607 (last visited Mar. 29, 2016), *archived at* http://perma.cc/9DM4-5MRN.

53. *See, e.g.*, Jonas Elmerraji, *Picking Your First Broker*, INVESTOPEDIA, http://www.investopedia.com/articles/younginvestors/06/firstbroker.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/MD4Y-JCFN ("[Y]ou can't start investing if you don't have a brokerage account.").

54. *See Broker*, THE FREE DICTIONARY, http://legal-dictionary.thefreedictionary.com/broker (last visited Mar. 29, 2016), *archived at* http://perma.cc/Q4ZY-QSGY (describing the function of various types of brokers, including securities brokers).

55. 15 U.S.C. § 78g (2012) (setting forth certain requirements governing brokers' extension of credit to customers).

56. *See Margin: Borrowing Money to Pay for Stocks*, U.S. SEC. & EXCH. COMM'N, www.sec.gov/investor/pubs/margin.htm (last visited Mar. 29, 2016), *archived at* http://perma.cc/4N53-

she then uses to effect so-called short sales, selling the borrowed securities and later buying the same quantity (hopefully at a price that is lower than the price at which she sold) in order to repay her loan.[57] Regardless of the type of borrowing, by virtue of the arrangement, the customer is able to increase the possible magnitude of her investment profits, as well as the possible magnitude of her losses, beyond what would be feasible in the absence of the arrangement.[58] She is able to, in other words, "leverage" the balance of her account.[59]

In connection with a broker's lending funds or securities to a customer, a certain portion of the securities or other assets in the customer's account will be deemed collateral for the loan (accounted for in a so-called "margin account"), pledged to the broker for so long as the loan remains outstanding.[60] In theory, the result of that circumstance is the same as in any lending context. If the customer does not repay the loan, the firm may lay claim to the encumbered assets.[61] Another, and more significant, result, however, is that the lending arrangement also typically constitutes authorization for the broker to "rehypothecate" the margin account's assets—that is, to use them for its own investment and trading activities.[62]

XQVT [hereinafter *SEC Brochure*] ("'Margin' is borrowing money from your broker to buy a stock and using your investment as collateral.").

57. *See The Basics of Short Selling*, INVESTOPEDIA, http://www.investopedia.com/articles/investing/100913/basics-short-selling.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/8SQS-HSVR (describing the mechanics of a short sale).

58. *See SEC Brochure*, *supra* note 56 (observing that "[i]nvestors generally use margin to increase their purchasing power so that they can own more stock without fully paying for it" but that "margin exposes [them] to the potential for higher losses").

59. *See Leverage*, INVESTOPEDIA, http://www.investopedia.com/terms/l/leverage.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/N6JP-33LV (defining "leverage" as "the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment").

60. *See* 15 U.S.C. § 78g (2012) (setting forth margin-related requirements); *Margin Account*, INVESTOPEDIA, http://www.investopedia.com/terms/m/marginaccount.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/M5RT-Q5A8 (defining "margin account" as "a brokerage account in which the broker lends the customer cash to purchase securities" and noting that "[t]he loan in the account is collateralized by the securities and cash").

61. *See Investing with Borrowed Funds: No "Margin" for Error*, FINRA, http://www.finra.org/investors/alerts/investing-borrowed-funds-no-margin-error (last visited Mar. 29, 2016), *archived at* http://perma.cc/WL3E-XTQ8 (describing how margin accounts work).

62. *See Rehypothecation*, INVESTOPEDIA, http://www.investopedia.com/terms/r/rehypothecation.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/8AZT-3JSE (defining rehypothecation as "the practice by banks and brokers of using, for their own purposes, assets that have been posted as collateral by their clients"). Although customer consent is required for this use, *see FINRA Rules*, *supra* note 52 (prohibiting brokers, in Rule 4330(a), from "lend[ing] securities that are held on margin for a customer and that are eligible to be pledged or loaned" unless the broker has first obtained the customer's consent), that consent may be part of the documentation by which the customer opens her account or, if separate, the lending agreement. *See id.* (permitting, in supplementary materials to Rule

Among other things, the firm might use the assets as collateral for its repurchase agreements—effectively short-term borrowing arrangements on which brokers rely heavily to meet day-to-day needs for cash or particular securities.[63] Or, the firm could use cash in the account to enter into resale (or "reverse repurchase") arrangements, in which the broker effectively makes a short-term loan to another firm, receiving securities as collateral.[64] The firm could also lend the securities to other customers for use in those other customers' short selling activities.[65]

At any given time, then, although the broker keeps track of the amount that each customer would be entitled to receive if the customer were to repay all borrowings from the firm and close her account, if all customers were to close their accounts simultaneously, the firm would be unable to satisfy its payment obligations to them.[66] Yet that is effectively what either precipitates or follows from a broker's insolvency. That is, either too many customers seek to withdraw their account balances, thereby leading to insolvency, or the firm's own investment, trading, and borrowing activities—whether carried out through borrowing customers' assets or not—drain the firm's assets, leading to insolvency and the resulting need to liquidate customers' accounts.[67] Regardless of the cause of the insolvency, the result may be the same, in that the amount of assets that the firm holds for customers may be less than customers' legitimate claims

4330(a), a customer account agreement to include customer consent for the broker's lending of margin securities).

63. *See Definition of Repurchase Agreement*, FIN. TIMES, http://lexicon.ft.com/Term?term =repurchase-agreement (last visited Mar. 29, 2016), *archived at* http://perma.cc/83D2-ZYZU (noting that a repurchase agreement is "a type of short-term loan . . . whereby the seller of a security agrees to buy it back at a specified price and time" and that "[t]he seller pays an interest rate, called the repo rate, when buying back the securities").

64. "Repos" and "reverse repos," as they are called, are simply two sides of the same coin: In any given transaction, one party has entered into a repo, while its counterparty has entered into a reverse repo. *See Repurchase Agreement—Repo*, INVESTOPEDIA, http://www.investopedia.com/terms/r/ repurchaseagreement.asp (last visited Mar. 29, 2016), *archived at* http://perma.cc/6APY-DLLW ("For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction, (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement.").

65. *See supra* note 57 and accompanying text (explaining short sales).

66. After all, at a minimum, it is likely that at least some customer securities will have been loaned to others for purposes of facilitating short selling activity. *See Short Sales*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/shortsale.htm (last visited Mar. 29, 2016) (noting that "[b]rokerage firms typically lend stock to customers who engage in short sales," using, among other sources, "the margin account of another of the firm's customers").

67. The latter cause arguably led to the 2008 collapse of Bear Stearns. *See, e.g.*, Bryan Burrough, *Bringing Down Bear Stearns*, VANITY FAIR (June 30, 2008, 12:00 AM), http://www.vanityfair.com/ news/2008/08/bear_stearns200808-2 (describing the reasons for the firm's collapse).

to them.[68] Moreover, because brokers have the ability to borrow cash and securities from customers and to collateralize those loans with various types of assets, the assets that *are* available may be of a different cash-securities mix than what would otherwise be the case.[69]

Although this description of typical securities brokerage arrangements may suggest that securities brokers are subject to few operational restraints in their handling of customer assets, in fact they are subject to many. Whereas a broker generally may use a customer's margin assets for a variety of purposes unrelated to the services it provides to the customer, the firm must adhere to certain procedurally focused operational requirements as to any other assets—that is, any unencumbered assets—the customer may hold with the firm.[70] Pursuant to these operational requirements, which are largely contained in the SEC's rules under the Exchange Act, a broker must maintain a reserve bank account for the exclusive benefit of customers, the minimum balance of which is determined based on a formula that nets the amount that the firm owes to its customers against the amount that customers owe to it.[71] The intention behind this reserve requirement is to ensure that securities brokers refrain from inappropriately using their customers' assets for their own activities, whether they be trading or business related.[72] In addition, the firm must maintain possession and control of those unencumbered assets[73]—and, therefore, must refrain from lending or selling them unless the broker

68. To retrieve their deposits, customers—like the firm's secured and unsecured creditors—will be required to submit a formal claim to the estate's administrators. *See* ADMIN. OFFICE OF THE U.S. COURTS, BANKRUPTCY BASICS 68 (2011), *available at* http://www.uscourts.gov/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf [hereinafter BANKRUPTCY BASICS] (observing that a customer of a bankrupt brokerage firm must file a "written statement of claim").

69. This possibility follows from the fact that a broker may engage in repos and reverse repos with customer assets. *See supra* notes 63–64 and accompanying text.

70. "Unencumbered assets" in this context are cash and securities that are not encumbered by the customer's obligations to the firm and include so-called "fully paid" securities—that is, securities purchased without use of a loan from the firm—and "excess margin" securities—which are securities that the customer may have purchased through use of the firm's funds but that are in excess of the amount required to be pledged as collateral for the loan. *See* 17 C.F.R. § 240.15c3-3(a)(3), (5) (2016) (defining "fully paid securities" and "excess margin securities," respectively).

71. *See id.* § 240.15c3-3(e) (setting forth reserve requirements).

72. *See* Thomas W. Sexton, Nat'l Futures Ass'n, Comments on Proposed Rule: Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products, 2001 WL 34790034, at *2 (Dec. 5, 2001) [hereinafter Sexton Comments] (observing that the reserve requirement seeks to ensure that "broker-dealers do not use customer funds to fund their own business and trading activities").

73. *See* 17 C.F.R. § 240.15c3-3(b) (setting forth requirements for the "physical possession or control" of customer securities).

complies with various requirements.[74] Taken together, these operational requirements aim to give customers exclusive use and withdrawal rights as to their assets that are not needed to "support" their borrowings from the broker.

The operational requirements that apply to securities brokers are intended to ensure that, notwithstanding the many uses to which a firm may put customer assets, the firm must also maintain some reasonable measure of customer protections. Serving as a backstop to these requirements is a second procedural regulatory tool: provisions of the Bankruptcy Code, contained in subchapter III of chapter 7,[75] which specify the procedures to be followed in the liquidation of insolvent securities brokers.[76] Pursuant to those provisions, the trustee of an insolvent broker must distribute "customer property" to the customers ratably based on customers' "net equity" claims.[77] More importantly for customer protection purposes, and as noted above,[78] customers' claims on that property have priority over all other claims on the firm's aggregate estate, with the exception of claims made to cover costs arising from the administration of the estate.[79]

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74. First, if a securities broker wishes to borrow a customer's fully paid securities for purposes of lending them to other customers wishing to sell the securities short, the customer must not have exercised her right under the Exchange Act to opt out of allowing such lending. *See* 15 U.S.C. § 78o(e) (2012) (providing a right for customers to opt out of lending securities in their accounts). In addition, if, as a result of the lending arrangement, the firm actually uses the customer's securities in furtherance of other customers' short sales, the firm must notify the customer that the firm may be compensated for doing so. *See id.* Second, prior to entering into a lending arrangement involving fully paid or excess margin securities, the firm and the relevant customer must enter into a written agreement that sets forth the compensation to the customer and the parties' respective rights and obligations with respect to the loan. *See* 17 C.F.R. § 240.15c3-3(b)(3) (setting forth the agreement requirement). Third, pursuant to a FINRA rule, the broker must "have reasonable grounds for believing that the customer's loan(s) of securities are appropriate for the customer" and exercise "reasonable diligence" in making that determination. *See FINRA Rules*, *supra* note 52 (setting forth, in Rule 4330(b), requirements governing a broker's use of fully paid and excess margin securities). Other requirements include that the firm provide collateral to the customer consisting of cash or US Treasury bills or certain other liquid and low-risk assets, *see* 17 C.F.R. § 240.15c3-3(b)(3)(iii)(A), and establish the value of the loaned securities on a daily basis (and, if necessary, provide additional collateral to the customer). *See id.* § 240.15c3-3(b)(3)(iii)(B).

75. 11 U.S.C. §§ 741–753 (2012).

76. In a bankruptcy brought under subchapter III, other provisions of the Bankruptcy Code continue to apply, including chapter 11's general provisions, certain provisions of both chapter 3 and chapter 5, and chapter 7's other provisions except to the extent otherwise specified in subchapter III. *Cf. In re* Griffin Trading Co., 245 B.R. 291, 302 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001) (reciting the provisions that apply in a bankruptcy proceeding under subchapter IV of chapter 7, which pertains to FCM bankruptcies).

77. *See* 11 U.S.C. § 752(a) (2012) ("The trustee shall distribute customer property ratably to customers on the basis and to the extent of such customers' allowed net equity claims . . . .").

78. *See supra* notes 46–47 and accompanying text.

79. *See* § 752 (setting forth the priority requirement and its exception).

It is not worth delving too deeply into the details of subchapter III, however, because, in practice, its provisions are overshadowed[80] by the third tool—the insurance regime provided by the Securities Investor Protection Act of 1970 ("SIPA").[81] SIPA's insurance program is predicated on the special risks arising from brokers' arrangements with their customers. In particular, the statute created a broker-funded insurance pool to be used to compensate customers of insolvent securities brokers whose accounts, at the time of the insolvency, do not contain all of the cash, securities, and other assets necessary to satisfy customers' net equity claims.[82] In other words, the insurance pool is designed to return to customers the amount of missing cash and securities (less any cash, securities, or other assets the customer owes the firm),[83] subject to a cap of $500,000, no more than $250,000 of which may consist of cash.[84]

SIPA's insurance regime is administrated by a non-profit corporation that SIPA created, the Securities Investor Protection Corporation ("SIPC").[85] Any securities broker that is a depository of customer assets—by no means the universe of brokers[86]—must be a SIPC member and make annual contributions to the insurance pool.[87] Accordingly, upon a broker's insolvency, if it appears that SIPC's involvement is necessary—and assuming that the firm is a SIPC member—SIPC, pursuant to its authority under SIPA, typically will ask the bankruptcy court to appoint a SIPC-

80. Subchapter III is rarely used, *see In re Griffin Trading Co.*, 245 B.R. at 302 ("Congress . . . recognized that the Bankruptcy Code would apply to stockbroker liquidations only in very rare cases."), given that securities brokers are liquidated under SIPA. *See* BANKRUPTCY BASICS, *supra* note 68, at 64 (citation omitted) ("Although the Bankruptcy Code provides for a stockbroker liquidation proceeding, it is far more likely that a failing brokerage will find itself involved in a proceeding under [SIPA], rather than a Bankruptcy Code liquidation case.").

81. 15 U.S.C. §§ 78aaa–78*lll* (2012).

82. *See* Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1096 (1999) (observing that "the SIPC fund will cover the shortfall" in the event an insolvent broker's estate has insufficient customer assets to satisfy customers' claims).

83. *See* 15 U.S.C. § 78fff-4 (2012) (setting forth customer payment procedures).

84. *See id.* § 78fff-3(a), (d) (providing for maximum payment amounts per customer).

85. *See SIPC Mission*, SEC. INVESTOR PROTECTION CORP., http://www.sipc.org/about-sipc/sipc-mission (last visited Mar. 29, 2016) (observing that "SIPC was created under [SIPA] as a non-profit membership corporation" and that "[i]n a liquidation under [SIPA], SIPC and the court-appointed Trustee work to return customers' securities and cash as quickly as possible"). As an acronym, SIPC is pronounced "Sip-ick."

86. Because some securities brokers do not hold customer deposits, their activities cannot put customer deposits at risk. Accordingly, they are not required to be SIPC members. *See* 15 U.S.C. §§ 78ccc(a)(2), 78ddd(c) (2012) (setting forth SIPC's membership and assessment requirements). Such brokers may, however, join SIPC voluntarily. *See* S. REP. No. 91-1218, at 4 (1970) (noting that becoming a SIPC member is voluntary for non-depository brokers).

87. *See* 15 U.S.C. §§ 78ccc(a)(2), 78ddd(c).

associated trustee to administer the firm's estate, including to oversee the payment of insurance proceeds to any affected customers.[88] In those circumstances, moreover, the brokerage-firm specific provisions of the Bankruptcy Code are stayed.[89]

Congress enacted SIPA for much the same reason that it has adopted all securities statutes: to protect investors and maintain their confidence in the securities markets.[90] More specifically, it sought to further those goals by ensuring the procedural protection of investors' capital. Regardless of how flagrantly a broker might disregard operational requirements or how severely it might overextend itself in its trading and borrowing activities, customers will be protected, at least to the extent that the amounts of their respective insurance claims are less than the cap.[91] As the next Subpart discusses, Congress's approach to regulating futures brokers is considerably different.

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88. *See id.* § 78eee (setting forth the required procedures for the appointment of a SIPC trustee).

89. *See* 11 U.S.C. § 742 (2012) (providing that SIPC's filing of an action for a protective decree under SIPA "stays all proceedings in the case under [the Bankruptcy Code]").

90. *See About SIPC: History and Track Record*, SEC. INVESTOR PROTECTION CORP., http://www.sipc.org/about-sipc/history (last visited Mar. 29, 2016), *archived at* https://perma.cc/Q3G9-VC2P ("SIPA's purpose is to protect customers against certain types of loss resulting from broker-dealer failure and, thereby, to promote investor confidence in the nation's securities markets.").

91. *See supra* note 84 and accompanying text (describing SIPA's coverage limitations). Of course, protecting investors was presumably not Congress's only objective. The insurance regime also serves the salutary cause of maintaining liquidity in the markets at times of financial stress. *Cf.* Charles W. Colomiris, *Runs on Banks and the Lessons of the Great Depression*, 22 REG. 1, 4 (1999), *available at* http://object.cato.org/sites/cato.org/files/serials/files/regulation/1999/4/deplesson.pdf (observing that, without insurance protection, bank customers' concerns about bank solvency can "cause otherwise solvent banks to fail and produce chaos in the payment system and in credit markets"). Without the protection of customers' brokerage funds that SIPA provides, customers would likely remove those assets at the first hint that their broker is experiencing financial difficulties—a phenomenon that famously produced the "bank runs" leading up to the Great Depression. *See id.* (explaining the phenomenon of bank runs). That result would, in turn, hinder the firm's continued use of repurchase agreements or other arrangements for short-term funding, thereby hindering its ability to loan capital and securities to other customers, to satisfy its obligations under swap and other agreements to which it is a party, and to maintain its investment and trading activities. *See* HAL S. SCOTT, COMM. ON CAPITAL MKTS. REGULATION, INTERCONNECTEDNESS AND CONTAGION 2 (2012), *available at* http://www.aei.org/files/2013/01/08/-interconnectedness-and-contagion-by-hal-scott_153927406281.pdf (evaluating "the impact of [Lehman Brothers'] insolvency on its creditors, including derivatives counterparties, prime brokerage clients, [and] structured securities investors"). Those results, without more, reduce the ability of others to transact in the financial markets and may have the further effect of nudging other institutions down a similar path. Nevertheless, given some important drawbacks to an insurance regime, insurance is not necessarily always the optimal approach. *See infra* notes 293–98 and accompanying text (explaining why insurance is not an ideal approach for improving FCM regulation).

B. Futures Brokers

Just as transacting in securities typically requires the assistance of a securities broker, transacting in futures contracts usually necessitates the use of a futures broker—an FCM.[92] And the regulation of FCMs generally—but not completely—relies on a combination of the same types of procedural tools that govern securities brokers, although these tools are formulated differently and have different underlying rationales. The one significant exception, however, is that there is no third mechanism of procedural regulation, as articulated in the previous Subpart. There is, in other words, no last-resort insurance regime similar to SIPA's. This Subpart discusses Congress's and the CFTC's approach to the procedural regulation of FCMs and the role that each mechanism plays in protecting futures customer assets.

Much like the regulation of securities brokers, the operational requirements governing FCMs spring from multiple sources. As suggested above, the regulatory structure governing FCMs is set forth in the CEA,[93] which the CFTC has fleshed out and elaborated through the rules it has adopted pursuant to the authority that Congress granted it under the CEA.[94] In addition, the CEA and associated rules are supplemented by rules adopted and enforced by multiple self-regulatory organizations ("SROs"), such as the Chicago Mercantile Exchange ("CME"), which is also a futures exchange, and the National Futures Association ("NFA").[95] Each FCM has a "designated" SRO, which oversees the FCM's day-to-day regulatory compliance.[96]

The particular operational requirements that have emerged in the FCM context are a product of the nature and function of futures brokerage services. Indeed, there are numerous differences between those services

92. *See* 7 U.S.C. § 1a(28) (2012) (defining "futures commission merchant" as one who is "engaged in soliciting or in accepting orders for" commodity futures and related instruments). The assistance of a broker typically is necessary because anyone wishing to transact in futures must be a clearing member of the relevant futures exchange and because only individuals registered as "floor traders" with the CFTC may actually execute futures trades—requirements that most futures market participants do not meet. *See In re* Griffin Trading Co., 245 B.R. 291, 296 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001) (additionally noting that "[i]ndividuals who want to trade commodities must do so through a 'broker' as the broker's 'customers'").

93. 7 U.S.C. §§ 1–27f (2012).

94. 17 C.F.R. §§ 1.1–190.10 (2016).

95. *See CFTC Glossary*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_d (last visited Mar. 29, 2016), *archived at* perma.cc/2UV2-QBBK (noting that the self-regulatory organizations are "the commodity exchanges and registered futures associations").

96. *See id.* (describing the regulatory function of designated self-regulatory organizations).

and those provided by securities brokers, the primary one being that, whereas a securities customer uses the assets in her account to buy and sell securities, the deposits in a futures customer's account—typically only cash—are not used to *buy* anything.[97] Rather, the cash serves as collateral (once again, "margin") for the customer's futures trades.[98] To transact in futures, a customer places an order with her FCM for a certain number and certain type of futures contracts.[99] The FCM executes the trade on the customer's behalf by forming a contract with a third party, which may be another FCM.[100] Thereafter, the parties "clear" the transaction, each providing the specifics of the transaction to the "clearinghouse" for the relevant futures exchange, which then matches the two sides and completes the trade.[101] In connection with completing the trade, the clearinghouse requires each FCM to deliver the amount of cash that is required as margin for "its" side of the transaction, and each FCM, in turn, subtracts the relevant amount from the relevant customer's brokerage account.[102] If, during the term of the futures contract, fluctuations in commodity prices advantage one side of the contract—meaning that that party is "in the money" as to the contract—the exchange will require the other party's FCM to deliver additional cash (additional margin, that is) to cover the greater amount that the FCM's customer is likely to owe to the advantaged party upon the contract's termination.[103]

Perhaps the most important of the operational requirements governing an FCM's holding of customer assets is section 4d of the CEA, which requires that the FCM separately account for all assets deposited by customers and prohibits the FCM from commingling customer assets with

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97. *See Funding a Futures Account*, THISMATTER.COM, http://thismatter.com/money/futures/futures-account.htm (last visited Mar. 29, 2016) (noting that "[f]utures are not bought and sold" and that "the margin required for a futures contract is not like the margin used to purchase stocks" but, instead, is intended "to insure contract performance").

98. *See In re* Griffin Trading Co., 245 B.R. 291, 296 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001) (observing that margin "is generally some small percentage of the total contract price offered as security for contract performance").

99. *See id.* (referring to the order placement process).

100. *See id.* (describing the trade execution process).

101. *See id.* ("The buying member and the selling member then 'clear' the trade by separately submitting details of the trade for matching by the exchange 'clearing house.'"). As described by the *Griffin* court, "'[c]learing' is the novation process through which 'the clearing house . . . becomes the buyer to each seller of a futures contract and the seller to each buyer, and assumes responsibility for protecting buyers and sellers from financial loss by assuring performance on each contract.'" *Id.* In the event that a customer's FCM is not a clearing member of the relevant exchange, the FCM must execute the transaction through another broker, one that is a clearing member of the exchange. *See id.*

102. *See id.* ("The broker usually transfers the initial margin from funds which the customer has deposited with it for this purpose.").

103. *See id.* (describing "variation margin calls").

the FCM's own funds.[104] This provision is supported by CFTC rule 1.20, which requires the FCM to segregate customer deposits "as belonging to [the FCM's] futures customers."[105] This segregation requirement applies on an aggregate basis. That is, for practical reasons, although each customer has her own account with its own ledger balance (and the customer's account statements reflect only her account balance as of the statement date), the FCM may pool all customer funds into a single account with a depository institution, such as a bank or a trust company.[106] Accordingly, the segregation requirement obligates the FCM only to segregate the pool of customer funds from "house" funds; it does not obligate the FCM to segregate each customer's funds from all other customers' funds.

Section 4d also prohibits an FCM's use of a customer's assets to "margin or guarantee the trades or contracts . . . of any customer" other than the customer who deposited the assets.[107] In other words, in delivering to a clearinghouse the margin required for a customer's trade, the FCM may not use segregated account funds in excess of the balance of that customer's ledger account. Accordingly, in the event that the margin that a clearinghouse requires of a customer exceeds the customer's account balance, the FCM must call upon the defaulting customer to deposit additional funds.[108] The result of an FCM's failure to heed that requirement, and to instead deliver to the clearinghouse funds in excess of the balance of the customer's account, should be obvious: Until the customer replenishes her account, the total amount of customer funds on deposit with the FCM, having been depleted by the amount of the deficit balance, will be insufficient to satisfy the other customers' legitimate claims if they were to simultaneously withdraw their balances—or if the firm were to be liquidated.[109]

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104. 7 U.S.C. § 6d(a)(2) (2012) (providing that customer deposits "shall be separately accounted for and shall not be commingled with the funds of such commission merchant").

105. 17 C.F.R. § 1.20(a) (2016).

106. *See id.* § 1.20(e)(1) ("A futures commission merchant may for convenience commingle the futures customer funds that it receives from, or on behalf of, multiple futures customers in a single account or multiple accounts . . . .").

107. 7 U.S.C. § 6d(a)(2).

108. *See In re* Griffin Trading Co., 245 B.R. 291, 296 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001) ("If there are not enough funds in [a customer's] account to cover [a] margin call, the broker will require the customer to make an additional deposit.").

109. *See id.* at 298 ("[O]ne trader's loss [that "reduces [the customer's] balance to a negative number"] does not change the book balances of other customers, but it does change the amount of money actually available in the segregated account to pay those [customers back].").

Pursuant to other operational requirements, which are contained in the CFTC's rules under the CEA, an FCM must, on a daily basis, electronically file with the CFTC and the FCM's designated

Those segregation-related requirements are buttressed by another: When depositing customers' funds in an account with a bank, trust company, or other institution, an FCM must clearly identify the account as containing customer funds and must obtain an acknowledgement from the institution that the funds belong to the FCM's customers and that the institution will promptly reply to any inquiries by CFTC personnel regarding customer accounts.[110] Moreover, the FCM must deposit its own funds in the customer segregated account in order to create a buffer that helps to ensure the firm's compliance with segregation requirements and may not withdraw more than 25% of those funds without pre-approval by a senior official of the FCM and notifying the CFTC and the relevant SRO.[111] A final requirement worth noting is that, if an FCM ceases to maintain the requisite amount of capital (net of liabilities) in its house accounts, it must halt its operations and transfer customer positions to another FCM until it is able to demonstrate compliance.[112] The objective behind the operational requirements, taken together, is to mitigate any risk that an FCM might borrow from the segregated account and be unable to repay those amounts—a possibility that would inevitably arise if, for example, the firm were on the verge of bankruptcy.[113]

Despite the hands-off policy that the segregation-related operational requirements impose, Congress and the CFTC recognized that an FCM's use of customer assets for particular types of trading and investment activities could be both beneficial for the FCM and relatively low-risk for

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SRO the FCM's calculation of the amount of funds required to be held in segregation and the amount actually held in segregation. *See* 17 C.F.R. § 1.32(c) (2016); *see also id.* § 1.12(h) (requiring an FCM to immediately report to the CFTC and to the FCM's designated SRO that it has failed to maintain sufficient segregated assets). As a result of that requirement, regulators are able to evaluate daily whether the FCM maintains sufficient funds in segregation. The notion is that, if the FCM reports a deficiency, the CFTC will be able to take action before any losses actually materialize—that is, prior to the FCM's insolvency and liquidation. *See* Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 77 Fed. Reg. 67,866, 67,889 (proposed Nov. 14, 2012) (to be codified at 17 C.F.R. pts. 1, 3, 22) [hereinafter CFTC Amendment Release II] (observing that rule 1.32 will allow CFTC staff "to determine almost immediately . . . whether a firm is undersegregated and immediately take steps to determine if the firm is experiencing financial difficulty or if customer funds are at risk").

110. *See* 17 C.F.R. § 1.20(d), app. A.

111. *See id.* § 1.23(c)–(d).

112. *See id.* § 1.17(a)(4). The institution additionally must grant the CFTC direct, read-only access to transaction and balance information for accounts holding customer funds and must agree that the CFTC or the relevant designated SRO may examine the accounts at any time. *See id.* § 1.20(d)(3).

113. *See* CFTC Amendment Release II, *supra* note 109, at 67,869 (describing recent FCM bankruptcies involving deficiencies of customer assets and noting that those events "have demonstrated the value of establishing . . . enhanced early warning systems to detect and address capital issues").

the FCM's customers.[114] Accordingly, another component of the operational requirements applicable to FCMs—CFTC rule 1.25—authorizes an FCM to invest segregated assets in certain financial instruments, including US government securities, municipal securities, certificates of deposit issued by an FDIC-insured bank, corporate notes and bonds guaranteed by the United States, and interests in money-market funds, and to reap the profit from those investments.[115] Moreover, an FCM may buy and sell those instruments pursuant to repurchase or resale agreements.[116] For example, the FCM may, using a repurchase agreement, sell (on a short-term basis) customer securities to another financial institution, receiving in return cash that permits the FCM to buy permitted instruments on a leveraged basis. The CFTC also, however, imposed limits on these activities, in terms of, among other things, the amount of customer assets that may be invested in permitted instruments and the amount that may be invested in any one issuer.[117]

In light of these rules, an FCM, like a securities broker, may effectively use customer assets for its own profit-generating purposes.[118] Yet, by imposing various limitations on that use, the CFTC sought to strike a balance between an FCM's self-focused investment activities and protecting customers from any losses arising from them. If investments must be conservative and, even then, pursued in moderation, the argument goes, then presumably they present no appreciable risks.[119]

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114. *See* Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78,776, 78,777 (Dec. 19, 2011) (to be codified at 17 C.F.R. pts. 1, 30) [hereinafter CFTC Amendment Release] (noting the "investment flexibility and opportunities" associated with an FCM's ability to invest customer deposits in certain "safe" instruments).

115. *See* 17 C.F.R. § 1.25; *see also* 7 U.S.C. § 6d(a)(2) (2012) (providing that an FCM may invest customer money in certain types of instruments, including those permitted by the CFTC).

116. *See* 17 C.F.R. § 1.25(a)(2).

117. *See id.* § 1.25(b)(3). The FCM must manage any such investments "consistent with the objectives of preserving principal and maintaining liquidity" (meaning that the investments must be convertible into cash in one business day without a "material loss of value"). *Id.* § 1.25(b). In addition, to the extent an FCM uses repurchase or resale agreements in its rule 1.25-authorized transactions, only certain types of institutions may serve as counterparties to those agreements (FDIC-insured banks and securities brokers, for example), and the agreements must meet certain requirements relating to, among other things, their term, the maintenance of records pertaining to them, and the FCM's rights in the event of its bankruptcy. *See id.* § 1.25(d).

118. *See* 17 C.F.R. § 1.29 (providing that an FCM may retain interest and income arising from its investment of customer assets pursuant to rule 1.25).

119. *See* CFTC Amendment Release, *supra* note 114, at 78,776 (observing that the CFTC is "mindful that customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks . . . to preserve their availability to customers").

Bankruptcy rules comprise the second component of the procedural regulation of futures brokers. Specifically, Congress enacted subchapter IV of chapter 7 of the Bankruptcy Code[120] to specify the liquidation procedures that apply in FCM insolvencies. Perhaps because it did so at the same time that it enacted subchapter III, applicable to securities brokers, subchapter IV largely tracks subchapter III.[121] For purposes of achieving procedural regulatory goals, the central provision of subchapter IV is section 766, which provides that, in an FCM liquidation, the bankruptcy trustee must distribute customer property to customers ratably on the basis of the customers' net equity claims. As in the securities brokerage context, those claims have priority over all other claims on the estate.[122]

The key to appreciating the unique protection that subchapter IV provides, however, lies in the definition of "customer property" contained in section 761(10).[123] That definition becomes critical if, at the time of an FCM's insolvency, there are insufficient funds in the segregated account to satisfy customers' claims—a circumstance that could arise if, for example, the FCM used customer assets for unauthorized purposes or otherwise violated the operational requirements detailed above.[124] Under the definition, customer property means, among other things, property "received, acquired, or held" by or for the FCM "from or for the account of a customer," including property held for purposes of margining, buying, or selling a futures contract, profits arising from the customer's trades, and, as set forth in subsection (A)(ix) of section 761(10), other (non-segregated) property of the FCM that "any applicable law, rule, or regulation requires to be set aside or held for the benefit of a customer."[125]

Following subchapter IV's enactment, pursuant to authority deemed granted[126] by Congress,[127] the CFTC adopted "applicable rules" refining

120. 11 U.S.C. §§ 761–767 (2012).

121. *See supra* notes 75–79 and accompanying text (describing the provisions of the Bankruptcy Code that govern a securities broker's insolvency).

122. *See* 11 U.S.C. § 766(h) ("[T]he trustee shall 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 . . . .").

123. *See id.* § 761(10).

124. The FCM bankruptcies discussed in Part III exemplify this possibility. *See infra* notes 151–61 and accompanying text (discussing MF Global's and PFGBest's bankruptcies).

125. 11 U.S.C. § 761(10).

126. The use of "deemed" is appropriate here, as it is not certain that the CFTC had authority to adopt at least one of the rules that it did. *See infra* notes 218–40 and accompanying text (describing the validity concerns associated with the Recourse Rule).

127. *See* 7 U.S.C. § 24(a) (2012) (providing that the CFTC may specify that "certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer

the subchapter's provisions, including rules that expanded the scope of section 761(10)'s definition of customer property.[128] The CFTC's "Part 190" rules, as they are called, go far to protect customers, largely as a result of a single provision.[129] Specifically, much like section 761(10) of subchapter IV, the Part 190 rules set forth a list of property that is to be considered customer property, and, for the most part, that list mirrors section 761(10)'s list.[130] The CFTC's list goes further, however, providing in rule 190.08(a)(1)(ii)(J) (the "Recourse Rule") that customer property also includes, critically, general property *of the FCM*, to the extent that the property falling within the other categories on the list is insufficient to satisfy in full all customer claims.[131] In other words, regardless of whether any of the property held in the name of the FCM is connected to or derived from property that is held or should have been held for the benefit of customers, customers are entitled to it if necessary to make them whole. Not only is that provision not included in subchapter III, which applies to insolvent securities brokers, it likely is also unique among the expansive body of bankruptcy laws and rules.[132]

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As the discussion above suggests, there are marked similarities between some of the procedural regulatory tools used in the futures brokerage context and some of the tools used in the securities brokerage context. For example, both regimes require that special accounts be maintained for the benefit of customers,[133] and both contain special liquidation provisions under chapter 7 of the Bankruptcy Code.[134] By the same token, there are also marked differences. For example, although both securities brokers and futures brokers may use customer assets for purposes of generating firm profit, securities brokers may do so only as to

property or member property").

128. *See* 17 C.F.R. pt. 190 (2016).

129. *See id.*

130. *See id.* § 190.08(a)(1); *see also* 11 U.S.C. § 761(10).

131. *See* 17 C.F.R. § 190.08(a)(1)(ii)(J) (providing that "customer property" includes "cash, securities or other property of the debtor's estate . . . , but only to the extent that" the property enumerated in rules 190.08(a)(1)(i)(E) and 190.08(a)(i)(ii)(A)-(H) is insufficient).

132. *See infra* Part III.B (discussing the limitations of the Recourse Rule).

133. Although the futures industry's segregation requirement is, at first glance, similar to the reserve account requirement to which securities brokers are subject, the requirements differ in various respects. Among other things, although futures brokers must calculate the segregated account balance on a daily basis, securities brokers may calculate required reserves on a weekly or monthly basis. *See* Sexton Comments, *supra* note 72, at *2 (describing how customer account maintenance requirements in the futures brokerage and securities brokerage contexts differ).

134. *See supra* Part II.A–B (describing specifics of the procedural regulation of securities brokers and FCMs, respectively).

customers to whom they have extended credit, whereas futures brokers are permitted to do so as to all customers.[135] And, of course, there is the fact that securities regulation relies on an insurance regulatory regime as a formidable protective tool, whereas futures regulation does not.[136] These differences, and many others, may be attributable to the fact that futures are very different from securities and the associated fact that FCMs function differently from securities brokers in important respects.[137] Yet, when one considers the substantial weaknesses in the procedural regulation of FCMs that the next Part highlights, that rationale becomes less convincing.

III. UNCERTAIN CUSTOMER PROTECTION

Both the regulation of securities brokers and the regulation of FCMs rely on specific tools to achieve the goal of procedural regulation, which, again, is to protect assets that customers have deposited with their brokers for purposes of carrying out their financial activities. In each of these regulatory spheres, the tools employed are generally some mixture of operational requirements, bankruptcy rules, and insurance-like compensation. Although the preceding discussion describes the particular combination of tools on which each sphere relies, it does not provide a normative assessment of them.

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135. *See supra* notes 60–65, 114–17 and accompanying text (describing regulations permitting securities and futures brokers to invest customer assets for the brokers' own benefit).

136. In 1974, Congress instructed the CFTC to conduct a study addressing whether there was a need for insurance in the FCM context, and, in 1976—two years before Congress enacted subchapter IV of the Bankruptcy Code—the agency rendered its report, which concluded that insurance was not necessary. *See* MARKHAM, *supra* note 10, at 87 (discussing the CFTC's conclusion that "there was no need for legislative action" as to insurance for futures customers). The report noted, among other things, that futures customer losses in connection with FCM bankruptcies from 1938 through 1974 were, overall, lower than losses arising in connection with securities broker bankruptcies and that there was adequate public confidence in FCMs' protection of customer deposits. *See id.* (listing the bases for the CFTC's conclusion that insurance protection for futures customers was unnecessary). Accordingly, concluded the report, the benefits of an insurance program were insufficient to warrant the associated costs. *See id.* (observing that, according to the CFTC, "the cost-benefit ratios demonstrated that insurance protection was not cost effective"). Soon after the issuance of the report, two FCM bankruptcies arising from customer defaults resulted in substantial customer losses. *See id.* at 87–89 (describing the two bankruptcies and resulting customer losses). Nonetheless, the CFTC—or, more precisely, its Division of Trading and Markets—maintained that, despite the risks posed by customer defaults, existing regulations generally provided sufficient protections against default-related losses. *See id.* at 89 (noting the CFTC's position that "existing regulatory safeguards . . . operate[d] to mitigate the effect of [one FCM failure] on customers and the exchange itself").

137. *See supra* notes 9–10, 98–103 and accompanying text (describing what a futures contract is and what FCMs do); *see also* Sexton Comments, *supra* note 72, at *2 ("The segregation requirement was developed to meet the particular needs and characteristics of the futures industry . . . .").

That is the task of this Part. It focuses primarily on the regulatory regime governing FCMs, which has received little attention from scholars to date, particularly in comparison to the widespread and extensive focus that securities brokers have received.[138] Critical analysis of FCM regulation is especially important now, moreover, given the ever-growing number of retail investors deploying their assets in the futures markets.[139] Part III.A focuses on the operational requirements governing FCMs, elucidating how, even after having been substantially overhauled in recent years, they harbor weaknesses that present substantial risks to customers, while Part III.B analyzes the deficiencies of the seemingly protective futures-specific bankruptcy rules.

A. Operational Requirements

As Part II details, various statutes and CFTC rules that apply to FCMs govern the manner in which FCMs conduct their businesses.[140] Collectively, these provisions aim to ensure the safety of customer deposits by, among other things, specifying where and how the deposits must be maintained and prohibiting the use of other customers' deposited funds to support a defaulting customer's transactions.[141] Operational requirements of some variety are, moreover, necessary, especially considering two recent FCM bankruptcies that produced substantial anguish and losses for FCM customers.[142] After briefly describing these calamitous episodes and summarizing the regulatory reform that they spawned,[143] this Subpart explains why, without more, the requirements presently governing FCMs still are not up to the task of protecting customer assets.[144]

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138. As an imprecise example, a Westlaw search in late 2014 showed that over 5000 law journal articles in Westlaw's "Law Reviews & Journals" database used the term "securities broker" or "broker-dealer," while fewer than 400 used the term "futures commission merchant" or "futures broker."

139. *See* Andrew Greene, *Managed Futures Reach Retail Portfolios*, FIN. TIMES (June 9, 2012), http://www.ft.com/intl/cms/s/0/d0f8c1be-aef1-11e1-a4e0-00144feabdc0.html#axzz3L9aWXsrj ("Managed futures, which a few short years ago were available only in hedge fund and institutional products, are increasingly finding their way into retail investors' portfolios.").

140. *See supra* notes 104–19 and accompanying text (describing operational requirements in the futures brokerage context).

141. *See supra* notes 104–19 and accompanying text.

142. *See infra* notes 151–61 and accompanying text.

143. *See infra* notes 172–80 and accompanying text (describing regulatory changes made in the bankruptcies' aftermath).

144. *See infra* notes 181–205 and accompanying text.

1. Regulatory Failures and Responses

As Part II observes, the most important operational requirement governing FCMs requires an FCM to segregate customer assets from the FCM's own assets and to continuously maintain a specified amount of net capital in its own accounts, thereby helping to ensure its financial health.[145] Of course, as Part II also notes, amidst the operational duties that apply to FCMs is an operational *right*: An FCM may invest its customers' assets in certain types of financial instruments for its own benefit, retaining any profits arising from those investments.[146] The operational requirements constrain this activity, too, however. There are only a limited number of instruments in which FCMs are permitted to invest customer assets, and investments in those instruments are subject to fairly stringent requirements and limitations.[147]

In evaluating these operational requirements, it is important to keep in mind that, even though FCMs traditionally have been permitted to use customer assets for generating investment-related profit, the futures brokerage business model nonetheless has differed substantially from its securities brokerage counterpart. In the securities arena, firms' business structures contemplate brokers' lending funds and securities to customers and their use of the collateral associated with those loans both for providing services to *other* customers—namely, lending securities to other customers to facilitate their short sales—and for proprietary investing and trading.[148] Perhaps because securities brokers hold the customer assets that they use in these ways as collateral, the brokers are permitted not only to use the assets somewhat less conservatively than what is permitted by CFTC rule 1.25 for FCMs, but also to repledge them in connection with their own borrowing activities.[149] Accordingly, FCMs' activities historically have not been viewed as creating the same risk for customer assets as the activities that securities brokers pursue.[150] Particularly given

145. *See supra* notes 104–06, 112 and accompanying text.

146. *See supra* notes 114–17 and accompanying text.

147. *See supra* notes 114–17 and accompanying text.

148. *See supra* notes 62–65 and accompanying text.

149. *See* Alarna Carlsson-Sweeny, *Trends in Prime Brokerage*, PRAC. L. CO. (Apr. 1, 2010), http://us.practicallaw.com/7-501-8652?q=%22trends+in+prime+brokerage%22 (noting that brokerage firms have the ability "to rehypothecate (or re-pledge) the assets that clients post as margin or collateral for trades," allowing a firm to "use the client's assets, for example, to lend to . . . hedge funds or post as collateral itself for another purpose").

150. *Cf.* MARKHAM, *supra* note 10, at 87 (listing the reasons behind the CFTC's conclusion that insurance coverage of futures accounts was not warranted, including that losses arising from FCM

this difference, the operational requirements applicable to FCMs may seem sufficient for protecting customer assets, if not overly precautionary.

Certainly one might have surmised as much prior to October 31, 2011. On that day, the large FCM (and registered securities broker) MF Global, Inc. was placed in liquidation when its parent company, MF Global Holdings, Ltd., declared bankruptcy.[151] The bankruptcy was later determined to have had a number of causes, all of which could generally be distilled to one factor: the firm's pursuit of high-risk investment activities, centering on European sovereign debt (in the form of bonds).[152] Although MF Global's management believed these instruments to be virtually risk-free,[153] they proved to be virtually the opposite.[154] Putting aside for the moment the cause of the bankruptcy, however, the most notable aspect of the event, and certainly the most disturbing for MF

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insolvencies had not been as high as losses in contexts, such as securities brokerage, in which insurance existed).

151. *See* Michael J. de la Merced & Ben Protess, *MF Global Files for Bankruptcy*, N.Y. TIMES DEALBOOK (Oct. 31, 2011, 10:21 AM), http://dealbook.nytimes.com/2011/10/31/mf-global-files-for-bankruptcy/?_r=0, *archived at* http://perma.cc/2EAF-5Q7V (reporting on MF Global's bankruptcy filing). MF Global, Inc. was only the firm's US brokerage subsidiary; to perform brokerage functions outside of the United States, the firm had established additional MF Global subsidiaries in other countries, at least some of which were also placed in liquidation. *See* STAFF REPORT PREPARED FOR REP. RANDY NEUGEBAUER, CHAIRMAN, SUBCOMM. ON OVERSIGHT & INVESTIGATIONS, COMM. ON FIN. SERVS. 22 (2012), *available at* http://financialservices.house.gov/uploadedfiles/256882456288524.pdf [hereinafter STAFF REPORT] (listing MF Global Holdings's regulated subsidiaries and the regulation governing each such subsidiary); Kyri Evagora et al., *MF Global Enters Insolvency Proceedings on Both Sides of the Pond*, REED SMITH (Nov. 1, 2011), http://m.reedsmith.com/mf-global-enters-insolvency-proceedings-on-both-sides-of-the-pond-11-01-2011/ (observing that SIPC "initiated the liquidation of MF Global, Inc." under SIPA and that "the UK subsidiary, MF Global UK Limited, was placed into a new special administration regime for investment banks"). Because each of the subsidiaries was wholly owned and controlled by the the parent company, *see* Disclosure Statement for the Plan of Liquidation for MF Global Holdings Ltd., MF Global Finance USA Inc., and Their Debtor Affiliates at 90, *In re* MF Global Holdings Ltd., 481 B.R. 268 (Bankr. S.D.N.Y. 2012) (No. 11-15059 (MG)) (depicting the MF Global entities and their relationship to one another), this Article uses "MF Global" to refer to the parent company or the brokerage subsidiaries, as appropriate.

152. Matthew Leising, *MF Global's $310 Million Margin Call Exceeded Its Market Value*, BLOOMBERG (Feb. 6, 2012, 6:36 PM), http://www.bloomberg.com/news/2012-02-06/mf-global-faced-a-310-million-margin-call-on-futures-broker-s-final-day.html, *archived at* http://perma.cc/9KZH-WKZ9 (describing how MF Global's "$6.3 billion European debt trade," among other things, precipitated MF Global's bankruptcy).

153. *See* John Carney, *The Trade That Killed MF Global*, CNBC (Nov. 2, 2011, 12:02 PM), http://www.cnbc.com/id/45132384, *archived at* http://perma.cc/X9SX-4WXE (reporting that, in pursuing its "European debt trade," MF Global was "taking what it viewed as a nearly risk-free trade").

154. *See* Report of Investigation of Louis J. Freeh, Chapter 11 Trustee of MF Global Holdings Ltd. et al. at 97, *In re* MF Global Holdings Ltd., No. 11-15059 (MG) (Bankr. S.D.N.Y. Apr. 4, 2013), *available at* http://www.mfglobalcaseinfo.com/pdflib/1279_15059.pdf (observing that MF Global's bet on European sovereign debt "exposed [the firm] to an excessive level of risk").

Global's customers, was that, at the point of bankruptcy, the firm's segregated accounts contained insufficient funds to cover customers' legitimate claims.[155] The shortfall, which totaled approximately $1.6 billion,[156] or approximately 27% of customer deposits,[157] was the product of the firm's inappropriate use of customer funds to meet its ever growing liquidity needs as it neared insolvency.[158]

A mere nine months after MF Global's bankruptcy, another FCM, PFGBest, went bankrupt—an event that similarly revealed a mammoth deficiency of customer assets.[159] Although PFGBest's customer assets were but a fraction of those held by MF Global, PFGBest's bankruptcy was substantially larger in scale than MF Global's, in terms of the percentage of customer assets that were missing from the segregated account.[160] In addition, the cause of PFGBest's shortfall was arguably more troublesome than the inept managerial decisions that stood at the heart of MF Global's downfall. PFGBest's founder had, quite simply, stolen customers' funds, draining the segregated account beginning in the early 1990s and fabricating the quarterly account statements required by the NFA, as PFGBest's designated SRO.[161]

The effects of these dual bankruptcies were far-reaching. Futures traders and other market participants left the market (at least temporarily),

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155. *See* STAFF REPORT, *supra* note 151, at 1 (observing that MF Global's demise produced a substantial deficiency of customer funds).

156. *See id.*

157. This conclusion arises from the fact that, in the estimates of the bankruptcy trustee, "customers held up to $5.9 billion altogether." Hilary Russ, *MF Global Trustee Reveals Suspicious Transfers*, LAW360 (Dec. 9, 2011, 4:11 PM), http://www.law360.com/articles/292134/mf-global-trustee-reveals-suspicious-transfers, *archived at* http://perma.cc/LY5L-6L2T.

158. *See* Jason M. Breslow, *MF Global Trustee Hints at Negligence Suit Against Jon Corzine*, PBS (June 4, 2012), http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/mf-global-six-billion-dollar-bet/mf-global-trustee-hints-at-negligece-suit-against-jon-corzine/, *archived at* http://perma.cc/W3GL-ZYS9 (reporting the conclusion of MF Global's trustee that the firm had used customer funds to cover "margin calls on European sovereign debt positions").

159. *See* Jerry A. Dicolo et al., *Q&A: What PFGBest Customers Can Expect*, WALL ST. J. (July 11, 2012, 6:23 PM), http://online.wsj.com/articles/SB10001424052702303644004577521122246505822, *archived at* http://perma.cc/R2PY-687B (noting that PFGBest filed for bankruptcy under chapter 7 of the Bankruptcy Code).

160. *See* Peter Lattman, *Futures Executive Is Arrested After Admitting Fraud*, N.Y. TIMES (July 13, 2012, 5:23 PM), http://dealbook.nytimes.com/2012/07/13/futures-executive-confesses-to-stealing-millions-from-customers/, *archived at* https://perma.cc/R2F8-H83D (reporting that although PFGBest's "supposed bank statement with U.S. Bank said [the firm] had $221 million in customer funds," the account actually contained only $6.3 million).

161. *See id.* (describing details of the fraud carried out by PFGBest's founder); *see also* Karen Gullo & Edvard Pettersson, *Peregrine's Wasendorf Gets 50 Years for Theft of Millions*, BLOOMBERG (Jan. 31, 2013, 12:21 PM), http://www.bloomberg.com/news/articles/2013-01-31/u-s-wants-peregrine-s-wasendorf-imprisoned-for-50-years (referring to PFGBest's founder's "20-year embezzlement starting in the early 1990s").

simultaneously reducing market liquidity;[162] firms known as commodity trading advisors, who traded in futures on behalf of their advisory clients, closed their businesses;[163] and farmers who relied on futures trading to hedge against fluctuations in grain prices had insufficient capital to pursue their business activities as a result of having lost the funds they had used to margin their trades.[164] Many affected parties and horrified onlookers blamed the CFTC, as well as the CME and the NFA, which had been, respectively, MF Global's and, as noted, PFGBest's designated SROs, primarily for having adopted overly lax rules governing FCMs' use of customer funds.[165]

On that score, there was, in fact, substantial room for improvement. Rule 1.25 at the time permitted FCMs to invest customer assets in a wider range of instruments than what is permitted now, including corporate notes and bonds other than those guaranteed by the US government and interests in sovereign debt[166]—the securities that felled MF Global and that are known to "carr[y] enormous default and liquidity risks."[167] In addition, FCMs that were also regulated securities brokers could engage in "in-

162. *Cf.* Nick Santiago, *5 Reasons Why Volume Has Died*, INTHEMONEYSTOCKS.COM (May 14, 2012, 3:53 PM), https://www.inthemoneystocks.com/free-services/rant-rave-blog/item/21921-5-Reasons-Why-Volume-Has-Died, *archived at* https://perma.cc/8ZCQ-SVKP (observing that one reason why "trading volume has been extremely light since . . . March 2009" is that MF Global's bankruptcy caused traders to "los[e] faith in the entire financial system"); Jeffrey Carter, *Fraud Is Killing Retail Futures Business*, POINTS & FIGURES (July 13, 2012), http://pointsandfigures.com/2012/07/13/fraud-is-killing-retail-futures-business/ (stating that, during the years since the MF Global and PFGBest bankruptcies, "we have sensed that the [futures] business was contracting," that "[f]ewer players are doing more volume," and that "[t]he breadth of that volume is now concentrated into fewer and fewer hands").

163. *See* Daniel P. Collins, *New York Times Once Again Gets It Wrong*, FUTURES (Jan. 19, 2014), http://www.futuresmag.com/2014/01/19/new-york-times-once-again-gets-it-wrong, *archived at* https://perma.cc/EJ8P-6HXH (discussing "commodity trading advisors that shut down" in the aftermath of MF Global's bankruptcy).

164. *See id.* (referencing "farmers and ranchers out millions unable to buy seed or restock herds due to their money being gone" as a result of MF Global's bankruptcy).

165. *See, e.g.*, Bob Burgdorfer & Philip Shishkin, *Insight: Farm Belt Rage over MF Global Could Chill Markets*, REUTERS (Nov. 22, 2011, 2:12 AM), http://www.reuters.com/article/2011/11/22/us-mfglobal-futures-idUSTRE7AL06I20111122, *archived at* https://perma.cc/BW77-A485 ("Traders are livid over both MF Global's collapse and what they perceive as the CME Group's failure to act quickly or boldly enough to restore order to the market . . . ."); Mike Obel, *PFG Collapses in MF Global-Like Debacle; Broker Rues Lack of Caution, Oversight*, INT'L BUS. TIMES (July 11, 2012, 7:44 AM), http://www.ibtimes.com/pfg-collapses-mf-global-debacle-broker-rues-lack-caution-oversight-722119, *archived at* https://perma.cc/AN7U-ATJ2 (describing customers' and financial professionals' scorn for federal regulators after MF Global's and PFGBest's bankruptcies).

166. *See* 17 C.F.R. § 1.25(a)(1)(vi), (vii) (2007).

167. Press Release, H. Comm. on Fin. Servs., Subcommittee Investigation Reveals Decisions by Corzine Led to MF Global Bankruptcy and Missing Customer Funds (Nov. 14, 2012), *available at* http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=311647, *archived at* https://perma.cc/AT5W-XUXY.

house" repurchase transactions, exchanging customer assets for permitted investments that they held in their capacities as securities brokers.[168] Finally, FCMs whose customers traded in non-US futures markets were not obligated to segregate all of those customers' deposits from their own assets.[169] Instead, if the firms chose to use the "alternative method" of segregation for foreign futures trading contained in CFTC rule 30.7, they were required to segregate only the portion of those assets that might be needed to margin the relevant customers' open trades.[170] Any excess amounts that the customers had deposited could be freely commingled with the firm's own assets.[171]

In late 2011, shortly after MF Global's bankruptcy, the CFTC eliminated several of the permitted investments for customer assets contained in rule 1.25.[172] As Part II points out, customer funds and securities now may be used only for certain types of "safe" investments, including US government bonds and securities, municipal securities, and bonds issued by US government corporations.[173] The agency also eliminated the ability of dually-registered FCMs to enter into in-house repurchase transactions using customer assets,[174] as well as the alternative method of segregating customer assets set forth in rule 30.7.[175]

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168. *See, e.g.*, 17 C.F.R. § 1.25(a)(3)(i) (2007) (authorizing a dually-registered FCM to exchange customer money for "securities that are permitted investments and are held by the [FCM] in connection with its securities broker . . . activities"). The CFTC has articulated the risks that these transactions present:

> [I]n an in-house transaction, cash and securities are under common control of the same legal entity, which presents the potential for conflicts of interest in the handling of customer funds that may be tested in times of crisis. Unlike a [third-party] repurchase or reverse repurchase agreement, there is no mechanism to ensure that an in-house transaction is done on a delivery versus payment basis. Furthermore, an in-house transaction, by its nature, is transacted within a single entity and therefore cannot be legally documented, since an entity cannot contract with itself . . . .

CFTC Amendment Release, *supra* note 114, at 78,783.

169. *See* CFTC Amendment Release II, *supra* note 109, at 67,895 (describing the "alternative method" of segregating customer assets).

170. *See id.* at 67,867 (observing that rule 30.7 "requires an FCM to maintain in separate accounts an amount of funds only sufficient to cover the margin required on open foreign futures contracts, plus or minus any unrealized gains or losses").

171. *Cf. id.* (noting that, pursuant to rule 30.7, an FCM "is not required to maintain a sufficient amount of funds in [the] separate accounts to pay the full account balances of all of its foreign futures . . . customers at all times").

172. *See* CFTC Amendment Release, *supra* note 114, at 78,778 (announcing the adoption of the amendments to rule 1.25).

173. *See supra* notes 114–19 and accompanying text.

174. *See* CFTC Amendment Release, *supra* note 114, at 78,782–83 (eliminating rule 1.25(a)(3), thereby prohibiting "exchange[s] of cash or permitted instruments, held by a dually registered FCM/broker dealer, for customer funds").

175. *See* Enhancing Protections Afforded Customers and Customer Funds Held by Futures

Beyond amending existing rules, the CFTC adopted a number of new ones, many of which center on providing information to regulators and customers.[176] These new rules require that FCMs inform regulators if their financial health falters[177] and provide customers with extensive disclosures about the risks associated with holding a futures brokerage account.[178] Another new rule requires FCMs to establish risk management programs targeted at managing risks relating to customer funds.[179] Regardless of their specific content, however, all of the new rules were intended to fortify the procedural regulation of FCMs in order to forestall another fiasco like those wrought by MF Global and PFGBest.[180]

2. Ongoing Deficiencies

By themselves, however, these operational rules are not enough. Regardless how limited the range of uses of customer funds or how extensive FCMs' reporting and disclosure requirements may be, FCMs may nonetheless fail to act accordingly. Case in point is MF Global. To be sure, FCM regulation at the time of the firm's bankruptcy would have permitted MF Global's use of customer assets to invest in the

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Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,506, 68,573 (Nov. 13, 2013) (to be codified at 17 C.F.R. pts. 1, 3, 22, 30, 140) (adopting an amendment to section 30.7 to eliminate the alternative method).

176. *See generally id.* (describing the rationale for the amendments and new rules and formally adopting them).

177. Among other things, an FCM must notify its designated SRO and the CFTC of its failure to maintain the required amount of net capital, *see* 17 C.F.R. § 1.12(a) (2016), its having experienced a material change in its ability to pay its financial obligations, *see id.* § 1.12(k), and certain material changes to its operations that could adversely affect its available cash and other resources. *See id.* § 1.12(*l*).

178. The risk disclosure statement must include notices to the effect that customer assets are not protected by insurance and that the FCM may commingle a customer's assets with those deposited by other customers (thereby creating risk arising from the activities of other customers), deposit customer assets with its affiliates, and invest customer assets in certain types of investments, as permitted by the CFTC. *See id.* § 1.55(b).

179. *See* 17 C.F.R. § 1.11(a), (e) (requiring FCMs to adopt risk management programs and setting forth the necessary elements of those programs).

180. *See* Laura Goldsmith, *III. The Collapse of MF Global and Peregrine Financial Group: The Response from the Futures Industry, Regulators, and Customers*, 32 REV. BANKING & FIN. L. 25, 30 (2012) (observing in connection with the CFTC's amendments to rule 1.25, "[a]lthough Rule 1.25 exemptions may not have caused MF Global's collapse, the CFTC reacted swiftly to fortify its regulations in order to protect customer funds and avert a repeat crisis"); CFTC Amendment Release II, *supra* note 109, at 67,869 (describing the rule changes discussed in the text accompanying notes 175–79, *supra*, and noting that the MF Global and PFGBest insolvencies "highlighted weaknesses in the customer protection regime prescribed in the [CFTC's] regulations").

instruments—European sovereign bonds[181]—that proved so devastating to the firm.[182] However, the rules did not permit MF Global to use customer funds to satisfy its margin payment obligations to its counterparties,[183] nor did they permit the firm to invest customer assets in instruments that the CFTC had not expressly authorized[184] or to commingle customer funds with its own funds,[185] which the firm is also alleged to have done.[186]

Of course, one obvious objection to the prospect that an FCM may flout applicable rules is that "flouting" is a possibility in every financial services regulatory context, from investment adviser regulation, to securities broker regulation, to banking regulation and beyond. But here is the difference: While FCM regulation relies heavily on operational requirements to achieve the procedural regulatory goal of protecting customers' assets, the regulation of other types of financial services is not so limited. SIPA-based insurance coverage exists in the securities brokerage context,[187] and there is FDIC insurance in the banking context.[188] Moreover, in other financial services realms, such as financial planning and mutual fund marketing, providing services does not require the service provider to take custody of customer assets, thereby alleviating any need for protections more robust than operational requirements.[189]

There are exceptions to this general state of affairs, as one might expect. For example, there is no insurance regime or special bankruptcy

181. *See supra* notes 166–67 and accompanying text. Although rule 1.25 permitted FCMs to invest customer assets in bonds issued by other sovereignties, the firm predominantly used its own assets for those investments. *See* Breslow, *supra* note 158. However, it later used customer assets to cover margin calls when the value of the investments declined precipitously. *See id*.

182. *See supra* notes 151–54 and accompanying text (describing the events leading to MF Global's bankruptcy).

183. *See* 17 C.F.R. § 1.23(b) (2016) (providing that an FCM's withdrawal of funds from its segregated customer account may not result "in the funds of one futures customer being used to purchase, margin or carry the trades, contracts or commodity options, or extend the credit of any . . . other person").

184. *See* CFTC Complaint, *supra* note 45, at 10 ("An FCM may invest customer segregated funds only if the investment is on the applicable CFTC Regulation's list of 'permitted investments.'").

185. *See* 7 U.S.C. § 6d(a)(2), (b) (2012) (prohibiting the commingling of futures customer assets with the FCM's own assets); *see also supra* notes 104–06 (describing the segregation requirement to which FCMs are subject).

186. *See* CFTC Complaint, *supra* note 45, at 37–40 (charging MF Global and certain of its officers with violations of the CEA and various CFTC rules).

187. *See supra* notes 78–91 and accompanying text (describing SIPA insurance protection).

188. *See Understanding Deposit Insurance*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/deposit/deposits/ (last visited Mar. 29, 2016), *archived at* https://perma.cc/L7KA-KK2H.

189. This is evident, for example, from the fact that the SEC's "custody rule" under the federal statute governing investment advisers, the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. §§ 80b-1 to 80b-21 (2012), provides that it is a fraudulent act for an investment adviser to have custody of customer assets unless it complies with a number of detailed requirements. *See* 17 C.F.R. § 275.206(4)-2(a) (2016).

rules in the investment advisory context, despite the fact that at least some investment advisers, including many hedge fund managers and most private equity fund managers, are deemed to have "custody" of (control over and access to) investor assets,[190] as are many commodity trading advisors.[191] Once more, however, there is an important distinction to be made between the regulation of these financial services and the regulation of futures brokerage services. Only in the latter realm may the service provider use its customers' assets for its own purposes. Investment advisers are not permitted to do so; rather, an investment adviser's interaction with assets over which the adviser has custody is generally limited to the investment of those assets on the relevant clients' behalf, for the clients' benefit.[192] Analogous limitations apply to the activities of commodity trading advisors.[193]

To be sure, it may not be obvious why the distinction between having the ability to use customer assets and not having that ability is meaningful. The answer lies in the ways in which financial services providers' incentives may differ when dealing in customer assets for their own benefit, as compared with dealing in customer assets for the benefit of customers. When a financial services provider uses customer assets for its own purposes, the firm may have a greater incentive than it otherwise would to go beyond the letter of the law to achieve a greater return for the firm—that is, a greater benefit from the use of customer assets. Once again, MF Global is instructive. As noted, among that firm's numerous

190. *See, e.g.*, 17 C.F.R. § 275.206(4)-2(d)(2)(iii) (providing that "[c]ustody includes . . . [a]ny capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities").

191. That many commodity trading advisors are deemed to have custody of customer assets is a product of the fact that they are also commodity pool operators that, therefore, act as general partner of a commodity pool. *See infra* notes 308–09 and accompanying text (describing the function of commodity pool operators).

192. Although the Advisers Act does not expressly state as much, this conclusion is implied by the fact that the statute does not permit advisers to engage in any other activities with client assets and that advisers are deemed fiduciaries to their clients. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 190–91 (1963) (observing that the relationship of investment advisers to their clients is one of "trust and confidence" and that an investment adviser may not carry out its services so as to "operate against the interests of clients and the public").

193. No provision of the laws and rules governing commodity trading advisors permits them to invest customer assets for their own benefit. In addition, like investment advisers, commodity trading advisors may be deemed fiduciaries under common law. *See* DIV. OF SWAP DEALER & INTERMEDIARY OVERSIGHT, U.S. COMMODITY FUTURES TRADING COMM'N, CFTC ADVISORY NO. 13-79, STAFF ADVISORY CONCERNING COMMODITY TRADING ADVISORS AND SWAPS 12 (2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-79.pdf (noting that commodity trading advisors could be deemed fiduciaries and, additionally, are subject to antifraud provisions under the CEA).

regulatory transgressions was its investment of segregated account assets in instruments other than those that were expressly permitted by rule 1.25.[194] If corporate bonds are deemed safe from a regulatory perspective, why not other instruments with similar risk/reward profiles? For that matter, why not other instruments with slightly more risk but also greater possible rewards? And although CFTC rules require an FCM to reimburse the segregated account for any losses arising from the FCM's investment of customer funds,[195] that requirement is of little help as the firm approaches the precipice of bankruptcy.

Indeed, the incentives that accompany conflicts of interest inform various regulations governing *substantive* activities that, though largely for the benefit of the relevant customer, nevertheless contain an element of benefitting the firm. For example, an investment adviser may charge a client a performance-based fee, which is a fee that is a certain percentage of the profits that the adviser achieves for the client.[196] Because, however, such a fee is deemed to create a conflict of interest—that is, the adviser may have an incentive to effect too many or the wrong kind of transactions for the client in hopes of generating a greater performance fee[197]—the rules applicable to investment advisers specify that no client may be subject to a performance fee unless her net worth exceeds a certain threshold.[198] By contrast, the rules implicitly recognize that, when services are purely service-providing in nature and involve no additional benefit to the service provider, the service provider arguably has fewer incentives to push the boundaries because it is not afflicted with a similar conflict of interest.[199]

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194. *See supra* notes 183–86 and accompanying text.

195. *See* 17 C.F.R. § 1.29(b) (2016) ("The [FCM] . . . shall bear sole responsibility for any losses resulting from the investment of customer funds in instruments described in § 1.25.").

196. *See* 17 C.F.R. § 275.205-3 (permitting investment advisers to charge performance-based fees under certain circumstances).

197. *See, e.g.*, Amerivest Inv. Mgmt., LLC, SEC No-Action Letter (Aug. 19, 2014), *available at* http://www.sec.gov/divisions/investment/noaction/2014/amerivest-081914-205a1.htm, *archived at* https://perma.cc/RRK4-UYWU (internal quotation marks omitted) (observing that performance-based compensation may "encourage advisers to take undue risks with the funds of clients, to speculate, or to overtrade").

198. *See* 17 C.F.R. § 275.205-3(a) (providing that only clients that meet certain net-worth thresholds may be charged performance-based fees).

199. In the context of adviser compensation, this conclusion is implied by the fact that asset-based fee arrangements, under which an adviser is paid a particular percentage of the assets it manages, are not subject to the regulatory strictures that apply to performance-based compensation arrangements, other than the requirement that the fees not be excessive. *See, e.g.*, Jones v. Harris Assocs. L.P., 559 U.S. 335, 346 (2010) (observing that, under the Investment Company Act of 1940, an investment adviser cannot "charge a[n asset-based] fee that is so disproportionately large that it bears no

The effects of conflicts of interest may be discerned also in the many recent examples of under-segregation—instances in which regulators have penalized an FCM for maintaining insufficient assets in its segregated account.[200] The amount that an FCM must maintain in segregation is a precise number and can be calculated at any given time.[201] Accordingly, it would seem a relatively straightforward matter for the FCM always to ensure that the requisite amount of assets remains segregated. That picture is complicated, however, by FCMs' awareness that not *all* uses of customer funds are off limits. If the assets can be used to generate income or profit for the FCM through the activities that rule 1.25 permits,[202] then they can be used. Period. To be sure, customer assets cannot be used for many purposes,[203] but at the point at which at least some uses become possible, conflicts of interests become more prominent. When that happens, the line between *types* of uses of customer assets cannot be as clear and certain as would be the line between *some* uses, on one hand, and none at all, on the other—regardless of the content of any particular rules or requirements.

Ultimately, the conflict of interest that arises when a firm is allowed to use customer assets for its own benefit is the reason why operational requirements are not enough. This insight is reflected in SIPA[204]—securities brokers may engage in activities using customer assets that are, quite simply, too risky. Of course, FCM regulation involves more than operational requirements, in that operational protections are reinforced by special, customer-oriented rules of the Bankruptcy Code.[205] As the next

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reasonable relationship to the services rendered and could not have been the product of arms length bargaining").

Of course, even in contexts in which a service provider may not, under applicable laws and rules, use customer assets to benefit itself, the service provider may nonetheless engage in arguably worse behavior, such as by expropriating customer or client assets or by carrying out a Ponzi scheme with them. *See, e.g.*, Matthew Goldstein, *Credit Crunch Unmasks Madoff*, BLOOMBERG (Dec. 11, 2008, 11:00 PM), http://www.bloomberg.com/news/articles/2008-12-11/credit-crunch-unmasks-madoff (reporting the discovery of Bernard Madoff's Ponzi scheme, through which Madoff defrauded his advisory clients of multiple billions of dollars).

200. *See U.S. FCM Violations: Customer Segregated and Secured, Minimum Capital Violations*, NEEDHAM CONSULTING, http://needhamconsulting.net/2013/09/27/u-s-customer-segregated-funds-violations/ (last visited Mar. 29, 2016), *archived at* https://perma.cc/BF3C-VFE8 (listing FCMs against whom the CFTC has brought enforcement actions for violating the CFTC's segregation requirements).

201. *See supra* note 109 (describing CFTC rules requiring FCMs' daily reporting of both the amount of funds required to be segregated and the amount actually segregated).

202. *See supra* notes 114–17 and accompanying text (describing activities that rule 1.25 permits).

203. *See supra* notes 114–17 and accompanying text.

204. *See supra* notes 90–91 and accompanying text (summarizing SIPA's purpose).

205. *See supra* Part II.B.

Subpart describes, however, those rules also cannot be counted on to remedy a shortfall in customer assets that may exist at the time of an FCM's bankruptcy.

B. Bankruptcy Rules

As Part II discusses, special bankruptcy rules govern the liquidation of FCMs. In particular, subchapter IV of chapter 7 of the Bankruptcy Code sets forth the liquidation framework, and Congress authorized the CFTC to adopt rules building out that framework, such as rules including certain types of cash, securities, or other assets within the definition of customer property or excluding certain types of assets from the definition.[206] Pursuant to that grant of authority, the CFTC adopted the Part 190 rules, which contain the Recourse Rule, among others.[207] Under the Recourse Rule, recall, assets of the FCM's general estate may be deemed customer property if there is insufficient property in the estate otherwise constituting customer property.[208] As a result of that provision, in the event that, in connection with an FCM's liquidation under subchapter IV, there would otherwise be a shortfall of customer property, customers have a first priority claim to the estate's assets, ahead of the firm's unsecured creditors.[209]

The Part 190 rules may seem to go far in offsetting the fact that the operational requirements governing FCMs are not failsafe mechanisms for protecting customers. Such a conclusion would be mistaken, however, as a result of three factors: (1) the rules may be inapplicable, (2) if they do apply, they may be held invalid; and (3) if they both apply and are held valid, they may be irrelevant. The remainder of this Subpart discusses each of these factors in turn.

1. Inapplicability

Although, in the early era of FCM regulation, most FCMs likely were single-purpose businesses, today many FCMs perform other types of services in the financial markets, including, above all, securities brokerage

206. *See* 7 U.S.C. § 24(a) (2012) (providing that authorization); *see also supra* notes 120–25 and accompanying text (generally summarizing subchapter IV).

207. *See supra* notes 126–31 and accompanying text (describing the Part 190 rules).

208. *See supra* notes 129–31 and accompanying text.

209. *See supra* notes 129–32 and accompanying text.

services.[210] That is, these firms act both as securities brokers for customers wishing to trade in securities and as FCMs for customers wishing to transact in futures. In light of their dual role, they are dual-registrants, registered concurrently with the CFTC as FCMs and with the SEC as broker-dealers and subject to regulation and oversight by both agencies.[211] The fact of dual registration, though perhaps efficient for a dually-registered firm's customers, is problematic for those customers when the firm undergoes liquidation as a result of bankruptcy.

The SIPA-created insurance regime that applies to securities brokers provides that, in the event the SEC calls upon SIPC to administer the liquidation of a bankrupt securities broker's estate, the bankruptcy provisions of chapter 7 are to be stayed.[212] In that event, not only would the bankruptcy provisions governing securities brokers, set forth in subchapter III of Chapter 7, be stayed, but the bankruptcy provisions governing futures brokers, set forth in subchapter IV of Chapter 7, may also be stayed.[213] As a result, the estate of an insolvent FCM that is also a securities broker might be *entirely* administered under SIPA, at least to the extent that subchapter IV and SIPA are inconsistent with one another.[214] If that occurs, SIPC—or, more precisely, the trustee that SIPC designates—would oversee the administration of the liquidation of both the futures and the securities sides of the business, notwithstanding that only securities customers would be entitled to insurance compensation in the event that, after all efforts to retrieve customer property, customer property remains insufficient to satisfy customer claims.[215]

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210. *See Futures Brokerage Activities and Futures Commission Merchants*, *in* TRADING AND CAPITAL-MARKETS ACTIVITIES MANUAL § 3030.1, at 5 n.5 (1998), *available at* http://www.federalreserve.gov/boarddocs/supmanual/trading/3000p3.pdf ("Many FCMs also are SEC-registered as broker-dealers . . . .").

211. *See id*.

212. *See* 11 U.S.C. § 742 (2012); *see also supra* notes 87–89 and accompanying text.

213. *See* Bankruptcy, 48 Fed. Reg. 8716, 8720 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190) ("The [CFTC] is aware that the potential for an interpretation giving only limited recognition to subchapter IV under SIPA may well raise problems in implementing that subchapter in a joint bankruptcy.").

214. *See* 15 U.S.C. § 78fff-1(b) (2012) ("To the extent consistent with the provisions of [SIPA] . . . , a [SIPA] trustee shall be subject to the same duties as a trustee in a case under chapter 7 of [the Bankruptcy Code], including, if the debtor is a commodity broker, . . . the duties specified in subchapter IV of such chapter 7 . . . .").

215. This conclusion arises inevitably from the fact that SIPA's protections apply only to securities brokerage customers and do not apply to customers holding other types of accounts. *See supra* notes 80–84 and accompanying text (describing SIPA and the insurance coverage that it provides). The liquidation of MF Global exemplified this result. The trustee for the liquidation of both the firm's securities brokerage business and its futures brokerage business was a SIPC designee. *See* Nick Brown, *MF Global Clients Face Shortfall Despite Protections*, REUTERS (Nov. 9, 2011, 6:54

The less-than-ideal result for futures customers is evident from two perspectives. First, staying chapter 7 may mean not only that subchapter IV of chapter 7 is inapplicable, but also that the CFTC's Part 190 rules, including the Recourse Rule, are inapplicable. After all, the CFTC adopted the Part 190 rules pursuant to Congress's subchapter IV-specific grant of authority[216]—and, by all accounts, the Recourse Rule *is* inconsistent with SIPA, which, like the Bankruptcy Code, does not contemplate recourse to the estate's assets in the event of a shortfall in customer assets. Second, there arises the possibility of conflicts of interest on the part of the SIPC trustee. Specifically, if a question were to arise regarding whether particular property should be deemed futures customer property distributable to futures customers in satisfaction of their claims or whether it should be deemed securities customer property distributable to securities customers in satisfaction of their claims, the SIPC trustee may have an incentive to label it as the latter in order to minimize the amount that ultimately may need to be paid from the insurance pool that SIPC is responsible for maintaining.[217]

2. Invalidity

Not every FCM is a joint registrant, of course, and subchapter IV and the Part 190 rules will apply in the event that any such FCM becomes insolvent (since there will be no reason to stay those provisions). Even in those circumstances, however, it is far from certain that the Recourse Rule would apply if the need were to arise—that is, if there were a shortfall of customers' assets that could not be remedied by locating other assets of the FCM's estate otherwise constituting customer property. That uncertainty arises from the fact that those who stand to lose from the Rule's application—namely, the estate's unsecured creditors—are likely to challenge its applicability, primarily based on the contention that it goes

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AM), http://www.reuters.com/article/us-mfglobal-customers-idUSTRE7A77S420111109, *archived at* https://perma.cc/SC5Z-RTE6 (describing how, despite SIPC's involvement in the MF Global liquidation, SIPA covers only securities brokerage customers); Mike Spector & Aaron Lucchetti, *SIPC Appoints Trustee to Take Over MF Global's Brokerage*, WALL ST. J. (Oct. 31, 2011, 4:42 PM), http://blogs.wsj.com/deals/2011/10/31/sipc-to-appoint-trustee-to-take-over-mf-globals-brokerage/, *archived at* https://perma.cc/PS4Y-LQJV (reporting that SIPC had appointed a trustee).

216. *See supra* notes 126–29 and accompanying text.

217. *See* Andrea M. Corcoran, *Bankruptcy Pitfalls for Dually-Licensed Brokerage Firms*, 12 FUTURES INT'L L. LETTER 1, 6 (1993) (describing conflicts that may arise from the fact that SIPA insurance covers only securities brokerage accounts, including that an insurer "may want to limit the extent of any claim on its own funds").

too far.[218] And, indeed, at least one federal court, in *In re Griffin Trading Company*,[219] agreed with that argument, concluding that the provision was invalid under the first prong of the *Chevron* test.[220]

The general argument against the Recourse Rule's validity proceeds along the following lines: The Bankruptcy Code affirms general regulatory authority to expand the definition of customer property contained in section 761(10) of subchapter IV.[221] Subsection (A)(ix) of that section, recall, states that customer property includes other property of the FCM that, under applicable laws and rules, is required to be held for a customer's benefit.[222] In addition, at the time Congress enacted subchapter IV, Congress also enacted section 24 of the CEA, pursuant to which the CFTC may, for purposes of subchapter IV and notwithstanding any provisions to the contrary in Chapter 11, provide that "certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property."[223] At first blush, these two provisions seem to support one another in authorizing the CFTC's adoption of the Recourse Rule.

The difficulty with the Recourse Rule, and the factor that may cause it to fail *Chevron* analysis, however, stems from another provision of subchapter IV—namely, section 766(j)(2).[224] That section provides that "if a customer is not paid the full amount of such customer's allowed net equity claim from customer property, the unpaid portion of such claim is a claim entitled to distribution under section 726 of this title."[225] Section 726, for its part, specifies the order of priority of unsecured creditors of the estate.[226] As a result of section 766(j)(2), then, any customer with a shortfall remaining after a full distribution of customer property is to be

218. Most recently, the creditors of MF Global challenged the validity of the Recourse Rule. *See* Trustee's Response to Briefing Regarding the Legal Principles and Framework for Allocation and Distribution of Customer Property at 4–5, *In re* MF Global Holdings Ltd., No. 11-15059 (MG) (Bankr. S.D.N.Y. Jan. 9, 2012), *available at* http://dm.epiq11.com/MFG/Document/GetDocument/1555541.

219. *In re* Griffin Trading Co., 245 B.R. 291 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001).

220. *See id.* at 317. Under *Chevron*, a court evaluates an agency's rulemaking by focusing on whether Congress expressly addressed the question at issue (prong 1) or, if not, whether the agency's reading of the statute is a permissible construction (prong 2). Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984).

221. 11 U.S.C. § 761(10) (2012).

222. *See id.* § 761(10)(A)(ix).

223. 7 U.S.C. § 24 (2012).

224. 11 U.S.C. § 766(j)(2) (2012).

225. *Id.*

226. *Id.* § 726 (generally providing that unsecured claims as to which proof has been timely filed have priority over unsecured claims as to which proof has not been timely filed, which have priority over claims for fines, penalties, or damages).

treated as a general unsecured creditor of the FCM's estate, meaning that customers and general unsecured creditors must share the same pool of assets.[227] That result is, on its face, inconsistent with the Recourse Rule, which, again, provides that customers are entitled to assets of the estate ahead of unsecured creditors until customers' claims have been paid in full: If there are insufficient estate assets to satisfy customers' claims, then unsecured creditors will receive nothing.[228] If there are sufficient estate assets to satisfy customers' claims, then unsecured creditors will have exclusive claim to the remaining estate assets after all customer claims have been paid.[229] Either way, section 766(j)(2) is rendered meaningless,[230] an outcome that, according to the *Griffin* court, both counters the "clear" intent of Congress that section 766(j)(2) expresses[231] and produces an outcome that canons of statutory construction seek to avoid.[232]

Additionally, section 24 of the CEA may be read to support section 766(j)(2). Section 24, as noted above, provides that the CFTC may add "certain . . . property" to what subchapter IV considers to be customer property.[233] Pointing to section 24, the *Griffin* court opined that "the authority to include or exclude 'certain' . . . property is not authority to include any or all property in general."[234] The court noted that, in the Part 190 rules, the CFTC included as customer property the proceeds of letters of credit received to secure a futures contract, property pledged to an FCM as security for a loan, and funds recovered to eliminate a debit balance in a customer account.[235] Each of those items of property, in the court's view, is a specific and discrete item and, therefore, may rest on stronger statutory

227. *See id.* § 766(j)(2).

228. *See In re* Griffin Trading Co., 245 B.R. 291, 315–16 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001) (observing that, if there are insufficient assets in the estate to cover the shortfall, then "invoking § 766(j)(2) with the [Recourse Rule] in place would be an exercise in futility, because there would be nothing left in the estate to be paid out under . . . § 726").

229. *See id.* at 315 (observing that, if there are sufficient assets in the estate to cover the shortfall, then "there would be no customers who were not paid the full amounts of their claims, and the event which would trigger § 766(j)(2) . . . would never occur").

230. *See id.* (noting that, under either of the alternative scenarios, "§ 766(j)(2) is made superfluous").

231. *See id.* at 311 (observing that "Congressional intent is clear from the text of § 766(j)(2)").

232. *See id.* at 315 ("[T]he rule of statutory construction that avoids an interpretation of one section that renders another section meaningless also leads to the conclusion that the [Recourse Rule] is invalid and must be stricken.").

233. *See supra* note 223 and accompanying text.

234. *In re Griffin Trading Co.*, 245 B.R. at 311–12.

235. *See id.* at 311.

grounds as being "certain" property than the estate property referred to in the Recourse Rule.[236]

Relatedly, the concept of customer property harbors a traceability requirement that the Recourse Rule arguably fails to meet. As suggested in Part II,[237] section 761(10)'s definition of customer property begins by stating that "customer property means . . . property . . . received, acquired, or held by or for the account of the debtor, from or for the account of a customer."[238] In light of that preface, the section may be read to require that anything that the CFTC might deem to be customer property be traceable in some way to a customer's account.[239] Accordingly, although the section proceeds to list what items of property are included in the preface's general description—a list that includes subsection (A)(ix), covering other property that applicable rules or regulations require to be set aside for the benefit of customers—the Recourse Rule may go beyond what section 761(10) permits.[240] After all, it is likely the case that much, if not most, of the general property of an FCM's estate is not property originating "from or for the account of a customer."[241]

3. Irrelevance

As one might expect, there are other interpretations of subchapter IV and the Part 190 rules that produce a different conclusion about the validity of the Recourse Rule. This alternative conclusion begins with CFTC rule 1.20.[242] That rule—which, recall, requires FCMs to segregate customer assets from proprietary assets[243]—also effectively provides that, whatever may be the reason for a shortfall in customer segregated property that occurs during the course of an FCM's operations, the FCM must fill the deficiency, even if doing so requires the FCM to use its own funds or other assets.[244] Extending customer priority to a bankrupt FCM's general estate, as the Recourse Rule does, may be regarded as consistent with that

236. *See id.*
237. *See supra* note 125 and accompanying text.
238. 11 U.S.C. § 761(10) (2012).
239. *See In re Griffin Trading Co.*, 245 B.R. at 312 (observing that section 761(10) "[p]lainly . . . requires that 'customer property' must come from . . . or be intended for the account of a customer").
240. *See id.* at 317 (concluding that the Recourse Rule "does not harmonize with the language, origins, or purpose of [section 761(10)]," among other provisions).
241. 11 U.S.C. § 761(10) (2012).
242. 17 C.F.R. § 1.20(a) (2016).
243. *See supra* notes 104–09 and accompanying text (summarizing section 4d and rule 1.20).
244. *See* 17 C.F.R. § 1.20(a) (requiring an FCM to maintain at all times "in the separate account or accounts money, securities and property in an amount at least sufficient in the aggregate to cover its total obligations to all futures customers").

operational requirement. Of course, that insight cannot end the analysis. The fact that the Recourse Rule may be consistent with certain sections of the CEA does not mean that it is permitted by subchapter IV.

There are other ways to view that analysis, however. Here, one must return to subsection (A)(ix) of section 761(10) of subchapter IV and its reference to "other property of the debtor" that, pursuant to "any applicable law, rule, or regulation," the debtor is required to set aside or hold for the benefit of a customer.[245] By its terms, that provision does not say that such other property of the debtor *actually* has been set aside or held for the benefit of a customer. Rather, it refers only to other property that, under law or regulation, *should* have been set aside or held for customers.[246] In other words, under applicable law, it is precisely in shortfall scenarios that property to which customers are entitled may not actually have been set aside for them. Hence, there arises the need to resort to the FCM's own assets or, in a bankruptcy situation, the FCM's general estate.

This analysis also addresses the presumed traceability requirement of section 761(10): property that should have been set aside or held for customers arguably constitutes the property described in the preface, namely, "property . . . held by or for the account of the debtor . . . from or for the account of a customer."[247] The general estate property is held "for the account of the debtor," but it is also "for the account of a customer" in the sense that customers have become entitled to it pursuant to CFTC rule 1.20. As for CEA section 24, which authorizes the CFTC to designate "certain" property as customer property,[248] one might argue that property of the debtor's general estate is, itself, certain property. In any event, there is no apparent indication that Congress intended "certain" to encompass only discrete bits of property.

That leaves section 766(j)(2) and its requirement that customers whose claims have not been paid after exhausting other sources of customer property stand in line with the estate's unsecured creditors.[249] Although Congress likely knew when it enacted 766(j)(2) that the CFTC would adopt rules that possibly expanded the definition of customer property, it could not have known what those rules would be. Certainly, unless the CFTC adopted a rule that would extend to the assets of the debtor's

245. 11 U.S.C. § 761(10)(A)(ix) (2012); *see also supra* note 125 and accompanying text.
246. 11 U.S.C. § 761(10)(A)(ix).
247. *Id.* § 761(10).
248. 7 U.S.C. § 24(a) (2012).
249. 11 U.S.C. § 766(j)(2); *see also supra* notes 224–32 and accompanying text.

general estate, there was a possibility that the aggregate property ultimately deemed customer property would not be sufficient to pay customers in full. One could argue that section 766(j)(2) merely serves as a backstop in the event the question should ever arise. Recall that the section provides that, in the event that a customer's claim is not completely satisfied from the pool of customer property, the remaining portion of the claim is entitled to payment as an unsecured creditor claim.[250] Under what circumstances might a customer's claim not be paid in full from customer property, satisfying section 766(j)(2)'s condition? One such circumstance is the CFTC's failure to adopt a rule that deems general estate assets as customer property when all other sources have been exhausted.[251]

In any event, however, even if the Recourse Rule is ultimately determined to be a valid exercise of regulatory authority, it may not have the effect that the CFTC intended. In the event of an FCM bankruptcy in which a shortfall in customer assets requires paying customers' claims from the FCM's general estate, there quite likely will be insufficient assets in the estate because of how many FCMs—like many other financial services firms—are structured. In particular, FCMs are often part of a much larger group of affiliated entities, and, as a result, an FCM commonly is a subsidiary of another entity within the affiliated group.[252] Certainly that describes MF Global, Inc., which was owned by MF Global Holdings, Ltd. and had tens of entity affiliates,[253] as well as the FCMs under the umbrellas of JP Morgan[254] and Merrill Lynch,[255] for example.

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250. *Id.*

251. To be sure, this interpretation discounts, if not ignores entirely, the "construe-statutes-to-avoid-surplusage" canon on which the *Griffin* court relied. *See In re* Griffin Trading Co., 245 B.R. 291, 315 (Bankr. N.D. Ill. 2000), *vacated on other grounds*, 270 B.R. 882 (N.D. Ill. 2001). However, in the modern administrative state, ignoring canons of construction may be precisely what is required. *See, e.g.*, Stephen F. Ross, *Where Have You Gone Karl Llewellyn? Should Congress Turn Its Lonely Eyes to You?*, 45 VAND. L. REV. 561, 562 (1992) (noting that canons of statutory construction are indeterminate and subject to misuse).

252. *See* Anita K. Krug, *Escaping Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039, 2043 (2013) (observing that firms, including financial services firms, "frequently are components of groups of affiliated entities that, together, pursue related or mutually beneficial activities as a larger enterprise").

253. *See* Motion Pursuant to Federal Rule of Bankruptcy Procedure 9019 for Entry of Order Approving Settlement Agreement Between the Debtor, the Trustee, MF Global UK Limited (in Special Administration) and MFGUK Joint Special Administrators at 4, *In re* MF Global Inc., 481 B.R. 268 (Bankr. S.D.N.Y. 2012) (No. 11-2790 (MG) SIPA), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfgimfguksettlement122112.pdf, *archived at* perma.cc/GQ6E-QUVD ("MFG Holdings . . . was the parent of nearly fifty direct or indirect subsidiaries . . . .").

254. *See* Press Release, Reuters, Fitch Assigns Initial 'AA-/F1+' Ratings to J.P. Morgan Securities LLC (July 29, 2011) (noting that J.P. Morgan Securities LLC, a registered FCM, is a wholly-owned

Given that a bankrupt FCM, for all practical purposes, may have been controlled and operated by a separate entity, the FCM may be more poorly capitalized than might be the case if it had operated as a standalone entity.[256] The parent company, after all, may have had ample reason to distribute to itself any assets of the FCM beyond what might be necessary for the FCM to meet regulatory capital requirements.[257] Yet neither the Recourse Rule nor any other part of subchapter IV or the Part 190 rules palpably contemplates that FCMs are situated within parent-subsidiary arrangements. Therefore, those rules do not address the relevance of any entity's assets other than the bankrupt FCM's. To be sure, every FCM ownership arrangement is different, but arguably the picture is less optimal for customers the more the entity that is the FCM resembles just another asset of a much larger entity or group of entities.

IV. THE FUTURE OF FCM REGULATION

The predominant lesson from Part III is that existing regulatory protections of FCM customers, even if more robust than they were five years ago, are still far from adequate. Customers open accounts with FCMs and deposit funds, as banking customers do with banks. They expect those funds to be available for their use in transacting in futures, just as banking customers expect account deposits to be available for their use in buying goods and services. They understand that their activities in the futures markets may cause losses to their accounts—if they enter into losing trades, for example—much as banking customers understand that their own uses of deposited funds will diminish the value of their accounts. And, given that they engage an FCM only to provide brokerage services in connection with transactions they have chosen to effect, they surely expect their account deposits to be safe, just as banking customers do. Yet the analogy between holding funds in a futures account with an FCM and holding assets in a bank account goes only so far because, unlike bank deposits, deposits with an FCM are not adequately protected.

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subsidiary of JPMorgan Chase & Co.).

255. *See Commodity Futures Trading Commission Rule 1.55(k) AND (O): FCM-Specific Disclosure Document*, BANK OF AM. MERRILL LYNCH, http://corp.bankofamerica.com/business/bi/commodity-futures-trading-commission-rule-1.55-k- (last visited Mar. 30, 2016), *archived at* https://perma.cc/BT6A-ZDEQ (noting that the Merrill Lynch entity that acts as an FCM is an indirect subsidiary of Bank of America Corporation).

256. *See* Krug, *supra* note 252, at 2079–80 (describing how parent entities of financial services subsidiaries may not ensure that those subsidiaries are sufficiently capitalized).

257. *See id.*

The weaknesses in procedural regulation governing FCMs are all the more troublesome given that the futures markets are no longer the province of commercial enterprises that rely on futures for hedging purposes and other institutional and sophisticated traders. Rather, futures traders—and, therefore, futures customers—increasingly are retail market participants who use futures to further diversify their portfolios and who generally have an inadequate understanding of the risks posed by FCMs and unreasonable expectations about the safety of placing assets with them.[258] What, then, is to be done? Part IV.A proposes an answer, one that encompasses several reinforcing measures that not only would go far in plugging the gaping holes in the procedural regulation of FCMs, but that also would bolster market confidence, which was badly damaged by MF Global's and PFGBest's bankruptcies. Part IV.B evaluates the proposed reforms from the perspective of the unique history of futures regulation. It argues that, given the particular evolution of futures regulation in the United States, the reforms would help transform the status of the futures markets within the broader financial markets.

A. Regulatory Reform

As Part III describes, the CFTC's rules are formulated such that FCMs need not be hands off. That is, an FCM may invest customer deposits in certain instruments and may buy and sell those instruments pursuant to resale and repurchase agreements.[259] Apart from the fact that an FCM's use of customer assets in these ways necessarily involves risk is the fact that that use gives rise to conflicts of interest that may affect the FCM's ability to stay within the confines of regulatory requirements.[260] That circumstance is exacerbated by the fact that there is no equivalent to SIPC or the FDIC, meaning that deficiencies in customer assets that may exist at the time of the FCM's insolvency must be borne by customers.

Of course, Congress enacted special provisions of the Bankruptcy Code, set forth in subchapter IV of chapter 7, and the CFTC adopted

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258. *See* Dan Weil, *Alternative Mutual Funds: Are They Worth It?*, BANKRATE (Oct. 16, 2014), http://www.bankrate.com/finance/investing/are-liquid-alternative-mutual-funds-worth-it.aspx (noting that many mutual funds now transact in futures and other deriviatives and that their doing so "obviously brings in risk, and the average investor loses the ability to understand").

259. *See supra* notes 114–17 and accompanying text (describing the ways in which FCMs may invest customer assets).

260. *See supra* notes 194–203 and accompanying text (discussing conflicts associated with a financial services provider's use of customer assets for its own benefit).

special rules to specify that customers have priority in liquidation.[261] Yet, if customer assets cannot be located and retrieved under the doctrine of tracing,[262] and if the liquidation takes place under subchapter IV—not a given for insolvent FCMs that are jointly registered as securities brokers—even those special rules may not help.[263] This Subpart describes the measures that Congress and the CFTC should pursue to overcome the significant problems associated with the procedural regulation of FCMs and additionally discusses why establishing a futures-specific insurance program is not among them.

1. Investment of Customer Assets

In light of the concerns this Article identifies, the operational requirements applicable to FCMs should be reformulated. Most importantly, rule 1.25, the rule permitting FCMs to invest customer assets, should be eliminated. Such a change, of course, may seem too drastic, too much of a pendulum swing, given the efforts that FCMs have expended over the past sixteen years to have the CFTC *broaden* the rule's scope. Specifically, prior to 2000, the rule had been relatively conservative, permitting FCMs' investment of customer assets only in instruments that the CEA expressly describes, which are widely deemed to be particularly safe.[264] However, industry pressure led to the CFTC's expansion of authorized instruments to include more risky ones, including corporate and sovereign debt obligations.[265] Thereafter, the rule remained largely unchanged until the CFTC amended it in the aftermath of MF Global's bankruptcy.[266] Nonetheless, prior to those most recent amendments, certain FCMs—MF Global among them—regarded the rule as sufficiently

261. *See supra* notes 120–31 and accompanying text (describing the FCM-specific bankruptcy rules).

262. Tracing is a remedy in equity that permits aggrieved parties "to track their assets after they have been taken by [f]raud, misappropriation, or mistake." *Tracing*, THE FREE DICTIONARY, http://legal-dictionary.thefreedictionary.com/Tracing (last visited Mar. 30, 2016).

263. *See supra* notes 210–56 and accompanying text (describing problems associated with the bankruptcy provisions).

264. *See* CFTC Amendment Release, *supra* note 114, at 78,776 (observing that the CEA permits FCMs to invest customer funds in "obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities) and general obligations of any State or of any political subdivision thereof (municipal securities)").

265. *See id.* (describing the expansion of rule 1.25 in 2000).

266. *See generally id.* (adopting the most recent amendments to rule 1.25); *see also supra* notes 172–73 and accompanying text (describing investments currently permitted under rule 1.25).

important to their businesses to lobby against any changes that would make it more restrictive.[267]

Despite the fact that FCMs may once have had designs on the rule as a potentially meaningful source of profits, given the rule's current content, that can no longer be the case. In that regard, the new world has already arrived. Yet, if investing customer assets can no longer produce the reward for which FCMs may have once hoped, the continuing risks to customers associated with investments under rule 1.25 remain substantial. As discussed above, those risks arise less from the rule's use than from its misuse—or, at least, the inevitable temptation to misuse it.[268]

Beyond that consideration is an additional one, stemming from the fact that futures are very different from securities. Futures, unlike securities, are not repositories of investment capital; they are contracts obligating each side to do something at a future time.[269] Obtaining leverage through borrowing funds has no meaning in the futures context because leverage is an inherent and inseparable component of each and every futures contract.[270] This leverage is the product of the fact that the possible gains (or losses) on any futures transaction are multiples of what the trader is required to supply as margin.[271] Accordingly, although rule 1.25 permits an FCM's use of customer assets, that use, unlike in the securities context, is not symbiotic with or dependent on the services the FCM provides to its customers. That is suggested by the fact that, in contrast to a securities broker, an FCM may invest its customers' assets pursuant to rule 1.25, regardless of whether it has loaned cash or securities to the customers or provided other, non-brokerage services to them. That difference, moreover, renders rule 1.25 all the more dispensable.

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267. *See* Daniel P. Collins, *Debate Over On Rule 1.25: MF Global Effect*, FUTURES (Jan. 1, 2012), http://www.futuresmag.com/2012/01/01/debate-over-on-rule-125, *archived at* https://perma.cc/25PB-UKEN ("MF Global had lobbied against changes that would restrict [FCMs'] . . . ability to invest in sovereign debt and execute repurchase agreements with affiliates.").

268. *See supra* notes 196–203 and accompanying text. And, of course, additional risks arise from the fact that rule 1.25 continues to countenance repurchase and resale agreements. *See also* 17 C.F.R. §1.25(a)(2)(i) (2016).

269. *See supra* notes 98–103 and accompanying text (explaining how futures transactions are structured).

270. *See Leverage*, THE FREE DICTIONARY, http://financial-dictionary.thefreedictionary.com/Leverage (last visited Mar. 30, 2016), *archived at* https://perma.cc/RH43-JFNX (noting that a futures contract embodies a "type of leverage").

271. *See Futures Fundamentals: Characteristics*, INVESTOPEDIA, http://www.investopedia.com/university/futures/futures4.asp (last visited Mar. 30, 2016), *archived at* https://perma.cc/KY8V-LDY7 ("The smaller the margin in relation to the cash value of the futures contract, the higher the leverage.").

More, however, is necessary. After all, even without rule 1.25, an FCM's insolvency could cause a shortfall in customer assets. As Part II details, the activities of some customers, such as their "defaulting" by failing to replenish exhausted deposits, may lead to a deficiency in customer assets.[272] In addition, as MF Global's and PFGBest's respective bankruptcies demonstrated,[273] a shortfall might also result from an FCM's misuse or its personnel's theft of customer assets—a possibility that the CFTC's recent rulemaking did not (indeed, could not) eliminate completely.

2. Bankruptcy Rules

That brings the analysis to the bankruptcy rules that apply to FCMs—the provisions of subchapter IV of chapter 7 of the Bankruptcy Code and the CFTC's Part 190 rules, including the Recourse Rule. The bankruptcy rules are potentially very protective of customers, since, in the context of a shortfall of customer assets, if the shortfall is not otherwise eliminated through tracing procedures, customers' remaining losses will be covered by the assets of the bankrupt FCM's estate, ahead of payment of other creditors' claims.[274] Recall, however, that there are a number of problems associated with those rules.

First, given that FCMs are often regulated also as securities brokers, in the event of a bankruptcy it is unlikely that the provisions of subchapter IV or the Part 190 rules would apply, as they would be stayed pursuant to SIPA, the statute governing securities broker bankruptcies.[275] Second, the fact that the Recourse Rule is an agency creation, rather than a Congressional mandate, means that its enforceability is uncertain.[276] Third, even if the Rule ultimately were determined to be valid and enforceable, its application might still be insufficient to compensate customers completely if, as is likely, the FCM is a subsidiary within a multi-entity

272. *See supra* notes 107–09 and accompanying text.

273. *See supra* notes 151–61 and accompanying text (noting the causes of both bankruptcies).

274. *See supra* notes 130–31 and accompanying text.

275. *See supra* notes 210–17 and accompanying text.

276. *See supra* notes 218–40 and accompanying text. In any bankruptcy in which the Recourse Rule might apply, the estate's unsecured creditors would almost certainly contest its validity because, as a result of the Rule's application, it would leave them with a smaller pie to share than would be the case if customers were deemed unsecured creditors to the extent of any remaining shortfall. *See supra* notes 214–17 and accompanying text (highlighting one case in which an FCM's creditors contested the validity of the Recourse Rule).

enterprise.[277] If that is the case, most of the "firm's" remaining assets may be held by its parent entity and therefore beyond the rule's reach.

Given the substantial difficulties with subchapter IV and the Part 190 rules, Congress should amend SIPA and possibly also the Bankruptcy Code to reflect that, to the extent that there is a shortfall of customer assets in the context of an FCM bankruptcy, the protective provisions of subchapter IV and the Part 190 rules will apply, notwithstanding that SIPA may otherwise govern the FCM's liquidation. In the process, Congress should augment subchapter IV by including a provision equivalent to the Recourse Rule or, at least, by affirming the CFTC's authority to adopt such a rule. In addition, both Congress and the CFTC should clarify their respective bankruptcy provisions to allow customers who must turn to estate assets for complete compensation to have recourse, if necessary, also to any entity that, as a parent company, controls the FCM and its capitalization.[278]

Of course, as noted above, while ensuring the return of customer deposits that should never have been at risk is a worthy goal, it is one that may substantially impact the rights of third parties, namely, creditors. There is, however, a fairly straightforward response to this concern: Creditors—at least voluntary ones—should be able to negotiate for protections *ex ante*, such as by conditioning an extension of credit to an FCM on a commitment not to engage in risky trading and investment activities involving customer deposits.[279] Or, to avoid concerns that the FCM would breach that agreement, the creditor could demand sufficient collateral.[280] The point is that prospective creditors (even unsecured creditors), unlike most prospective futures customers (even institutional customers), have the ability to take action; they generally (although not always) have negotiating leverage vis-à-vis the FCM. Their exercise of that leverage, moreover, could redound to the benefit of customers, in light of the disciplining effect that it might have on the FCM's activities.

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277. *See supra* notes 252–57 and accompanying text.

278. Another possible proposal, aimed at addressing problems arising from the fact that FCMs are often parts of larger, multi-entity financial enterprises might be for Congress to require that FCMs be legally separate from other financial services firms. For a number of reasons, largely based on considerations of economic practicality and the increasing necessity of financial firms to diversify their services, this Article does not pursue that proposal.

279. *Cf.* Roe, *supra* note 35, at 571 (contending, in another context, that if creditors are aware of the possible adverse consequences of a borrower's bankruptcy, they can negotiate for protections).

280. *Cf. id.*

3. Insurance

As noted above, one difference between the procedural regulation of FCMs and that of securities brokers is that the former has no insurance program that may be called upon to compensate customers of an insolvent FCM in the event there is insufficient customer property to pay customers the amount to which they are entitled.[281] That fact came into stark relief in 2011 and 2012, thanks to the turn of events at MF Global and PFGBest.[282] As Part III suggests, those firms' dramatic bankruptcies suggested to many observers that the procedural regulation of FCMs as it then existed could not accomplish the job that it was supposed to do.[283] Although the CFTC responded by amending some of its rules and adopting several new ones,[284] reform-related discussions largely centered on the prospect of implementing an insurance regime, such as one modeled after that set forth in SIPA in the securities regulatory context.[285] It had become apparent, after all, that futures brokerage customers faced risks not unlike those confronting securities brokerage customers.

Regulators and market participants proposed several different models of futures customer insurance coverage, with two alternatives garnering the most support.[286] In one model, an entity called the Futures Insurance and Customer Protection Corporation ("FICPC") would pay futures brokerage customers as much as $250,000 to compensate them for losses they might incur as a result of an FCM's failure to maintain sufficient

281. *See supra* notes 92–93 and accompanying text.

282. *See supra* notes 151–61 and accompanying text (describing the MF Global and PFGBest bankruptcies).

283. *See supra* notes 162–64 and accompanying text (noting some market participants' reaction to the bankruptcies).

284. *See supra* notes 172–80 and accompanying text (describing the regulatory changes that occurred in the bankruptcies' aftermath).

285. *See, e.g.*, JOHN L. ROE, COMMODITY CUSTOMER COAL., RECOMMENDATIONS ON THE POLICY RESPONSE TO THE MF GLOBAL BANKRUPTCY 10 (2012), *available at* http://commoditycustomercoalition.org/wp-content/uploads/2012/07/CCC-Recommendations-on-the-Policy-Response-to-the-Bankruptcy-of-MF-Global-FINAL.pdf (advocating "an account insurance mechanism for commodities customers" on the basis that it would "be an effective, economical means to shield commodity customers from insolvency risk"); Bart Chilton, Comm'r, U.S. Commodity Futures Trading Comm'n, The Plan, Stan—Moving Forward on a Futures Insurance Fund (Aug. 9, 2012) (proposing the establishment of a "futures insurance fund"); Press Release, Nat'l Grain & Feed Ass'n, NGFA Sends Congress, CFTC Proposed Changes to Bankruptcy Code, Other Measures to Protect Against Future MF Global-Type Liquidations (July 3, 2012) (noting that the National Grain and Feed Association had recommended to Congress that it establish "insurance protection for commodity futures accounts").

286. As yet, neither model—nor any other insurance proposal—has gained sufficient traction among policymakers to move forward.

assets in its segregated account.[287] To fund the insurance pool, each FCM would be required to contribute 0.5% of its annual gross revenues arising from futures transactions until a targeted funding amount of $2.5 billion had been attained.[288] According to some estimates, reaching that target funding level would take approximately fifty-five years (assuming that there were no losses in the interim).[289] A second model, by contrast, would involve the creation of a captive insurance company—the Futures Industry Customer Asset Protection Insurance Company ("FICAP")—that would be owned by FCMs on a purely voluntary basis.[290] In the event of an FCM insolvency requiring that the insurance pool be accessed, the FCMs participating in the company would cover the first $50 million of losses as a deductible of sorts.[291] Up to $250 million more would be funded by FICAP—or, more specifically, a consortium of insurance companies—subject to a maximum payout of $50 million for each participating FCM.[292]

Although it might seem reasonable to extend insurance coverage to the futures brokerage context, doing so may not, in fact, be an appropriate solution. The primary argument that others have voiced against insurance centers on the prospect that it would unduly increase the cost of transacting in futures.[293] After all, the costs associated with any insurance

287. *See* Joanne Morrison, *Seg Funds Revisited: Industry Response to Peregrine and MF Global Collapses*, FUTURES INDUSTRY MAG., Sept. 2012, at 24–25, *available at* https://secure.fia.org/files/css/magazineArticles/article-1507.pdf (describing the details of the FICPC plan).

288. *See id.*

289. *See* Press Release, Karen Wuertz, Nat'l Futures Ass'n, Futures Industry Releases Insurance Study (Nov. 15, 2013) [hereinafter NFA Press Release] (observing that "it would take approximately 55 years to reach the [FICPC] target funding level, assuming no interim losses"). The cost to the industry of such a program would be a product of a number of factors, including underwriting evaluations, the number of FCMs that participate in the program, and the arrangement settled on by the FCMs and the insurance companies. *See Insurers Weigh Forming Captive to Insure Customers of Bankrupt Futures Brokers*, INS. J. (Nov. 17, 2013), http://www.insurancejournal.com/news/national/2013/11/17/311506.htm, *archived at* https://perma.cc/9MQU-GQMN. According to a study by the CME Group, the Futures Industry Association, the Institute for Financial Markets, and the National Futures Association, even if the $2.5 billion funding level is ultimately reached, "a government backstop would likely be necessary" in the short term to fill the gap between potential customer claims and funds available. NFA Press Release, *supra.*

290. *See* NFA Press Release, *supra* note 289.

291. *See id.*

292. *See id.* An alternative possibility regarding insurance might be for customers to buy insurance privately, apart from organized arrangements. However, if customers do not fully appreciate the risks that they face as FCM customers—and it is likely that even sophisticated customers do not—there may not develop a sufficient market for such insurance.

293. *See* Goldsmith, *supra* note 180, at 34–35 (noting that "industry leaders remain largely focused on the negatives of a futures protection fund, such as the high cost"); Alexander Osipovich, *Post-MF Global Segregation Reforms Spark Fierce Debate*, RISK (Jan. 24, 2013), http://www.risk.net/energy-risk/feature/2238649/postmf-global-segregation-reforms-spark-fierce-debate, *archived*

regime would ultimately be borne by futures customers, through higher commissions charged by FCMs.[294] Another common contention centers on the age-old concern about moral hazard and, in particular, the notion that insurance encourages brokers to engage in excessively risky activities that place both customers and the brokers themselves at risk.[295] Regardless of what activities a broker might pursue, the argument goes, it is assured of deposits from customers that, taking comfort in the security blanket that insurance provides, fail to evaluate the firm's quality and financial soundness.[296]

Once again, of course, there are alternative perspectives. If customers are the beneficiaries of insurance, should they not bear its costs? As for concerns about moral hazard, insurers could possibly serve as watchdogs, monitoring FCMs' activities and thereby reducing both moral hazard risks and insurance costs. Whether that supposition is tenable is certainly a worthy area of exploration. Finally, if these difficulties are as formidable as some have suggested, are they not ones from which the SIPA insurance regime also suffers?

For present purposes, however, the most important reason for eschewing an insurance regime covering FCM customers is that it would be largely ineffective as to the customers who need its protections the most—retail customers. Retail customers, by and large, obtain exposure to the futures markets through investing in mutual funds that engage in futures trading.[297] Accordingly, it is those mutual funds—rather than the retail customers themselves—that are FCM customers. Being the aggregation tool that they are, mutual funds have large amounts of capital—often hundreds of millions or billions of dollars—to put to work toward their investment strategies.[298] In the event that a mutual fund were

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at https://perma.cc/2X98-3JAW (discussing concerns about the cost associated with a customer insurance program).

294. *See* Osipovich, *supra* note 293 (observing that an insurance program would "essentially impos[e] a transaction tax on futures market participants").

295. *See* Goldsmith, *supra* note 293, at 34 (citing the concern that insurance protection creates a "moral hazard risk").

296. *Cf.* David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437, 460 (2013) (noting the oft-cited concern in the bubble-era mortgage-lending context that government guarantees backing Fannie Mae and Freddie Mac "created a form of moral hazard which encouraged these two private companies to maximize their risk-taking").

297. *See supra* notes 16–17 and accompanying text.

298. *See* Richard Loth, *Mutual Fund Asset Size*, INVESTOPEDIA, http://www.investopedia.com/university/quality-mutual-fund/chp5-fund-size/ (last visited Mar. 30, 2016), *archived at* https://perma.cc/KV64-7J3A (citing research finding that "during the 2001-2005 period the number of $1 billion-plus funds grew from 730 to 1,123" and that "among small cap funds, the figure went from 36 to 81").

a customer of an FCM that became insolvent under circumstances creating a shortfall in customer assets, the necessary per-customer cap on insurance proceeds would have the effect that each of the mutual fund's investors would be compensated for only a portion (likely a small portion) of the losses that she incurred as a result of the shortfall. After all, $500,000 (or so) in insurance proceeds will go only so far in covering losses of possibly millions of dollars.

Beyond that consideration is the fact that insurance is unnecessary—or, at least, it would be unnecessary if the other reforms proposed above were adopted. To be sure, these reform measures are relatively incremental—they can be achieved, after all, without rewriting either the Bankruptcy Code or the CFTC's rules. Yet they would substantially shore up the existing procedural regulation of FCMs.

B. The Significance of Reform

There is another reason, unexplored to date, why reforming the procedural regulation governing FCMs is necessary: It would be the last, critical step in bringing FCM regulation, and the regulation of the US futures markets generally, into the modern era of investment and diversification. Appreciating how that is so begins with the long and serpentine road from the earliest forms of futures market regulation to today's regulatory regime. As this Subpart's journey down that road reveals, although reform efforts throughout the decades consistently recognized that the futures markets had evolved from the earliest era, in which only farmers and associated traders legitimately used futures, they nonetheless remained firmly oriented toward it.

Congress first attempted to regulate the futures markets in the late 1800s, but the first federal legislation directly governing futures trading came about in 1921, with the passage of the Futures Trading Act.[299] The primary change effected by that statute was the designation of particular futures exchanges as "contract markets" on which futures trading could occur.[300] After the Supreme Court declared the Futures Trading Act to be unconstitutional in 1922,[301] Congress replaced it with the Grain Futures

299. *See History of the CFTC*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/About/HistoryoftheCFTC/history_precftc (last visited Mar. 30, 2016), *archived at* https://perma.cc/AT43-5N63.

300. *See id.* ("Under the Future Trading Act, the Secretary of Agriculture is empowered to designate exchanges that meet certain requirements enumerated in the Act as 'contract markets' in grain futures.").

301. *See* Hill v. Wallace, 259 U.S. 44, 68–70 (1922).

Act of 1922, which, though substantially the same, additionally mandated that futures exchanges work to halt manipulative conduct in the futures markets.[302] The Grain Futures Act, for its part, was superseded in 1936 by the CEA, which, however, retained its predecessor's core regulatory approach: regulation through the requirement that futures trading take place only on federally authorized contract markets.[303] At the time it enacted the CEA, Congress also created the Commodity Exchange Commission to administer and enforce the new statute. The Secretary of Agriculture, who was one of the three members of that Commission,[304] in turn created the Commodity Exchange Authority to carry out day-to-day regulatory responsibilities.[305]

By 1974, the shortcomings of the Commodity Exchange Authority had become evident and included a lack of professional skills among employees and enforcement authority that was too limited to effectively regulate the ever-expanding futures markets.[306] Accordingly, that year, through enacting the Commodity Futures Trading Commission Act ("CFTC Act"), Congress established the CFTC to replace the Commodity Exchange Authority and, in so doing, amended the CEA to grant the CFTC substantial investigative, enforcement, and emergency authority.[307] The CFTC Act also amended the CEA to establish additional categories of regulated persons—commodity trading advisors and another group of professionals known as commodity pool operators, which operate futures-focused funds[308]—based on the recognition that futures market participants increasingly were enlisting the assistance of advisors to pursue their futures trading activities and engaged in trading through collective, or "pooled," investment entities, often structured as privately-offered funds.[309] Those changes, taken together, brought the CEA to the general form that it maintained until it was extensively amended in 2010 in

302. *See* MARKHAM, *supra* note 10, at 15 ("The Grain Futures Act also sought to prevent price manipulation by requiring exchanges to act to prevent such conduct.").

303. *See id.* (discussing the CEA and observing that "Congress still seeks to regulate futures trading by subjecting it to the requirement that such transactions be conducted on a 'contract market,' licensed by the federal government").

304. The other two members of the Commission were the Attorney General and the Secretary of Commerce. *See id.* at 27.

305. *See id*.

306. *See id.* at 61–65 (discussing the perceived inefficacy of the Commodity Exchange Authority in enforcing the CEA).

307. *See id.* at 65–72 (describing the powers granted to the CFTC).

308. *See id.* at 67–68.

309. Jeffrey S. Rosen, *Regulation of Commodity Pool Operators Under the Commodity Exchange Act*, 40 WASH. & LEE L. REV. 937, 939–44 (1983) (describing the role of commodity trading advisors and commodity pool operators and Congress's rationale for regulating them).

connection with Congress's enactment of Dodd-Frank.[310] In the interim, however, Congress amended the Bankruptcy Code in 1978 to add subchapter IV[311] and amended the CEA in 2000 to address the regulatory status of swaps,[312] and the CFTC adopted a variety of rules, including rules governing disclosures by FCMs, commodity trading advisors, and commodity pool operators, as well as, of course, its Part 190 rules.[313]

Each new regulatory measure from 1921 through the 1970s further strengthened the futures regulatory regime and the regulatory body in charge of administering it and further recognized the diversity of futures market participants. For present purposes, however, the more important unifying thread is that each measure came about in order to prevent price manipulation and other abusive practices that, since the beginning of futures trading in the United States, had been rampant. For example, the Futures Trading Act of 1921 was the product of years of volatility in agricultural commodity prices that harmed farmers.[314] And one of the rationales for the CEA was to stop "bear raids" and "squeezes" that had the same effect but that previous forms of regulation had not adequately addressed.[315] As Congress noted when it was considering the statute, the goal behind it was to "insure fair practice and honest dealing on the commodity exchanges, and to provide some measure of control over those forms of speculative activity which . . . disrupt the markets to the damage of producers and consumers."[316] Similarly, the CFTC Act was preceded by widespread concern that market-damaging trading activities, including manipulative trading that caused erratic changes in prices, were adversely affecting grain growers and, with them, consumers.[317]

In this day and age, the striking aspect of the concerns that led to regulatory reform is not that they were centered on market manipulation and its effects. That concern, which is, at heart, a concern with market stability, has also always been a fundamental basis of securities regulation,

310. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

311. *See supra* notes 120–25 and accompanying text (summarizing the content of subchapter IV).

312. The Commodity Futures Modernization Act of 2000 primarily had the effect of removing swaps from the CFTC's (and the SEC's) regulatory jurisdiction. *See* Pub. L. No. 106-554 app. E, §§ 103, 107, 114 Stat. 2763A-365, 377–78, 382–83 (2000).

313. The CFTC was particularly active with rulemaking in the early years of its existence. *See* MARKHAM, *supra* note 10, at 73–101 (detailing the CFTC's rulemaking in its first years of operations).

314. *See id.* at 10–13 (describing policymakers' concern with price fluctuations in the years prior to the enactment of the Futures Trading Act).

315. *See id.* at 12–13.

316. H.R. REP. No. 73-1637, at 1 (1934).

317. *See* MARKHAM, *supra* note 10, at 60–65.

among other forms of financial regulation.[318] Rather, what is notable about the history of futures regulation is that there is no significant focus or emphasis on a second fundamental basis of securities and other financial regulation—namely, investor protection or, using the more appropriate term given the particular context, *customer* protection.

Futures market regulation emerged and existed to stop abusive trading practices and to do so not for the purpose of protecting customers that use the futures markets for investment-related purposes but for the sake of commodity producers and consumers. Put another way, despite various modernizing reforms over the years, futures regulation has never completely entered the modern era of financial market participation, in which investors—including smaller, retail ones—hedge their securities (and other) investments through seeking exposure to a wide array of instruments and asset classes.[319] They pursue this objective, moreover, not only through investments in hedge funds and placing assets with specialized investment advisers, but also through their investments in mutual funds. In short, the world of futures no longer consists only of farmers, consumers, and gamblers; now it consists of those groups plus you and me.

This Article's proposed reforms would take futures regulation further, not just through changing the words of the statute and the rulebook but also through changing what futures regulation does and what its aims are. By providing meaningful procedural regulation, the reforms would usher futures regulation forward and situate it alongside other types of financial regulation—securities regulation, in particular. To be sure, more

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318. *See* Robert R. Bliss, *Multiple Regulators and Insolvency Regimes: Obstacles to Efficient Supervision and Resolution*, *in* THE STRUCTURE OF FINANCIAL REGULATION 132, 140 (David G. Mayes & Geoffrey E. Wood eds., 2007) ("The policing of various criminal activities—fraud, money laundering, market manipulation, insider trading—remains a primary focus of securities regulation."); INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 5 (2008), *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD265.pdf (listing "ensuring that markets are fair, efficient, and transparent" as a "core objective[]" of securities regulation); *Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets—Part II: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 74 (2009) (prepared statement of Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n), https://www.sec.gov/news/testimony/2009/ts032609mls.htm, *archived at* https://perma.cc/WA2B-7PNC ("The securities laws and our rules, and the rules of the exchanges and the national securities association we supervise, prohibit fraudulent trading practices, manipulation of securities prices, insider trading and other abuses.").

319. *See supra* notes 16–17 and accompanying text (describing retail investors' increasing participation in "alternative" mutual funds—that is, funds that pursue traditionally hedge-fund-like investment strategies); *see also* Jonathan Clements, *Three Reasons This Is a Good Time to Be an Investor*, WALL ST. J. (July 18, 2014, 12:42 PM), http://www.wsj.com/articles/three-reasons-this-is-a-good-time-to-be-an-investor-1405701775 ("Today, individual investors can build portfolios that would have been the envy of many institutional investors two decades ago.").

thoroughgoing reform, such as reform placing futures regulation and securities regulation under the jurisdiction of a single regulator, would undoubtedly accomplish more on that front, while at the same time better rationalizing two important financial regulatory arenas that are becoming ever more similar but that are kept apart by their very different histories. However, heeding the maxim that we must not let the perfect be the enemy of the good, and given the realities of political will, the proposed reforms are a realistic and promising next step.

V. CONCLUSION

The concerns that plague the procedural regulation of FCMs are significant. Most worrisome is that retail investors are at risk in ways that have not been made apparent—at least not on any wide-scale basis. These concerns will not alleviate themselves or otherwise dissipate without attention from regulators and policymakers. This Article will, ideally, help attract that attention.

Given such dire proclamations, of course, one may wonder why more has not been made of the regulatory problems. Indeed, it may seem that the dearth of policymaking focus to date suggests that the issue is not, in fact, important. One response might be that too many people continue to regard futures trading as the province of commodity producers, as well as, perhaps, sophisticated traders. After all, regulation itself has not yet completely escaped that seemingly stubborn notion.[320]

Yet, as is always the case, it need not be left to the popular press and statements by regulatory agencies to inform investors and onlookers about regulatory problems and policymaking needs. Rather, researchers and scholars—whether associated with think tanks, academia, or industry associations—often perform that function. However, only few of those who regularly plumb the depths of unexplored topics have addressed the futures markets or futures trading, leave aside the brokers that serve a facilitating function for both.

Whatever the reason for the lack of attention to FCM regulation, it should not be construed as a lack of urgency. The financial markets are evolving and growing, and the futures markets arguably are a considerable part of the reason for those changes. Accordingly, doing right by investors and ensuring their future confidence in the financial markets means doing right by customers of futures commission merchants

320. *See* discussion *supra* Part IV.B (discussing how the longstanding goals of futures regulation stem from the identity of the longstanding futures traders).