

2013

## Custodial Requirements for Customer Funds

Jerry W. Markham

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/bjcfcl>

---

### Recommended Citation

Jerry W. Markham, *Custodial Requirements for Customer Funds*, 8 Brook. J. Corp. Fin. & Com. L. (2013).

Available at: <https://brooklynworks.brooklaw.edu/bjcfcl/vol8/iss1/5>

This Article is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Journal of Corporate, Financial & Commercial Law by an authorized editor of BrooklynWorks.

# CUSTODIAL REQUIREMENTS FOR CUSTOMER FUNDS

*Jerry W. Markham\**

*If any one place his property with another for safe keeping, and there, either through thieves or robbers, his property and the property of the other man be lost, the owner of the house, through whose neglect the loss took place, shall compensate the owner for all that was given to him in charge. But the owner of the house shall try to follow up and recover his property, and take it away from the thief.*

Code of Hammurabi (c. 1772 B.C.E.)

## INTRODUCTION

A series of bankruptcies by large financial institutions in recent years resulted in massive shortages of customer funds. The first of those failures, Refco, Inc. (Refco), occurred in 2005 after the exposure of a massive fraud by its officers.<sup>1</sup> That debacle was followed in 2007 by the failure of Sentinel Management Group, Inc. (Sentinel), which had used several hundred million dollars of customer assets to leverage the firm's trading position.<sup>2</sup> The failure of Lehman Brothers Holdings Inc. (Lehman or Lehman Brothers) during the Financial Crisis in 2008 was the largest bankruptcy in U.S. history and resulted in extensive litigation over rights to customer funds held in custody here and abroad.<sup>3</sup> The Lehman debacle was soon followed by the unraveling of Bernie Madoff's massive Ponzi scheme, which led to billions of dollars of losses in customer funds.<sup>4</sup> Only a few months later, U.S. authorities charged that R. Allen Stanford had been running another giant Ponzi scheme out of Antigua that involved \$7 billion in customer funds.<sup>5</sup> A shortage of some \$1.2 billion in customer funds was discovered after MF Global Inc. (MF Global) declared bankruptcy in

---

\* Professor of Law, Florida International University College of Law. The author has acted as a consultant and expert witness in several of the proceedings discussed herein.

1. See generally *Refco: Rotten Yet Robust*, *ECONOMIST*, Oct. 22, 2005, at 86, available at <http://www.economist.com/node/5064953> (describing this failure).

2. See *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d 855, 857 (7th Cir. 2012) (describing this failure).

3. Patrick Fitzgerald, *Lehman Trustee Ends Citigroup Fight*, *WALL ST. J.*, Nov. 19, 2012, at C3, available at <http://online.wsj.com/article/SB10001424127887323852904578127202132976518.html>.

4. See DIANA B. HENRIQUES, *THE WIZARD OF LIES: BERNIE MADOFF AND THE DEATH OF TRUST* 10 (2011).

5. Clifford Krauss, *Jury Convicts Stanford in \$7 Billion Ponzi Fraud*, *N.Y. TIMES*, Mar. 7, 2012, at B1, available at <http://www.nytimes.com/2012/03/07/business/jury-convicts-stanford-in-7-billion-ponzi-fraud.html>.

October 2011.<sup>6</sup> That highly publicized failure was followed by a massive fraud at Peregrine Financial Group Inc. (Peregrine or PFG), where the firm's owner simply looted nearly \$215 million in customer funds held in custody.<sup>7</sup>

These shortfalls have raised widespread concerns over custodial arrangements for customer funds held at financial institutions. In Parts I–III, this Article describes custodial requirements for customer funds under the Commodity Exchange Act of 1936 (the CEA),<sup>8</sup> federal securities laws,<sup>9</sup> and banking regulations.<sup>10</sup> Part IV then addresses the gaps in those regulations that allowed losses of customer funds to occur, and Part V recounts regulators' efforts to prevent future failures. In Parts VI and VII, this Article will also recommend the creation of a universal custody arrangement that can be more readily monitored and provide greater protection of customer funds. This proposal would require that each customer account be treated as a separate trust that would be ring-fenced from the losses of other customers all the way from deposit at a broker or other intermediary to the bank or clearinghouse where the funds are held in custody. Improper use of customer funds by intermediaries and custodians would be addressed by requiring a tri-party custodian arrangement, which would allow independent reporting of funds held in custody for each customer.

## I. CEA CUSTODIAL REQUIREMENTS

### A. DOMESTIC FUTURES CUSTOMERS

The CEA requires futures commission merchants (FCMs) to register with the Commodity Futures Trading Commission (the CFTC) and to comply with CFTC rules governing the treatment of customer funds.<sup>11</sup> An FCM is the analogue in the futures industry to broker-dealers in the securities industry. An FCM accepts customer orders and funds for trading

---

6. Report of the Trustee's Investigation and Recommendations at 95–98, *In re MF Global Inc.*, No. 11-2790 (MG) (Bankr. S.D.N.Y. June 4, 2012) [hereinafter Trustee's Investigation and Recommendations].

7. Jacob Bunge, *Peregrine Accounts to Be Transferred to Vision Financial*, WALL ST. J., Oct. 8, 2012, at C3, available at <http://online.wsj.com/article/SB10000872396390444223104578040140301343094.html>.

8. Commodity Exchange Act of 1936 (Commodity Exchange Act), Pub. L. No. 74-675, 49 Stat. 1491 (codified as amended in scattered sections of 7 U.S.C. (2012)).

9. See Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp); Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

10. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: CUSTODY SERVICES (2002) [hereinafter COMPTROLLER'S HANDBOOK], available at <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/custodyservice.pdf> (describing those arrangements).

11. See 7 U.S.C. § 6f(a).

in commodity futures and commodity options.<sup>12</sup> FCM customers often have excess margin funds (excess funds) in their commodity futures and options accounts that are not needed to margin their open positions.<sup>13</sup> Excess funds occur for many reasons, such as the closing of an open position, which frees up the funds that were used to margin that position.<sup>14</sup> A favorable gain from variation margin can also create excess funds.<sup>15</sup>

Section 4d(2) of the CEA requires that funds of FCM customers be separately accounted for and be held in specially segregated accounts.<sup>16</sup> This provision was intended to require that customer funds be held in a trust account.<sup>17</sup> As Senator James Murray, the Senate sponsor of the CEA, noted in 1936, this requirement was needed because FCM customers were “rank[ed] only as general creditors. Surely they thought their margins were regarded as trust funds and would be handled with a reasonable degree of integrity.”<sup>18</sup> This mandatory trust fund status was intended to stop the then-common practice in the industry whereby futures “commission merchants receiving margin monies in excess of the amount required by the exchanges to be deposited use[d] these excess margin deposits as their own capital, for any purpose they [chose].”<sup>19</sup>

The CFTC has explained that the CEA requirements for handling customer funds in the futures industry are that:

[1] customer funds must be separately accounted for by the FCM, [2] must not be commingled with the FCM’s own funds, [3] must be held for the benefit of customers, [4] must be available to the customer and the FCM [when held by a custodian] immediately upon demand, and [5] must be

---

12. For a description of these contracts and their trading and the role of FCMs, see JERRY W. MARKHAM, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* 204 (1986) [hereinafter MARKHAM, *COMMODITY FUTURES TRADING*]. Section 724(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) also required funds of Cleared Swaps Customers that secure swaps to be segregated. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 724(a), 124 Stat. 1376, 1682–84 (codified as amended at 7 U.S.C. § 6d(f)).

13. MARKHAM, *COMMODITY FUTURES TRADING*, *supra* note 12, at 204–05.

14. *Id.*

15. *Id.*

16. *See* 7 U.S.C. § 6d(a)(2).

17. FCMs were required by this provision to “treat their customers’ money as trust funds.” H.R. REP. NO. 73-1637, at 6 (1934).

18. 80 CONG. REC. 7858 (1936) (statement of Sen. James Murray) (stating that section 4d(2) “merely provides that the public’s money put up for margin shall in fact be treated as belonging to the customer, and held in trust. Who can object to this?”).

19. *Id.* As the CFTC noted in *Dorn v. Shearson Hayden Stone, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 21,253 (Oct. 6, 1981):

The language of the statute and its legislative history indicate that Section 4d was designed for the broad purpose of protecting customers from having their money, securities or property appropriated by a futures commission merchant, or some other depository, without adequate legal basis, and the more specific purpose of ensuring the integrity of the futures market by preventing the use of customer funds to finance market transactions by a futures commission merchant for its own account or for other customers.

calculated so as to prevent the use of one customer's funds to margin or secure another customer's position.<sup>20</sup>

Additionally, (6) customer funds may not be used to secure a loan of the FCM.<sup>21</sup>

These requirements are implemented through a series of rules administered by the CFTC. CFTC Rule 1.20 imposes the basic requirement that customer funds be separately accounted for and segregated.<sup>22</sup> That rule further requires that any bank receiving commodity customer funds must provide a written acknowledgement that the bank was informed that "the customer funds deposited therein are those of commodity or option customers and are being held in accordance with the provisions of the [CEA] and this part."<sup>23</sup>

The Commodity Exchange Authority, the predecessor to the CFTC, opined after the adoption of the segregation requirement in 1936 that a third-party depository of segregated customer funds of an FCM could have no claim against those funds.<sup>24</sup> To assure this result, the Commodity Exchange Authority required banks to acknowledge that customer assets would in fact be segregated from the accounts of the FCM.<sup>25</sup> Banks acting in this depository capacity were required to waive any offset rights for credit extensions made to the FCM or anyone else.<sup>26</sup> That waiver requirement was subsequently rendered unnecessary when the CEA was amended in 1968 to apply its segregation requirements directly to banks and other depositories of FCM customer funds.<sup>27</sup>

Rule 1.20 prohibits the commingling of customer funds with those of the FCM or any other person, except that customer funds may be commingled with those of other customers—a form of collective trust.<sup>28</sup> However, CFTC Rule 1.23 allows FCMs to keep their own funds in customer segregated accounts to serve as a cushion in the event of an unexpected shortfall.<sup>29</sup> The FCM may also invest the customer funds held in segregation in securities specified in CFTC Rule 1.25, which includes

---

20. See Deposit of Customer Funds in an Offshore Depository, Interpretative Letter No. 88-14, Comm. Fut. L. Rep. (CCH) ¶ 24,295 (Aug. 1, 1988) (describing these requirements).

21. *Dom*, Comm. Fut. L. Rep. (CCH) ¶ 21,253, at \*9.

22. 17 C.F.R. § 1.20(a) (2013).

23. *Id.*

24. Commodity Exch. Auth., Administrative Determination No. 12 (Nov. 30, 1936).

25. *Id.*

26. *Id.*

27. See Commodity Exchange Act, Pub. L. No. 90-258, sec. 6, § 4d, 82 Stat. 26, 27–28 (1968) (codified as amended at 7 U.S.C. § 6d(b) (2012)). The 1968 amendments sought "to prohibit expressly customers' funds from being used to offset liabilities of the futures commission merchants or otherwise being misappropriated." S. REP. NO. 90-947, at 7 (1968), *reprinted in* 1968 U.S.C.C.A.N. 1673, 1679.

28. 17 C.F.R. § 1.20(a).

29. *Id.* § 1.23.

obligations of the U.S. government and of the states.<sup>30</sup> At variance with traditional trust principles, CFTC Rule 1.29 allows FCMs to keep for themselves the interest or other return from such investments.<sup>31</sup>

CFTC Rule 1.32 requires that FCMs make a computation of the amount required to be held in segregation as of the close of business each day.<sup>32</sup> That computation must be made by noon of the following day.<sup>33</sup> The CFTC requires that computation to be made by using the net liquidating value (the NLV) of all futures and options customers trading on domestic exchanges.<sup>34</sup> The NLV is computed by adding customer ledger balances, open trade equity, net option value, securities, and other property (excluding letters of credit), which is then grossed-up for any customer debit/deficit balances.<sup>35</sup> The ledger balance is computed by subtracting debits from credits to the account on the day of calculation.<sup>36</sup> CFTC Rule 1.12(h) requires the FCM to notify the CFTC if funds and securities on deposit in segregated accounts are less than the requirement.<sup>37</sup>

The Bankruptcy Reform Act of 1978<sup>38</sup> and CFTC part 190 rules promulgated under that statute<sup>39</sup> seek to give customer funds held in segregated accounts under section 4d of the CEA priority over the claims of creditors of the FCM. The House Report for this legislation stated that the relationship between a commodity broker and its customers “is not unlike the relationship between a stockbroker and his customers. Yet the current Bankruptcy Act provides no special protection for customers of commodity brokers as it does for stockbroker customers.”<sup>40</sup>

---

30. 17 C.F.R. §§ 1.25–.26 (requiring such investments to be held in segregated accounts).

31. *Id.* § 1.29. *See, e.g.,* *Bibbo v. Dean Witter Reynolds, Inc.*, 151 F.3d 559 (6th Cir. 1998) (FCM could retain the interest from such investments); *Marchese v. Shearson Hayden Stone, Inc.*, 822 F.2d 876 (9th Cir. 1987) (same); *Crabtree Invs., Inc. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 577 F. Supp. 1466, 1473 (M.D. La. 1984), *aff’d* 738 F.2d 434 (5th Cir. 1984) (same). However, most sophisticated customers with bargaining power will demand at least a portion of such returns. *See Craig v. Refco, Inc.*, 816 F.2d 347, 348 (7th Cir. 1987) (discussing such arrangements).

32. 17 C.F.R. § 1.32.

33. *Id.*

34. *Interpretive Notice 9066 - NFA Financial Requirements Section 16: FCM Financial Practices and Excess Segregate Funds/Secured/Amount/Cleared Swaps Customer Collateral Disbursements*, NAT’L FUTURES ASS’N, <http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9066&Section=9> (last modified July 1, 2013) [hereinafter *Interpretive Notice 9066*].

35. NAT’L FUTURES ASS’N, *MARGINS HANDBOOK 6* (1999), available at <http://www.nfa.futures.org/nfa-compliance/publication-library/margins-handbook.pdf>. The ledger balance calculation includes checks that have not yet cleared. Open trade equity is the unrealized gain or loss on open futures positions. *See* CFTC, *FORM 1-FR-FCM INSTRUCTIONS 10-2* (2010) [hereinafter *FORM 1-FR-FCM INSTRUCTIONS*], available at <http://www.cftc.gov/ucm/groups/public/@iointermediaries/documents/file/1fr-fcminstructions.pdf>. Net option value is the unrealized gain or loss on options positions. *Id.*

36. *FORM 1-FR-FCM INSTRUCTIONS*, *supra* note 35, at 5-1.

37. 17 C.F.R. § 1.12(h).

38. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

39. 17 C.F.R. pt. 190.

40. H.R. REP. NO. 95-595, at 269 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6227.

As described below, customers of broker-dealers are covered by an account insurance scheme administered by the Securities Investor Protection Corporation (SIPC) that provides up to \$500,000 in insurance in the event of a broker-dealer's bankruptcy that results in a shortage of customer funds.<sup>41</sup> No such insurance is available under the CEA for FCM customers.

The CFTC's so-called Part 190 rules govern the treatment of customer funds and securities when a FCM declares bankruptcy.<sup>42</sup> In proposing the Part 190 Rules, the CFTC stated:

The proposed regulations are intended to implement these customer and market protections and in this regard to achieve several specific purposes, including: (1) To promote equitable treatment of customers; (2) to enhance certainty as to the effects of a bankruptcy distribution; (3) to limit the period during which the bankrupt estate is at risk from fluctuations in value of the commodity contracts and other property contained therein; (4) to permit certain transactions which may be effected between customers without the intervention of the debtor to take place outside the bankrupt estate; (5) to maximize recovery in kind; and (6) to provide an understandable and workable method for operating the estate pending liquidation.<sup>43</sup>

An important element of those rules allows for the immediate transfer of open customer futures and options positions to another solvent FCM.<sup>44</sup> That ability is often critical in fast-moving markets where customers can experience large losses if they do not have control over their accounts.<sup>45</sup> Identifiable customer property may also be transferred.<sup>46</sup> Customer losses will be measured by the shortfall in the FCM's segregated account.<sup>47</sup>

## B. CUSTOMERS TRADING ON FOREIGN COMMODITY EXCHANGES

The CFTC created a separate regime for the protection of domestic customers trading on foreign exchanges through an FCM. This action was taken when an extensive series of problems with such trading arose after the creation of the CFTC.<sup>48</sup> The CFTC initially acted by adopting an anti-fraud

---

41. See *infra* note 77 and accompanying text.

42. 17 C.F.R. pt. 190.

43. Proposed Rules Implementing the Bankruptcy Reform Act of 1978, 46 Fed. Reg. 57,535–36 (proposed Nov. 24, 1981) (to be codified at 17 C.F.R. pt. 190) [hereinafter CFTC Proposed Rules, Bankruptcy Reform Act].

44. See 17 C.F.R. § 190.06(e).

45. See Andrea M. Corcoran & Susan C. Ervin, *Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers from Troubled Firms*, 44 WASH. & LEE L. REV. 849, 877 (1987) (describing these transfer arrangements).

46. See *id.* at 878.

47. *Id.* at 879.

48. See Foreign Options and Foreign Futures Transactions, 51 Fed. Reg. 12,104 (proposed Apr. 8, 1986) (to be codified at 17 C.F.R. pt. 30).

rule for foreign futures transactions.<sup>49</sup> There was concern, however, as to whether the CFTC had authority to take such action.<sup>50</sup> Congress, therefore, amended the CEA in 1982 to clarify that authority.<sup>51</sup> That amendment also granted the CFTC authority broadly to regulate foreign futures trading, including requirements for minimal financial standards, book and record keeping requirements, and the “safeguarding of customer funds.”<sup>52</sup>

To implement that authority, the CFTC adopted Rule 30.7, which imposed limited custody requirements for domestic customers trading on foreign commodity exchanges.<sup>53</sup> This rule required FCMs to set aside a “Secured Amount” as protection for the funds of such customers.<sup>54</sup> Like those governed by section 4d of the CEA, funds of customers trading foreign futures must be placed in a separate account identified as a secured amount account and commingling of FCM funds is prohibited, except to the extent the FCM places funds in the Secured Amount account to serve as a cushion against shortfalls.<sup>55</sup> However, unlike section 4d, CFTC Rule 30.7 was not intended to make those accounts trust funds where all of the Rule 30.7 customers’ excess funds would be held.<sup>56</sup>

The FCM must set aside the Secured Amount only as a form of security or deposit, somewhat akin to a margin requirement where only a portion of the contract price is set aside as security for performance.<sup>57</sup> The CFTC staff has thus noted that the funds in a Secured Amount account are a “security deposit only;” it “is not customer money per se as are segregated funds;” it “is ‘security’ and not a ‘trust’ of funds explicitly denominated as belonging to customers.”<sup>58</sup> Moreover, until recently, the FCM could invest those funds unconstrained by the investment restrictions for segregated funds of domestic customers under CFTC Rule 1.25.<sup>59</sup>

The amount required to be set aside in Secured Amount accounts could be considerably less than that required to be segregated for customers trading on domestic exchanges. The CFTC defined the secured amount in

---

49. 17 C.F.R. § 30.9.

50. *See id.*

51. This background is described in *Foreign Options and Foreign Futures Transactions*, 51 Fed. Reg. at 12,104.

52. *Futures Trading Act of 1982*, Pub L. No. 97-444, sec. 204, § 4, 96 Stat. 2294, 2299 (codified as amended at 7 U.S.C. § 6 (2012)) (adding a new section 4(b) to the CEA).

53. 17 C.F.R. § 30.7.

54. *Id.* § 30.7(a).

55. *Id.* § 30.7(a), (d).

56. *Id.*

57. *See* Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, 97 (1991) (describing the role of margin).

58. *Compliance and Operational Questions and Answers Concerning the Foreign Futures and Options Rule*, Advisory Letter No. 87-4, *Comm. Fut. L. Rep.* (CCH) ¶ 23,975 (Nov. 24, 1987).

59. *See* *Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions*, 76 Fed. Reg. 78,776, 78,776 (Dec. 19, 2011) (to be codified at 17 C.F.R. pts. 1, 30) [hereinafter *Investment of Customer Funds*] (amending CFTC Rules to subject Secured Amount accounts to CFTC Rule 1.25).

Rule 1.3 to be money, securities, and property required by a FCM to margin, guarantee, or secure open foreign futures contracts, plus or minus any unrealized gain or loss on foreign futures or options contracts and option premiums.<sup>60</sup> This formula in Rule 1.3 varied from the NLV's for the section 4d segregation computation in that customer securities or excess funds need not be included in the calculation.<sup>61</sup> As a result, the Secured Amount computed under Rule 1.3 would be less than the figure computed by the NLV method.<sup>62</sup> Nevertheless, for reasons of convenience, most FCMs used the NLV method to meet their Rule 30.7 requirements.<sup>63</sup> For the most part, only the larger firms had sufficient customers to justify the expense of a separate Rule 1.3 calculation.<sup>64</sup>

The CFTC complicated the situation by allowing those firms making a Rule 1.3 calculation to use the lesser of the Rule 1.3 calculation or of a NLV calculation on an account-by-account basis.<sup>65</sup> Further complexity was added by another formula to be used where the Secured Amount account included funds of foreign customers trading on foreign exchanges.<sup>66</sup> Again, the lesser of the Rule 1.33 calculation, NLV, or foreign person calculation could be used on an account-by-account basis.<sup>67</sup> These calculations were referred to as the "Alternative Method."<sup>68</sup>

## II. FEDERAL SECURITIES LAWS CUSTODY REQUIREMENTS

### A. BROKER-DEALER CUSTODY REQUIREMENTS

The U.S. Securities and Exchange Commission (the SEC) adopted Rule 15c3-3 to require broker-dealers to account for customer funds and

---

60. 17 C.F.R. § 1.3(p)(1).

61. Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 77 Fed. Reg. 67,866, 67,867 (proposed Nov. 14, 2012) (to be codified at 17 C.F.R. pts. 1, 3, 22, 30, 140) [hereinafter CFTC Proposed Rules, Enhancing Protections].

62. As the CFTC has noted:

[Section] 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 on such open positions, plus any funds representing premiums payable or received on foreign options (including any additional funds necessary to secure such options, plus or minus any unrealized gains or losses on such options) (i.e., the "Alternative Method"). Thus, under the Part 30 Alternative Method an FCM is not required to maintain a sufficient amount of funds in such separate accounts to pay the full account balances of all of its foreign futures or foreign options customers at all times.

*Id.*

63. JOINT AUDIT COMM., FOREIGN FUTURES AND OPTIONS GUIDE 5-6 (2001), available at <http://www.wjammer.com/jac/ForeignFuturesandOptionsGuide-Dec%202001.pdf>.

64. CFTC Proposed Rules, Enhancing Protections, *supra* note 61, at 172.

65. FORM 1-FR-FCM INSTRUCTIONS, *supra* note 35, at 12-2.

66. *Id.* at 5-2.

67. *Id.* at 12-2.

68. JOINT AUDIT COMM., *supra* note 63, at 5-6.

securities and hold them in specially designated accounts.<sup>69</sup> This requirement “was designed to assure that customers’ funds (as well as securities) held by broker-dealers are protected against broker-dealer misuse or insolvency.”<sup>70</sup> SEC Rule 15c3-3 is generally referred to as the SEC’s “Customer Protection Rule.”<sup>71</sup> It was adopted in the wake of the so-called “Paper Work Crisis” that occurred at the end of the 1960s.<sup>72</sup>

Over 100 New York Stock Exchange firms failed during that crisis as a result of their inability to deal with increased trading volumes.<sup>73</sup> Many brokerage firms lost control of their customer securities, and lost and stolen securities were widespread problems.<sup>74</sup> Concern was also raised that broker dealers were using customer free credit balances for their own purposes, and those securities and funds were lost when their broker-dealer failed.<sup>75</sup> Congress responded to these problems by enacting the Securities Investor Protection Act of 1970 (SIPA), which directed the SEC to adopt rules designed to protect customer funds in the custody of registered broker-dealers.<sup>76</sup>

SIPA also created an insurance scheme that provided account insurance of up to \$100,000 per customer (later increased to \$500,000, including \$100,000 of customer cash) for losses caused by their broker-dealer’s insolvency—it does not insure against investment losses.<sup>77</sup> That insurance fund is administered by SIPC, a private non-profit corporation that is funded by assessments on broker-dealers.<sup>78</sup>

---

69. 17 C.F.R. § 240.15c3-3 (2013).

70. Customer Protection Rule, Exchange Act Release No. 21,865, 1985 WL 548164 (Mar. 19, 1985) [hereinafter Customer Protection Release].

71. 17 C.F.R. § 240.15c3-3.

72. 2 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900–1970) 364–65 (2002) [hereinafter 2 MARKHAM, FINANCIAL HISTORY].

73. *Id.* at 364.

74. *See id.* (describing the Paper Work Crisis).

75. *See generally* HURD BARUCH, WALL STREET SECURITY RISK (1971) (criticizing these practices).

76. Security Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended in scattered sections of 15 U.S.C. (2012)). As the Supreme Court noted:

Following a period of great expansion in the 1960’s, the securities industry experienced a business contraction that led to the failure or instability of a significant number of brokerage firms. Customers of failed firms found their cash and securities on deposit either dissipated or tied up in lengthy bankruptcy proceedings. In addition to its disastrous effects on customer assets and investor confidence, this situation also threatened a “domino effect” involving otherwise solvent brokers that had substantial open transactions with firms that failed. Congress enacted the SIPA to arrest this process, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers.

*Sec. Investor Prot. Corp. v. Barbour*, 421 U.S. 412, 415 (1975).

77. 2 MARKHAM, FINANCIAL HISTORY, *supra* note 72, at 364–65.

78. *See Holmes v. Sec. Investor Prot. Corp.*, 503 U.S. 258, 261–62 (1992).

In the event of a failure of a covered broker-dealer, SIPC is authorized to seek its liquidation by a court-appointed trustee.<sup>79</sup> The claims of general creditors are subordinated to the claims of the broker-dealer's customers.<sup>80</sup> The trustee will return all securities held in the names of specific customers, and it then pools remaining securities for a pro rata distribution to customers.<sup>81</sup> In the event of a shortfall, SIPC will cover the loss up to the \$500,000/\$100,000 limits.<sup>82</sup>

The Customer Protection Rule includes a requirement that broker-dealers maintain special accounts "in the nature of a trust fund through which a broker-dealer must effectuate all transactions with regard to all 'funds carried for the account of any customer.'"<sup>83</sup> SEC Rule 15c3-3 requires that broker-dealers maintain at a bank a "Special Reserve Bank Account for the Exclusive Benefit of Customers" ('Reserve Bank Account') and deposit in this account its reserve requirement as computed in accordance with the Formula for Determination of Reserve Requirement For Brokers and Dealers ('Reserve Formula').<sup>84</sup>

The Reserve Formula is a complex one that totals the aggregate customer credits and debits with the broker-dealer.<sup>85</sup> The amount of any excess credits must then be made to the Reserve Bank Account.<sup>86</sup> Generally, the Reserve Formula must be completed by Tuesday of each week as of close of business at the end of the preceding week: usually Friday.<sup>87</sup> "In addition, before making a withdrawal from the Reserve Bank Account, a broker-dealer must make a computation which shows that after the withdrawal there is an amount remaining in the Reserve Bank Account at least equal to that required to be on deposit."<sup>88</sup> As the Eleventh Circuit has noted:

The specifics of the Reserve Formula are fairly arcane, but its operation is straightforward. On a weekly basis, firms must balance customer credits against customer debits. 17 C.F.R. § 240.15c3-3(e)(3). Subject to some adjustments, the Rule requires that firms hold an amount equal to the excess of credits over debits in the Reserve Account. 17 C.F.R. § 240.15c3-3a. As defined by the regulations, "customer credits" captures the amount the firm owes its customers while "customer debits" refers to

---

79. *See id.* at 261.

80. *See id.* at 261 n.1.

81. *See id.* at 261.

82. *See Holmes*, 503 U.S. at 261–62 & n.2 (1992) (describing SIPC insurance).

83. Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, Exchange Act Release No. 9388, 1971 WL 126121, at \*2 (Nov. 8, 1971); *see also* 17 C.F.R. § 240.15c3-3 (2013).

84. Customer Protection Release, *supra* note 70, at \*2.

85. *SEC v. Goble*, 682 F.3d 934, 940 (11th Cir. 2012) (citing 17 C.F.R. § 240.15c3-3(e)(3)).

86. *Goble*, 682 F.3d at 940; Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 55,431, 2007 WL 737662, at \*6 (Mar. 9, 2007).

87. 17 C.F.R. § 240.15c3-3(e)(3).

88. Customer Protection Release, *supra* note 70.

amounts the customers owe the firm. If, after the firm makes the reserve computation, it discovers that the Reserve Account balance is higher than the amount required by the Reserve Formula, the firm may make a withdrawal from the Reserve Account. 17 C.F.R. § 240.15c3-3(g).<sup>89</sup>

On July 31, 2013, the SEC adopted rule changes that require broker-dealers having custody of customer assets to file a Compliance Report with the SEC to verify they are properly protecting those assets and periodically sending account statements to customers.<sup>90</sup> Such broker-dealers must engage an independent public accountant to examine the broker-dealer's compliance report.<sup>91</sup> Further, broker-dealers must file a new, quarterly Form Custody report with the SEC that describes the broker-dealers' custodial arrangements.<sup>92</sup> Broker-dealers must also allow SEC staff to examine the work papers of their accountants and to interview those accountants.<sup>93</sup>

## B. INVESTMENT ADVISER CUSTODY REQUIREMENTS

The SEC has adopted custody requirements for the funds of clients of investment advisers under the Investments Advisers Act of 1940.<sup>94</sup> An investment adviser is a fiduciary to its customers.<sup>95</sup> In order to assure that investment advisers met their fiduciary duties, the SEC adopted a custody requirement for client funds (the IA Custody Rule).<sup>96</sup> It imposes strict and robust custody requirements for customer assets held by registered investment advisers.

The IA Custody Rule seeks to impose protections for the custody of investment adviser funds that are comparable to those available for other statutory trust funds.<sup>97</sup> The IA Custody Rule thus seeks to “enhance the protections afforded to advisory clients’ assets, harmonize the rule with

---

89. *Goble*, 682 F.3d at 940–41.

90. Press Release, SEC, SEC Adopts Rules to Increase Protections for Investors with Assets Being Held by Broker-Dealers (July 31, 2013) [hereinafter SEC Press Release], available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539740621#.Ugo6rBYqhGA>.

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

95. The Supreme Court has interpreted the Investment Advisers Act as congressional recognition of the fact that investment advisers are fiduciaries for their customers. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (quoting 2 LOUIS LOSS, *SECURITIES REGULATION* 1412 (2d ed. 1961) (“The Investment Advisers Act of 1940 thus reflects a congressional recognition ‘of the delicate fiduciary nature of an investment advisory relationship . . . .’”); *Mones v. Mones*, 169 B.R. 246, 256 (Bankr. D.D.C. 1994) (“[T]he Investment Advisers Act gives rise to a trust that imposes a fiduciary capacity. . . .”).

96. SEC Press Release, *supra* note 90; see 17 C.F.R. § 275.206(4)-2 (2013).

97. See generally U.S. GOV'T ACCOUNTABILITY OFFICE, *INVESTMENT ADVISERS: REQUIREMENTS AND COSTS ASSOCIATED WITH THE CUSTODY RULE* (2013), available at <http://www.gao.gov/assets/660/655754.pdf> (describing the IA Custody Rule).

current custodial practices, and clarify circumstances under which advisers have custody.”<sup>98</sup>

The IA Custody Rule was designed to require “an investment adviser who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser.”<sup>99</sup> The IA Custody Rule requires “investment advisers who have custody or possession of funds or securities of clients to segregate the securities and to hold them in safekeeping and to set up a separate trust account in a bank for funds belonging to each client.”<sup>100</sup> Alternatively, customer funds can be held in a collective account in the name of the investment adviser as agent or trustee for the clients.<sup>101</sup> The IA Custody Rule does not permit an investment adviser to route proprietary and customer assets through the same clearing and custodial accounts held with a bank.<sup>102</sup>

The IA Custody Rule requires investment advisers to maintain customer assets with “qualified custodians,” which “include the types of financial institutions that clients and advisers customarily turn to for custodial services. These include banks and savings associations and registered broker-dealers.”<sup>103</sup> The IA Custody Rule requires the qualified custodian to hold customer funds or securities in an account, either under the client’s name or under the adviser’s name as agent, or as trustee for its clients.<sup>104</sup>

The IA Custody Rule requires that investment adviser customers be given periodic reports by the qualified custodian of the amounts held in segregation.<sup>105</sup> Alternatively, the investment adviser may make such reports, but in such a case the accounts of the investment adviser that contain customer funds must be verified by an independent public accountant annually through a surprise audit.<sup>106</sup> A report on that examination must be filed with the SEC.<sup>107</sup>

---

98. Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 Fed. Reg. 56,692, 56,692 (Oct. 1, 2003) [hereinafter Custody of Funds Release].

99. Custody or Possession of Funds or Securities of Clients, Investment Advisers Act Release No. 123, 27 Fed. Reg. 2149, 2149 (Mar. 16, 1962) [hereinafter Custody or Possession Release].

100. Custody or Possession Release, *supra* note 99, at 2149.

101. 17 C.F.R. § 275.206(4)-2(a)(1)(ii).

102. SEC v. Slocum, Gordon, & Co., 334 F. Supp.2d 144, 178 (D.R.I. 2004); Custody of Funds Release, *supra* note 98, at 56,693.

103. Custody of Funds Release, *supra* note 98, at 56,693–94 (footnotes omitted).

104. See *id.* at 56,692–93 (discussing this requirement).

105. 17 C.F.R. § 275.206(4)-2(a)(3).

106. *Id.* § 275.206(4)-2(a)(4).

107. *Id.*

### C. INVESTMENT COMPANY ACT CUSTODY REQUIREMENTS

The IA Custody Rule<sup>108</sup> exempts from its reach investment advisers to investment companies registered with the SEC under the Investment Company Act of 1940 (the IC Act).<sup>109</sup> The IA Custody Rule is unneeded for those exempted advisers because the SEC has adopted custodial requirements for customer funds and securities held by mutual funds and other registered investment companies under the IC Act.<sup>110</sup>

For example, SEC Rule 17f-1 prohibits registered management investment companies from placing securities or other investments in the custody of a member of a national security exchange unless there is a written agreement in place governing that custody.<sup>111</sup> That agreement must provide that the securities held in custody must be individually identified, marked, and segregated from the securities and investments of other persons.<sup>112</sup> The securities segregated under Rule 17f-1 may not be subject to any lien or charge of any kind by the custodian.<sup>113</sup> The securities investments must also be verified by actual examination periodically and must be subject to inspection by the SEC staff.<sup>114</sup>

SEC Rule 17f-2 imposes requirements on investment companies that deposit securities or other assets with a bank to be held in custody.<sup>115</sup> The investments deposited at such custodians must be able to be withdrawn upon demand by the investment company.<sup>116</sup> Investments deposited at the bank custodian must be kept physically separate and segregated at all times from the assets of other persons.<sup>117</sup> This rule also imposes restrictions on the persons who may withdraw securities from segregation. In addition, the existence of the securities must be verified at least three times each year through actual examination by an independent public accountant.<sup>118</sup> Two of those inspection dates must be selected by the accountant.<sup>119</sup>

SEC Rule 17f-3 prohibits free cash accounts held at a bank by the investment company except for petty cash in an amount not to exceed \$500.<sup>120</sup> SEC Rule 17f-4 imposes requirements on investment companies that deposit fund assets with a securities depository or clearing

---

108. *Id.* § 275.206(4)-2(b)(5).

109. *See* Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to -64 (2012)).

110. *See* 17 C.F.R. §§ 270.17f-1 to -7.

111. *Id.* § 270.17f-1(a).

112. *Id.* § 270.17f-1(b)(1).

113. *Id.* § 270.17f-1(b)(3).

114. *Id.* § 270.17f-1(b)(4).

115. *Id.* § 270.17f-2.

116. *Id.* § 270.17f-2(a).

117. *Id.* § 270.17f-1(b)(1).

118. *See id.* § 270.17f-1(b)(4).

119. *Id.*

120. *Id.* § 270.17f-3.

organization.<sup>121</sup> In order to be eligible to be a custodian, those depositories, and any intermediate custodian, must be obligated to exercise due care in accordance with reasonable commercial standards in maintaining the assets held in custody.<sup>122</sup> SEC Rule 17f-5 imposes restrictions on the custody of funds held outside the United States,<sup>123</sup> and Rule 17f-7 regulates the deposit of funds with foreign securities depositories.<sup>124</sup>

### III. BANK CUSTODY REQUIREMENTS

#### A. IN GENERAL

General banking practices have long required funds placed on “special deposit” by one party for the benefit of others to be segregated and not used for securing the debts of the depositing party.<sup>125</sup> “A contract for a special deposit is not required to be in any particular form; it being a matter of intention and understanding of the parties.”<sup>126</sup> All that is required is notice to the bank of the special nature of the deposits:

A bank has knowledge of a special purpose account if the depositor labels the account in such a way that it is clear that the account is a special account. The bank also has knowledge of a special purpose account if the depositor and the bank have entered into an agreement giving the bank notice of the special purpose of the account. A special purpose account defeats a bank’s right to setoff because a third party who is not a debtor of the bank has an interest in the account. Since a party other than the bank’s debtor has an interest in the funds on deposit in a special account, the bank may not exercise its right to setoff the property not belonging to the debtor.<sup>127</sup>

Notice of a special deposit thus has important consequences for a bank. “It has universally been held that knowledge upon the part of a bank that deposits made by a debtor in his own name belong to a third person

---

121. *Id.* § 270.17f-4.

122. *Id.*

123. *Id.* § 270.17f-5.

124. *Id.* § 270.17f-7.

125. 5B MICHIE ON BANKS AND BANKING § 331, at 547 (2002).

126. *Id.* (citing *Bryan v. Coconut Grove Bank & Trust Co.*, 132 So. 481 (Fla. 1931); *Fogg v. Tyler*, 82 A. 1008 (Me. 1912)).

127. S. Perry Thomas, Jr., Comment, *Bank’s Right of Setoff in Virginia*, 41 WASH. & LEE L. REV. 1603, 1619 (1984) (footnotes omitted); *see also* *Union Stock-Yards Nat’l Bank v. Gillespie*, 137 U.S. 411, 422–23 (1890) (“The circumstances surrounding the deposits, and the relations between the depositor and the bank, were such as to impart notice to the bank that the beneficial ownership was outside of the legal title. With that notice, it had no right to appropriate the deposits to pay the obligations of the depositor to the bank . . . .”); *Cent. Nat’l Bank v. Conn. Mut. Life Ins. Co.*, 104 U.S. 54, 63–64 (1881) (discussing special deposits); *Cassedy v. Johnstown Bank*, 286 N.Y.S. 202, 205 (App. Div. 1936).

absolutely precludes the bank from applying such funds to the individual indebtedness of the depositor to it.”<sup>128</sup>

There is general agreement that if a person who has a claim against the trustee in his individual capacity accepts from the debtor, in payment of the debt, or as security therefor, property which the creditor knows or should know is trust property, the recipient takes part in a breach of the fiduciary obligation.<sup>129</sup>

## B. BANKING REGULATION

Banks may act as trustees for customer assets. Those activities are governed by state trust laws but are overseen by the Office of the Comptroller of the Currency (the OCC) and the Federal Deposit Insurance Corporation (the FDIC).<sup>130</sup> The FDIC thus requires its consent before an insured bank may exercise trust powers; it examines bank trust activities and may sanction banks that engage in fiduciary breaches.<sup>131</sup> It also insures trust accounts as bank deposits.<sup>132</sup>

OCC Regulation 9 governs fiduciary activities of national banks.<sup>133</sup> Such fiduciary activities include national banks that act as trustees.<sup>134</sup> Regulators distinguish between banks in their role as trustees and as a deposit institution. The relationship between the beneficiaries of a trust and the trustee is a fiduciary relationship.<sup>135</sup> That is not the case for bank depositors.<sup>136</sup> A bank may invest funds deposited by customers but may not do so for trust beneficiaries, except for their benefit.<sup>137</sup> This means, among other things, national banks must keep fiduciary assets separate from all other accounts.<sup>138</sup> However, individual trust accounts may be held collectively with other trust accounts.<sup>139</sup>

Large banks provide custodial services for other institutions, which involve the safekeeping of funds as collateral for a loan, credit exposure, or other reasons. “Banks provide custody services to a variety of customers,

---

128. B. C. Ricketts, Annotation, *Bank's Right to Apply Third Person's Funds, Deposited in Debtor's Name, on Debtor's Obligation*, 8 A.L.R.3d 235, 239 (1966).

129. GEORGE GLEASON BOGERT ET AL., *BOGERT'S TRUSTS AND TRUSTEES* § 904 (3d ed. 2007) (footnotes omitted).

130. FDIC, *TRUST EXAMINATION MANUAL* § 10.D.3 (2009) [hereinafter *TRUST EXAMINATION MANUAL*], available at <http://www.fdic.gov/regulations/examinations/trustmanual/>.

131. *Id.* § 10.B.

132. *Id.* § 10.A–B.3, .G.7.

133. 12 C.F.R. pt. 9 (2013).

134. *Id.* § 9.2.

135. *Id.*

136. AM. BANKERS ASS'N, *TRUST OPERATIONS* 360 (1992).

137. *Id.*

138. 12 C.F.R. § 9.13 (2012).

139. *Id.* § 9.18; see Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 121–22 (2006) [hereinafter Markham, *Mutual Fund Scandals*] (describing development of bank collective trust funds).

including mutual funds and investment managers, retirement plans, bank fiduciary and agency accounts, bank marketable securities accounts, insurance companies, corporations, endowments and foundations, and private banking clients.”<sup>140</sup> The OCC has noted:

National banks’ custody activities developed from providing safekeeping and settlement services to customers for a fee, and historically are viewed as permissible incidental [banking] activities . . . and often are in conjunction with the delivery of fiduciary services. A custody relationship is a contractual arrangement, and the services performed for customers vary. Services traditionally provided include the settlement, safekeeping, and reporting of customers’ marketable securities and cash. A custodian also may invest cash balances as directed, collect income, process corporate actions, price securities positions, and provide recordkeeping services. As custody services are contractual in nature, a bank must ensure compliance with the provisions of all applicable agreements. The custody industry has grown significantly in recent years, and now global custodians control trillions of dollars in assets in offices around the world.<sup>141</sup>

“Services provided by a bank custodian are typically the settlement, safekeeping, and reporting of customers’ marketable securities and cash.”<sup>142</sup> “A custodian providing core domestic custody services typically settles trades, invests cash balances as directed, collects income, processes corporate actions, prices securities positions, and provides recordkeeping and reporting services.”<sup>143</sup> Custodians may provide securities lending services that allow them to earn fees from the lending of their securities.<sup>144</sup> Custodians may also conduct daily sweeps of customer accounts and invest excess cash.<sup>145</sup> Global custodians provide other services such as cross-border settlements and foreign exchange transactions.<sup>146</sup>

The concept of safekeeping of customer funds held in segregated accounts is well recognized by banking regulators.<sup>147</sup> The OCC has thus noted that the term “segregation” has been defined as the “[o]ptional or compulsory separation of a participant’s own securities from those held on

---

140. COMPTROLLER’S HANDBOOK, *supra* note 10, at 1.

141. Office of the Comptroller of the Currency, Adm’r of Nat’l Banks, Interpretive Letter No. 1078, at 3 (2007) [hereinafter Comptroller Interpretive Letter No. 1078] (citations and footnotes omitted), available at <http://www.occ.gov/static/interpretations-and-precedents/may07/int1078.pdf>.

142. COMPTROLLER’S HANDBOOK, *supra* note 10, at 1.

143. *Id.* at 2.

144. *Id.*

145. MONTY P. GREGOR, TRUST OPERATIONS 25–26 (2000).

146. See COMPTROLLER’S HANDBOOK, *supra* note 10, at 2 (acknowledging that global custodians perform typical services such as settling trades and executing foreign exchange transactions).

147. See, e.g., *id.* at 15.

behalf of its customers.”<sup>148</sup> The OCC has opined, however, that “[a] custodian is not a trustee, and generally is not subject to the strict fiduciary standards that govern the relationship between a trustee and beneficiary.”<sup>149</sup>

The OCC has stated that “a custodian may perform functions that are fiduciary in nature,” but the OCC appears to limit such a role to those instances where the bank is exercising discretion over the trading of an account or providing investment advice.<sup>150</sup> This raises an issue: is the bank acting as a “trustee” when it holds customer assets in segregation under the CEA or federal securities laws? In that regard, the CEA does apply directly to custodians of excess customer funds.<sup>151</sup> There is no corresponding requirement in the federal securities laws, but the SEC views such arrangements to be trust accounts.<sup>152</sup>

The OCC has also pointed out that “[c]ustody services are contractual in nature, and a bank must ensure compliance with the provisions of all applicable agreements.”<sup>153</sup> The federal securities laws, at the least, require the custodian bank to recognize contractually the fact that funds held under SEC Rule 15c3-3 are to be kept in segregated accounts.<sup>154</sup> Further, the custodian bank must “ensure that assets of each custody account are kept separate from the assets of the custodian and maintained under joint control.”<sup>155</sup> The recordkeeping by the custodian bank must also comply with applicable laws.<sup>156</sup>

The interrelated nature of bank custodian roles and SEC segregation requirements is evidenced by the fact that banks may use SEC-regulated broker-dealers as custodians of fiduciary assets, and those funds will be protected by SEC Rule 15c3-3.<sup>157</sup> Conversely, as described above, banks are designated as qualified custodians under CFTC and SEC segregation requirements.

## IV. CUSTODIAL FAILURES

### A. REFCO’S FAILURE

The revelation of a massive fraud at Refco in October 2005 stunned the financial community.<sup>158</sup> That firm had made a successful initial public

---

148. *Id.* at 84.

149. Comptroller Interpretive Letter No. 1078, *supra* note 141, at 3 n.8.

150. COMPTROLLER’S HANDBOOK, *supra* note 10, at 11; Comptroller Interpretive Letter No. 1078, *supra* note 141, at 3 n.8 (citations omitted).

151. *See* 7 U.S.C. § 6d(b) (2012).

152. *See* Custody or Possession Release, *supra* note 99.

153. COMPTROLLER’S HANDBOOK, *supra* note 10, at 4.

154. *Id.* at 2 n.2; 17 C.F.R. § 240.15c3-3(b)(4)(i)(D)(iii) (2013).

155. COMPTROLLER’S HANDBOOK, *supra* note 10, at 15.

156. *Id.* at 21.

157. *See* TRUST EXAMINATION MANUAL, *supra* note 132, § 10.F.1.a.1.b.1.

158. *See* Capital Mgmt. Select Fund Ltd. v. Bennett, 680 F.3d 214, 223 (2d Cir. 2012).

offering of its stock only a few months before its bankruptcy.<sup>159</sup> Refco failed after it announced a previously undisclosed loss from uncollectible receivables in the amount of \$430 million and advised that investors could not rely upon its financial statements.<sup>160</sup> The uncollectible receivables had arisen from customer losses in the late 1990s, which eventually reached some \$1 billion.<sup>161</sup> Refco hid those losses on its books through an elaborate “round robin” loan scheme that took the receivable off Refco’s book at the end of each accounting period and restored it immediately afterwards.<sup>162</sup> This scheme was carried out over a period of several years by two Refco chief executive officers, both of whom were sentenced to long prison terms.<sup>163</sup>

Refco was the parent company of Refco, LLC, the largest independent futures commission merchant in the United States.<sup>164</sup> After Refco announced its previously undisclosed account receivable loss, customers at Refco’s affiliates began seeking to withdraw their funds, resulting in a “[p]roverbial ‘run on the bank’” that Refco sought to stop by declaring a fifteen-day moratorium on withdrawals.<sup>165</sup> However, Refco declared bankruptcy only a few days later.<sup>166</sup> The customer accounts at Refco, LLC

---

159. *Id.*

160. *Id.*

161. *Id.*

162. *See id.* at 223 (describing this scheme). The Refco bankruptcy examiner described these transactions as follows:

The Round Trip Loans were two short term loans of several weeks duration that spanned the end of Refco’s fiscal year-end or quarterly financial reporting periods. The first loan was made by a Refco entity to a third party at a certain interest rate for a certain period of time. The second one was made by that same third party to RGHI for the same period of time, but at a higher interest rate. The repayment of the loan by RGHI to the third party was guaranteed by RGL and the third party was also indemnified by RGL against any loss or expense for entering into the Round Trip Loan.

The funds or credit advanced for the loan to the third party were deposited into the third party’s account with RCM. Those funds were then transferred at the third party’s request from the third party’s account at RCM to RGHI’s account at RCM. The effect of these transactions was to reduce RGHI’s receivable balance owed to RCM by the amount of the Round Trip Loan, and to substitute a receivable in that amount from the third party. In most cases, these were bookkeeping entries and no cash actually “moved.” After the end of the applicable reporting period, the process was reversed and unwound.

Final Report of Examiner at 4, *In re Refco Inc.*, No. 05-60006 (Bankr. S.D.N.Y. July 11, 2007).

163. Ameet Sachdev, *Refco Inc.: Former Mayer Brown Partner Joseph Collins Sentenced to 7 Years in Prison*, CHI. TRIB., Jan. 15, 2010, at C23, available at [http://articles.chicagotribune.com/2010-01-15/news/1001150112\\_1\\_refco-mayer-brown-sentenced](http://articles.chicagotribune.com/2010-01-15/news/1001150112_1_refco-mayer-brown-sentenced).

164. Refco had previously settled a case with the CFTC over its failure to properly segregate customer funds. The CFTC charged in that case that Refco removed customer funds from segregation each day and used those funds to pay down its bank loans. Refco deposited a check from an affiliate to cover the amounts required to be segregated, but the bank account of the affiliate had insufficient funds to cover the checks. *See Refco, Inc.*, CFTC Docket 95-2, 1994 CFTC LEXIS 348, at \*5 (Dec. 20, 1994) [hereinafter *Refco, Inc.*].

165. *Capital Mgmt. Select Fund Ltd. v. Bennett*, 680 F.3d 214, 223 (2d Cir. 2012).

166. *Id.*

were held in segregation under the Commodity Exchange Act of 1936.<sup>167</sup> Those accounts were quickly auctioned off to Man Group for \$323 million and were transferred in bulk to a Man Group affiliate, Man Financial.<sup>168</sup> That transfer was accomplished without significant loss to Refco, LLC customers.<sup>169</sup>

Customers at another Refco affiliate were not so fortunate. One of Refco's affiliates was Refco Capital Markets, Ltd., a Bermuda-chartered securities and foreign exchange broker that traded over-the-counter derivatives for clients.<sup>170</sup> RCM's operations were conducted "under the leadership of, and through a sales force of account officers and brokers employed by, its affiliated corporation, Refco Securities, LLC, ('RSL'), a wholly-owned subsidiary of Refco that operated as a U.S.-based broker-dealer registered with the SEC."<sup>171</sup>

Customer funds were transferred to RCM from accounts at Refco, LLC, an FCM that was segregated under the CEA.<sup>172</sup> RCM held itself out as an unregulated offshore broker, and "RCM Customers' securities and other property deposited in their accounts were not segregated but were commingled in a fungible pool. As a result, no particular security or securities could be identified as being held for any particular customer."<sup>173</sup>

It was charged in class action lawsuits that RCM had used customer funds totaling several hundred million dollars to fund Refco's operations and help conceal the unreported uncollectible receivable loss.<sup>174</sup> Charges were also made by hedge fund investors, including celebrity investor James B. Rogers, that funds were improperly transferred out of Refco, LLC-segregated accounts to unsegregated accounts at RCM.<sup>175</sup> Rogers's funds had some \$362 million on deposit with Refco,<sup>176</sup> but he was able to recover all of those funds through various recovery efforts.<sup>177</sup>

The Refco bankruptcy trustee negotiated the return to the Refco bankruptcy estate of \$263 million of the \$312 million that a group of hedge funds had withdrawn from RCM two days after Refco announced its previously undisclosed account receivable loss.<sup>178</sup> Those investors brought

---

167. Refco, Inc., *supra* note 164, at \*5–6.

168. Alistair Barr, *Man Group Wins Refco LLC Auction*, WALL ST. J. MARKETWATCH (Nov. 10, 2005, 8:51 PM), <http://www.marketwatch.com/story/man-group-wins-refco-llc-auction-price-set-at-323m>.

169. *Id.*

170. *Bennett*, 680 F.3d at 220.

171. *Id.* at 223.

172. *Id.* at 220.

173. *Id.*

174. *Id.* at 224.

175. Barr, *supra* note 168.

176. 4 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM ENRON-ERA SCANDALS TO THE SUBPRIME CRISIS (2004–2006) 248 (2011).

177. *Seip v. Rogers Raw Materials Fund, L.P.*, 948 N.E.2d 628, 632 (Ill. App. Ct. 2011).

178. *In re Refco Inc.*, 505 F.3d 109, 112 (2d Cir. 2007).

litigation seeking damages from Refco's auditors, lawyers, and other professionals, claiming they aided and abetted Refco's fraud.<sup>179</sup> A district court denied a motion to dismiss by Refco's auditors on the aiding and abetting claims in that litigation.<sup>180</sup> The court also allowed claims for secondary liability brought against Refco's auditors, lawyers, and underwriters to proceed<sup>181</sup> but narrowed the duties claimed to be owed by those professionals.<sup>182</sup>

Various class actions were brought to challenge those transfers, and some of that litigation is still pending. In *Capital Management Select Fund v. Bennett*,<sup>183</sup> the Second Circuit affirmed the dismissal of claims brought by hedge funds against Refco's officers and auditors.<sup>184</sup> The court held that the RCM customer agreement allowed customer securities to be rehypothecated.<sup>185</sup> The court could find no strong inference of scienter where the firm used customer funds and securities to fund its trading operations.<sup>186</sup>

The Refco failure raised few concerns with the CFTC's segregation requirements because they worked remarkably well in protecting customer funds and securities. The transfer of customer positions to MF Global also went smoothly.<sup>187</sup> That being said, those customers who removed their funds from segregation at Refco, LLC to unregulated accounts at RCM did suffer massive losses.<sup>188</sup> Those losses evidenced that all custody and safekeeping arrangements do not provide the same protections as those available under the CEA.

## B. THE SENTINEL FAILURE

The failure of Sentinel in August 2007 was one of the first casualties stemming from the Financial Crisis, which peaked a few months later.<sup>189</sup> Sentinel was headquartered in Northbrook, Illinois, and was registered with the CFTC as an FCM and the SEC as an investment adviser.<sup>190</sup> Sentinel's

---

179. *Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 148–50 (2d Cir. 2010).

180. *In re Refco Inc. Sec. Litig.*, 826 F. Supp.2d 478, 515 (S.D.N.Y. 2011).

181. *In re Refco Inc. Sec. Litig.*, 859 F. Supp.2d 644, 653 (S.D.N.Y. 2012).

182. *In re Refco Inc.*, 505 F.3d at 115.

183. *Capital Mgmt. Select Fund Ltd. v. Bennett*, 680 F.3d 214 (2d Cir. 2012).

184. *Id.* at 219.

185. See *Kirschner v. KPMG LLP*, 626 F.3d 673, 677–78 (2d Cir. 2010) (affirming dismissal of other claims).

186. *Bennett*, 680 F.3d at 214.

187. *CME Group Continues Transfer of MF Global Customer Accounts*, CME GRP. (Nov. 4, 2011), <http://investor.cmegroup.com/investor-relations/releasedetail.cfm?ReleaseID=621115>.

188. *In re Refco Inc. Sec. Litig.*, 826 F. Supp. 2d 478, 514 (S.D.N.Y. 2011).

189. See James Lydon, *Two Executives Accused of \$500 Million Fraud*, WHITE COLLAR CRIME & INTERNAL INVESTIGATIONS (June 4, 2012), <http://www.thewhitecollarblog.com/2012/06/04/two-executives-accused-of-500-million-fraud/>.

190. Lene Powell, *District Court Reconsiders Segregated Funds Ruling, Finds Liability*, DODD-FRANK NEWS CENTER (Aug. 17, 2012), <http://financialreform.wolterskluwer1b.com/2012/08/district-court-reconsiders-segregated-funds-ruling-finds-liability.html>.

day-to-day operations involved the management of cash investments for proprietary and customer funds of FCMs, hedge funds, financial institutions, pension funds, and individuals.<sup>191</sup>

The CEA defines an FCM to be an entity that accepts both customer orders and funds.<sup>192</sup> Sentinel did not execute customer orders and registered with the CFTC as an FCM only because this would make it a permissible depository of customer funds segregated under the CEA.<sup>193</sup> The CFTC gave Sentinel special no-action relief that allowed Sentinel to operate without meeting the CFTC's onerous net capital requirements,<sup>194</sup> which were deemed unneeded because Sentinel would have no exposure from commodity futures or options positions.<sup>195</sup>

Sentinel's selling point was its claim that its investment expertise allowed it to produce the highest available returns on customer funds held in custody under the CEA.<sup>196</sup> FCMs like this approach because it means that they do not have to incur the costs of developing their own investment expertise, while still receiving high returns from the investment of their customer funds.<sup>197</sup> Other money managers also bought into Sentinel's claims of expertise.<sup>198</sup>

Sentinel then divided its investment programs into three groups. Its "SEG I" accounts were for the funds and properties of customers of other FCMs; "SEG II" accounts were for customers of other FCMs trading on foreign exchanges; and "SEG III" accounts were for all other clients, including proprietary FCM funds and the funds and property of hedge funds, trust accounts, endowments, and individuals that invested directly with Sentinel rather than through another FCM.<sup>199</sup> These groups were then subdivided into various trading programs offered by Sentinel.<sup>200</sup>

The Bank of New York Mellon (BONY) was the depository used by Sentinel for the safekeeping of the customer funds held in the SEG I–III accounts.<sup>201</sup> BONY signed separate, but virtually identical, letters in which it agreed that all of the funds and securities held in the SEG I–III accounts

---

191. *In re Sentinel Mgmt. Grp., Inc.*, 398 B.R. 281, 289 (Bankr. N.D. Ill. 2008) (citation omitted).

192. 7 U.S.C. § 1a(28) (2012).

193. *See* 17 C.F.R. § 1.20 (2013) (setting forth this requirement).

194. *See id.* § 1.12 (setting forth this requirement).

195. Letter from James L. Carley, Dir., Div. of Clearing & Intermediary Oversight, CFTC, to Eric A. Bloom, President & CEO, Sentinel Mgmt. Grp. n.2 (Jan. 21, 2004), in *Comm. Fut. L. Rep.* (CCH) ¶ 29,691.

196. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d 855, 857 (7th Cir. 2012), *vacated by* 704 F.3d 1009 (7th Cir. 2012).

197. *See id.* at 858–59.

198. *Id.* at 858.

199. *Grede v. FCStone, LLC*, 485 B.R. 854, 859–60 (Bankr. N.D. Ill. 2013).

200. *Id.* at 860.

201. *Id.* at 861.

would be segregated in accordance with the provisions of the CEA.<sup>202</sup> This meant that even the SEG III accounts, which were not otherwise covered by the CEA, were required to be held in segregation in the same manner as the SEG I accounts under the CEA.<sup>203</sup>

Sentinel's business model proved to be successful after its creation in 1981.<sup>204</sup> Sentinel took advantage of a decision by the CFTC in 2004 to expand the permitted range of investments for customer segregated funds that are identified in CFTC Rule 1.25.<sup>205</sup> The CFTC then allowed FCMs to engage in repurchase agreements (repos) of customer-deposited securities.<sup>206</sup> That expanded list of permitted investments improved returns at Sentinel, but the company also found a way to leverage customer funds in a way that had not been envisioned by the CFTC.<sup>207</sup>

In its repo transactions, Sentinel typically sold a security it was purchasing to a repo dealer with an agreement that Sentinel would buy the security back at some specified time in the future.<sup>208</sup> The repo dealer kept a haircut on the value of the security as collateral to protect itself in the event of a decline in the value of the security and a default by Sentinel.<sup>209</sup> Because Sentinel did not have the resources to fund this haircut, it financed the haircut through loans from BONY.<sup>210</sup> For example, if Sentinel purchased a \$10 million security from Dealer A, it had to pay that amount for the security. To acquire those funds, Sentinel did two things. It first transferred the security under an agreement to repurchase to either Dealer A or another dealer and received back cash in an amount less than \$10 million because of the haircut.<sup>211</sup>

Because Sentinel could not fully fund the purchase of a security through a repo transaction, Sentinel then used a loan facility supplied by BONY to finance the remaining portion of the purchase price not received from the repo counterparty.<sup>212</sup> Customer assets that should have been segregated were used to collateralize these loans from BONY to Sentinel.<sup>213</sup> As the bankruptcy court later found:

---

202. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d at 858–59.

203. *Id.* at 859.

204. *See id.* at 857–58; Complaint at ¶ 8, No. 08CV2410, CFTC v. Sentinel Mgmt. Grp., Inc., 2008 WL 2113281 (N.D. Ill. 2008).

205. 17 C.F.R. § 1.25 (2013).

206. Investment of Customer Funds, 69 Fed. Reg. 6140, 6141 (Feb. 10, 2004) (to be codified at 17 C.F.R. pt. 1).

207. CFTC v. Sentinel Mgmt. Grp., Inc., No. 08 C 2410, 2012 U.S. Dist. LEXIS 109747, at \*4–5 (N.D. Ill. Aug. 6, 2012); *see also* SEC v. Sentinel Mgmt. Grp., Inc., No. 07 C 4684, 2012 U.S. Dist. LEXIS 57579, at \*8 (N.D. Ill. Mar. 30, 2012) (reviewing Sentinel's use of leverage through reverse repo transactions in a manner similar to the court in *CFTC v. Sentinel Mgmt. Grp., Inc.*).

208. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d at 859.

209. *Sentinel Mgmt. Grp., Inc.*, 2012 U.S. Dist. LEXIS 57579, at \*8.

210. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d at 859.

211. *Id.*

212. *Id.*

213. *In re Sentinel Mgmt. Grp., Inc.*, 398 B.R. 281, 289 (Bankr. N.D. Ill. 2008).

As a FCM, and an entity managing other FCM investments, Sentinel was required to strictly segregate the investments of its customer groups from each other and from Sentinel's own funds. In fact, however, it did not segregate customer funds. Rather, Sentinel commingled customer funds with its own funds and used the customer funds as collateral for its loans from [BONY].<sup>214</sup>

Sentinel experienced high returns from this program but found itself in difficulty when dealers began demanding higher haircuts on the securities being reposed by Sentinel and in some cases refusing to deal at all in those securities.<sup>215</sup> Sentinel then failed, and BONY seized the SEG I–III securities that Sentinel had used to secure its loan with BONY.<sup>216</sup>

Sentinel's Liquidation Trustee sued BONY to recover the customer property it had seized.<sup>217</sup> The Trustee contended that section 4d(b) of the CEA,<sup>218</sup> which had been added to the CEA in 1968,<sup>219</sup> made the segregation provisions of the CEA directly applicable to depository banks such as BONY.<sup>220</sup> The trustee claimed that BONY breached its duties when it used customer segregated securities to secure its loan to Sentinel.<sup>221</sup> However, the district court refused to impose such a duty, and the Seventh Circuit initially agreed with the district court in *In re Sentinel Management Group, Inc.*<sup>222</sup> The Seventh Circuit held that a depository of CEA customer segregated funds need not return funds that were taken out of customer accounts and used to secure a loan to the FCM where it was not shown that the bank had acted fraudulently.<sup>223</sup> However, the panel rendering that decision withdrew it a few months later.<sup>224</sup> In August 2013, the Seventh Circuit issued a new opinion, which held that the improper transfer of customer funds out of segregation evidenced an actual intent to hinder,

---

214. *Id.* (citation omitted).

215. "Sentinel's troubles began in June 2007, when a broker who held over \$1 billion in outstanding reverse repos with Sentinel began to redeem them. The following month, another broker with \$600 million in outstanding reverse repos followed suit." *CFTC v. Sentinel Mgmt. Grp., Inc.*, No. 08 C 2410, 2012 U.S. Dist. LEXIS 109747, at \*5 (N.D. Ill. Aug. 6, 2012).

216. *Id.*

217. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d at 861.

218. 7 U.S.C. § 6d(b) (2012).

219. Commodity Exchange Act, Pub. L. No. 90-258, sec. 6(b), § 4d, 82 Stat. 26, 27–28 (1968).

220. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d at 865. The CFTC subsequently noted:

The language of the statute and its legislative history indicate that Section 4d was designed for the broad purpose of protecting customers from having their money, securities or property appropriated by a futures commission merchant, or some other depository, without adequate legal basis, and the more specific purpose of ensuring the integrity of the futures market by preventing the use of customer funds to finance market transactions by a futures commission merchant for its own account or for other customers.

*Dorn v. Shearson Hayden Stone, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 21,253 (Oct. 6, 1981), at \*9.

221. *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d at 865.

222. *Id.* at 866–67.

223. *Id.*

224. *In re Sentinel Mgmt. Grp., Inc.*, 704 F.3d 1009, 1009 (7th Cir. 2012).

delay, or defraud creditors. The case was remanded to reconsider the liquidation trustee's claim that the bank should be equitably subordinated to the claims of customers.<sup>225</sup>

Another issue raised by the *Sentinel* Liquidation Trustee was the priority to be given to the remaining Sentinel assets as between SEG I and SEG III customers—there were almost no SEG II customer funds.<sup>226</sup> This dispute arose after it was discovered that Sentinel had been largely taking securities from the SEG I accounts to collateralize the BONY loan.<sup>227</sup> However, only a few weeks before its failure, Sentinel substituted those securities for securities taken from the SEG III customer accounts, so that when Sentinel failed, it was the SEG III securities that were seized by BONY rather than the SEG I securities.<sup>228</sup>

The *Sentinel* Liquidation Trustee sought to have the SEG I and SEG III customers share losses from Sentinel on a pro rata basis.<sup>229</sup> The Trustee contended that those losses should not be borne solely by the SEG III customers merely because of Sentinel's last-minute and arbitrary decision to substitute the SEG III for the SEG I securities that Sentinel had previously used to fund the BONY loan.<sup>230</sup> The Liquidation Trustee also argued that equal protection was appropriate because the SEG III customer funds were held in custody under the Investment Advisers Act of 1940.<sup>231</sup> The Trustee contended that SEC's IA Custody Rule should be given equal status and protection as customer funds held in segregation under the CEA.<sup>232</sup> This claim gave rise to a battle of the experts over whether the segregation requirements of the CEA were more robust than those under the IA Custody Rule. Another issue was whether the CEA created a "floating trust" that preempted all other trusts.<sup>233</sup> The district court ruled that the Sentinel customers would share pro rata in the remaining proceeds of the estate and that the CEA segregation requirements did not trump the IA Custody Rule or create a floating trust.<sup>234</sup>

### C. LEHMAN BROTHERS

The failure of Lehman Brothers on September 15, 2008, was the largest bankruptcy in U.S. history and resulted in the largest liquidation of a

---

225. *In re Sentinel Mgmt. Grp., Inc.*, 728 F.3d 660, 672 (7th Cir. 2013).

226. *In re Sentinel Mgmt. Group, Inc.*, 398 B.R. 281, 292–93 (Bankr. N.D. Ill. 2008).

227. *Id.* at 289.

228. *Id.* at 292–93.

229. *Id.* at 293.

230. *Grede v. Bank of N.Y. Mellon*, 441 B.R. 864, 902 (Bankr. N.D. Ill. 2010).

231. *See id.* at 886–900; *Grede v. FCStone, LLC*, 485 B.R. 854, 870 (Bankr. N.D. Ill. 2013).

232. *See Grede*, 485 B.R. at 870; *see also Grede*, 441 B.R. at 886–900.

233. The floating trust concept is found in the Perishable Agricultural Commodities Act, which creates a statutory trust model in which "[t]rust assets are to be preserved as a nonsegregated 'floating' trust. Commingling of trust assets is contemplated." 7 C.F.R. § 46.46(b) (2013).

234. *See Grede*, 485 B.R. at 871.

broker-dealer ever.<sup>235</sup> About \$92 billion in funds and securities were almost immediately transferred out of Lehman for the benefit of customers.<sup>236</sup> Customers were allowed to move those funds and their accounts to other brokerage firms.<sup>237</sup> The bulk of the remaining Lehman Brothers securities customers and their assets (about \$40 billion) were transferred to Barclays Bank, giving rise to “the largest, most expedited and probably the most dramatic asset sale that has ever occurred in bankruptcy history.”<sup>238</sup>

That sale worked well for most of the accounts transferred. However, Barclays refused to take many large accounts totaling several billion dollars; those accounts were subject to long delays in resolving their treatment and encountered conflicting treatment under bankruptcy laws in various countries.<sup>239</sup> A dispute also arose over whether the sale to Barclays included \$769 million in Lehman accounts that were segregated under SEC Rule 15c3-3 and \$507 million held at the Options Clearing Corp. as customer margins.<sup>240</sup> After extended litigation, the district court held that those assets should not have been included in the transfer of assets to Barclays.<sup>241</sup>

Numerous Lehman Brothers customers, including several hedge funds and banks, were not paid their funds held at Lehman Brothers, but the bankruptcy trustee was able to obtain settlements over the course of several years of litigation that allowed the return of virtually all of their funds.<sup>242</sup> For example, the trustee reached a \$38 billion settlement over funds held in London by a Lehman affiliate and a \$6 billion settlement over funds held at a Swiss affiliate.<sup>243</sup> The Lehman bankruptcy trustee reached a settlement late in 2012 with Citigroup Inc., which required that bank to return \$435 million of a disputed \$1 billion in funds that it held in connection with the clearing of foreign exchange trades for Lehman’s broker-dealer affiliate.<sup>244</sup>

JPMorgan Chase Bank, N.A. (JPMorgan) also became ensnared in litigation over its role as custodian of customer plans segregated under the CEA. In *In re JPMorgan Chase Bank, N.A.*, the CFTC found by consent that respondent had improperly delayed the return of segregated funds of Lehman Brothers’ customers.<sup>245</sup> The CFTC further charged that JPMorgan

---

235. See 5 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE SUBPRIME CRISIS TO THE GREAT RECESSION (2006–2009) 524–31 (2011) [hereinafter 5 MARKHAM, FINANCIAL HISTORY].

236. See Fitzgerald, *supra* note 3, at C3.

237. See *id.*

238. See *In re Lehman Bros. Inc.*, 478 B.R. 570, 576 (S.D.N.Y. 2012).

239. See Trustee’s Preliminary Investigation Report and Recommendations at 62, 122, *In re Lehman Bros. Inc.*, No. 08-01420 (JMP) SIPA (Bankr. S.D.N.Y. Aug. 25, 2010).

240. See *In re Lehman Bros. Inc.*, 478 B.R. at 579–80.

241. See *id.* at 599.

242. See Fitzgerald, *supra* note 3, at C3.

243. See *id.*

244. See *id.*

245. See *JPMorgan Chase Bank, N.A.*, Comm. Fut. L. Rep. (CCH) ¶ 32,156 (Apr. 4, 2012).

had been making improper loans to Lehman based on those segregated funds.<sup>246</sup> JPMorgan thereafter entered into a settlement with Lehman's liquidators in which the bank agreed to pay \$100 million in settlement of claims by the estate against that bank.<sup>247</sup>

Otherwise, customer positions and funds segregated at Lehman Brothers under the provisions of the CEA and CFTC rules went smoothly and were transferred out over a five-day period.<sup>248</sup> However, customer segregated assets that were subject to U.K. customer rules were not able to be transferred and remained tied up in lengthy litigation in the United Kingdom for several years.<sup>249</sup> The U.K. Supreme Court eventually held that customer funds that were supposed to have been segregated under U.K. Financial Services Authority rules would be treated as being segregated even if the firm did not actually segregate the funds.<sup>250</sup> A settlement was also reached that provided for the return of all U.S. customer funds.<sup>251</sup> The new U.K. Financial Conduct Authority has proposed rules that will allow the prompt return of customer funds when a financial services firm fails.<sup>252</sup> Hopefully, this will avoid a repeat of the Lehman debacle.

#### D. BERNIE MADOFF

On December 10, 2008, the sons of Bernie Madoff reported to authorities that their father had confessed to them that he had been running the largest Ponzi scheme in history.<sup>253</sup> Madoff was a well-known figure in the securities industry and had been innovative in introducing electronic trading to the securities markets.<sup>254</sup> Madoff operated a securities broker-dealer, Bernard L. Madoff Investment Securities LLC (BLMIS).

---

246. *See id.*

247. Ben Protess, *With JPMorgan Settlement, MF Global Clients Move Closer to Payout*, N.Y. TIMES DEALBOOK (Mar. 20, 2013, 9:37 AM), <http://dealbook.nytimes.com/2013/03/20/with-jpmorgan-settlement-mf-global-clients-move-closer-to-payout/>.

248. *See* Ronald H. Filler, *Consumer Protection: How U.K. Client Money Rules Differ from U.S. Customer Segregated Rules When a Custodian Firm Fails to Treat Customer Property Properly*, 24 J. TAX'N & REG. FIN. INSTITUTIONS 25 (2011).

249. *See id.*

250. *In re Lehman Bros. Int'l (Eur.) (In Admin.) & In re Insolvency Act 1986*, [2012] UKSC 6 (appeal taken from Eng.), available at [http://www.supremecourt.gov.uk/docs/UKSC\\_2010\\_0194\\_Judgment.pdf](http://www.supremecourt.gov.uk/docs/UKSC_2010_0194_Judgment.pdf).

251. *See* James W. Giddens, *How to Avoid the Next MF Global Surprise*, WALL ST. J., July 10, 2013, at A11, available at <http://online.wsj.com/article/SB10001424127887324766604578458624010464206.html>.

252. Lindsay Fortado, *U.K. Seeks to Tighten Client-Money Rules After Lehman, MF*, BLOOMBERG (July 12, 2013, 8:07 AM), <http://www.bloomberg.com/news/2013-07-12/u-k-seeks-to-tighten-client-money-rules-after-lehman-mf.html>.

253. *See* HENRIQUES, *supra* note 4 (describing Madoff's background and fraud).

254. MARKHAM, *supra* note 235, at 609–13.

“Outwardly, BLMIS functioned both as an investment advisor to its customers and a custodian of their securities.”<sup>255</sup>

Madoff was able to attract billions of dollars in investor funds through claims of high returns from his so-called “split-strike conversion strategy.”<sup>256</sup> In reality, there was no such strategy. Madoff failed to segregate customer funds in accordance with either the SEC Customer Protection Rule for broker-dealer customers or the SEC IA Custody Rule for investment adviser customers.<sup>257</sup> Profits were also fabricated and redemption requests were paid out of other customers’ funds until the whole scheme came apart during the Financial Crisis in 2008.<sup>258</sup> Madoff’s failure gave rise to over 15,000 customer claims totaling over \$68 billion.<sup>259</sup> Actual out-of-pocket losses were eventually determined to total over \$17 billion, and as of November 15, 2013, the SIPC trustee has recovered a little over one-half that amount through various recovery actions.<sup>260</sup> That amount also included a \$708 million commitment from SIPC for its insurance coverage.<sup>261</sup>

After Madoff’s fraud was exposed, SIPC sought the appointment of a trustee to liquidate BLMIS.<sup>262</sup> That touched off a lengthy fight over how customer claims for SIPC insurance would be computed.<sup>263</sup> The SIPC trustee used the “Net Investment Method,” which computed customer account balances by crediting the amount of cash deposited by the customer and debiting the amounts withdrawn by the customer.<sup>264</sup> Customers who

---

255. *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. 122, 127 (Bankr. S.D.N.Y. 2010), *aff’d*, 654 F.3d 229, 242 (2d Cir. 2011), *cert. dismissed sub nom. Sterling Equities Assocs. v. Picard*, 132 S. Ct. 2712 (2012).

256. *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. at 129.

257. *Id.* at 129 n.17.

258. The Second Circuit has described Madoff’s scheme as follows:

When customers invested with Bernard L. Madoff Investment Securities LLC (“BLMIS”), they relinquished all investment authority to Madoff. Madoff collected funds from investors, claiming to invest those funds pursuant to what he styled as a “split-strike conversion strategy” for producing consistently high rates of return on investments. The split-strike conversion strategy supposedly involved buying a basket of stocks listed on the Standard & Poor’s 100 Index and hedging through the use of options. However, Madoff never invested those customer funds. Instead, Madoff generated fictitious paper account statements and trading records in order to conceal the fact that he engaged in no trading activity whatsoever. Even though a customer’s monthly account statement listed securities transactions purportedly executed during the reporting period and purported individual holdings in various Standard & Poor’s 100 Index stocks as of the end of the reporting period, the statement did not reflect any actual trading or holdings of securities by Madoff on behalf of the customer.

*In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 231–32 (citations and footnote omitted).

259. *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. at 124.

260. *Recoveries to Date*, MADOFF RECOVERY INITIATIVE, <http://www.madofftrustee.com/recoveries-04.html> (last visited Nov. 17, 2013).

261. *Id.*

262. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 231.

263. *Id.* at 233.

264. *Id.*

withdrew more than they deposited would have no claim for SIPC insurance.<sup>265</sup> The issue of whether funds could be clawed back from investors who were paid out more than they invested in their accounts at BLMIS was also the subject of litigation.<sup>266</sup>

#### E. SIR R. ALLEN STANFORD AND OTHER PONZI SCHEMES

Another shoe dropped on February 17, 2009, when the SEC charged that Sir R. Allen Stanford had been running a giant \$7 billion Ponzi scheme out of the Caribbean island of Antigua, where he had been knighted.<sup>267</sup> Stanford was charged with and convicted of a criminal fraud involving approximately 30,000 investors in 113 countries through fraudulent high-return certificates of deposit (CDs) issued by the Stanford International Bank of Antigua.<sup>268</sup> This fraud was the second largest in history, trailing only Bernie Madoff in size.<sup>269</sup>

The SEC and SIPC found themselves embroiled in a fight over whether SIPC was required to insure customers suffering losses from those CDs.<sup>270</sup> A federal district court judge rejected the SEC's effort to force SIPC to commence proceedings to liquidate the Stanford operations and provide insurance coverage to victims.<sup>271</sup> Stanford owned a Houston-based broker-dealer that was registered with the SEC, but the Antigua bank, which issued the CDs, was not so registered.<sup>272</sup> The district court held that the victims of Stanford's fraud were not customers of a broker-dealer, even though the CDs were sold through Stanford's registered broker-dealer in Houston, which was a member of SIPC.<sup>273</sup> The Court held that the broker-dealer was not performing a custodial function in selling the CDs. Rather, customers made checks directly payable to the Stanford bank and their CDs were not held at the broker-dealer.<sup>274</sup>

---

265. See *In re Bernard L. Madoff Inv. Sec.*, 424 B.R. 122, 133 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229, 242 (2d Cir. 2011), *cert. dismissed sub nom. Sterling Equities Assocs. v. Picard*, 132 S. Ct. 2712 (2012) (stating that a customer who "withdrew funds from BLMIS in an amount that exceeds their initial investments and subsequent deposits" has no net equity claims).

266. See Jessica D. Gabel, *Midnight in the Garden of Good Faith: Using Clawback Actions to Harvest the Equitable Roots of Bankrupt Ponzi Schemes*, 62 CASE W. RES. L. REV. 19, 61 (2011) (citing *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. at 125) (stating that Madoff trustee wanted the "net equity" method and demanded that the 'net winners' return their 'profits' to ensure a more equitable distribution of funds).

267. Krauss, *supra* note 5, at B1; see also ROBERT HOFFMAN, *SIR ALLEN & ME: AN INSIDER'S LOOK AT R. ALLEN STANFORD AND THE ISLAND OF ANTIGUA* (2009) (describing Stanford's background and operations).

268. Krauss, *supra* note 5, at B3.

269. *Id.*

270. SEC v. Sec. Investor Prot. Corp., 872 F. Supp.2d 1, 3 (D.D.C. 2012).

271. *Id.* at 12.

272. *Id.* at 7.

273. *Id.* at 8.

274. *Id.* at 7–8.

The Madoff and Stanford fraud schemes were preceded and succeeded by a number of Ponzi schemes in which customer funds were misappropriated. To name just a few, Kenneth Kasarjian raised over \$800 million in a Ponzi scheme; J.T. Wallenbrock & Associates raised over \$230 million in a Ponzi scheme; the Reed Slatkin Investment Club Ponzi scheme took in over \$600 million; and Kevin Leigh Lawrence raised \$90 million in his Ponzi scheme.<sup>275</sup> The Manhattan Investment Fund in Florida defrauded investors of \$350 million; the Maricopa Index Hedge Fund raised \$120 million through a Ponzi scheme; and the KL Group turned out to be a \$200 million Ponzi scheme.<sup>276</sup> In 2005, the Bayou Hedge Fund Group was unmasked as a classic Ponzi scheme that cost investors some \$200 million.<sup>277</sup> Danny Pang's Ponzi scheme involved some \$700 million in investor funds.<sup>278</sup> The CFTC has also brought numerous cases in recent years against commodity pool operators who were engaged in Ponzi schemes.<sup>279</sup>

#### F. MF GLOBAL'S FAILURE

MF Global and its fifty affiliated entities failed on October 31, 2011.<sup>280</sup> That firm was headed by Jon S. Corzine, the former governor and U.S. Senator from New Jersey and a former leader of Goldman Sachs.<sup>281</sup> Corzine had tried to shore up MF Global's declining profits by investing in European government debt in Greece and other faltering euro zone countries on the theory that the European Union would bail them out at 100 cents on the dollar.<sup>282</sup> MF Global's \$6 billion plus bet on that debt resulted in large losses and a ratings downgrade that caused a decrease in the firm's liquidity.<sup>283</sup> A takeover of MF Global by Interactive Brokers Group Inc. fell through after a massive amount of customer funds could not be located.<sup>284</sup>

MF Global's failure was the eighth-largest bankruptcy in the United States and the largest failure of a financial services firm since Lehman

---

275. 5 MARKHAM, FINANCIAL HISTORY, *supra* note 235, at 487–89.

276. Markham, *Mutual Fund Scandals*, *supra* note 139, at 120.

277. *United States v. Marino*, 654 F.3d 310, 311 (2d Cir. 2011).

278. *See* 5 MARKHAM, FINANCIAL HISTORY, *supra* note 235, at 631 (describing that scheme).

279. 13 JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS § 27:20 (2012) (describing those cases).

280. STAFF OF H.R. SUBCOMM. ON OVERSIGHT & INVESTIGATIONS OF THE COMM. ON FIN. SERVS., 112TH CONG., STAFF REPORT PREPARED FOR REP. RANDY NEUGEBAUER, CHAIRMAN 96 (2012) [hereinafter STAFF REPORT], available at <http://ftalphaville.ft.com/files/2012/11/MFGreport.pdf>.

281. *Id.* at 20.

282. *Id.* at 31–32, 35.

283. *See id.* at 36–42, 47 (describing the timeline of MF Global's expansion of its European sovereign debt portfolio and the subsequent losses therein).

284. *Id. passim.* (describing MF Global's failure).

Brothers.<sup>285</sup> There was also a massive shortfall in customer funds totaling some \$1.6 billion.<sup>286</sup> This included about \$900 million of customer segregated funds in commodity and securities accounts and \$700 million in funds that were subject to CFTC Rule 30.7, i.e., customers of MF Global's CFTC-regulated futures commission merchant who were trading on foreign exchanges.<sup>287</sup> As described above, under Rule 30.7, only a limited amount of their funds were required to be held in a Secured Amount account and were not required as excess margin funds for trading on regulated U.S. commodity option and futures exchanges.<sup>288</sup>

An SIPC trustee was appointed for MF Global, Inc. (MFGI), a dually registered broker-dealer and futures commission merchant.<sup>289</sup> Other MF Global units were subject to liquidation by other trustees, and their claims over remaining customer funds were conflicting and led to disputes in the United States and in London.<sup>290</sup> MFGI asserted customer claims of some \$910 million against MF Global UK.<sup>291</sup> Customer funds that were held in MF Global UK were claimed by the London trustee to be unprotected funds, which meant they would be treated as general creditors only.<sup>292</sup> However, the U.S. trustee was able to reach an agreement that allowed the return of roughly \$500 million at issue in the London proceeding for the benefit of the Rule 30.7 customers.<sup>293</sup> Before that settlement, the SIPC trustee had returned eighty percent of customer funds that were segregated under section 4d of the CEA, but only five percent of Rule 30.7 funds had been returned.<sup>294</sup> Nevertheless, the MF Global bankruptcy trustee predicted that these customers would eventually be made whole.<sup>295</sup> The SIPC trustee

---

285. See Mike Spector et al., *MF Global Collapses as Books Questioned*, WALL ST. J. (Nov. 1, 2011), available at <http://online.wsj.com/article/SB10001424052970204528204577009473406903312.html>.

286. STAFF REPORT, *supra* note 280, at 1.

287. See Trustee's Investigation and Recommendations, *supra* note 6, at 2.

288. *Id.* at 10.

289. *Id.* at 1.

290. *Id.* at 21–22, 47, 48, 111, 161, 169.

291. *Id.* at 157.

292. *Id.* at 158.

293. Michael J. de la Merced, *MF Global Officials Reach Accord over Claims*, N.Y. TIMES, Dec. 23, 2012 at A24, available at <http://dealbook.nytimes.com/2012/12/22/mf-global-overseers-reach-accord-over-claims/>.

294. Motion of James W. Giddens, SIPC Trustee for The Liquidation of MF Global Inc., to Approve Further Distributions to Former Commodity Futures Customers of MF Global Inc. at 4, *In re MF Global Inc.*, No. 11-2790 (MG) SIPA (Bankr. S.D.N.Y. Dec. 21, 2012).

295. Devlin Barrett & Aaron Lucchetti, *Hope for MF Global Clients — Bankruptcy Trustee Tells Congress U.S. Customers 'Eventually Will Be Made Whole'*, WALL ST. J., Aug. 1, 2012, at A1, available at <http://online.wsj.com/article/SB10000872396390444405804577561531001893726.html>; see also Aaron Lucchetti, *MF Clients to Get Bigger Payments*, WALL ST. J., Jan. 12, 2013, at B2, available at <http://online.wsj.com/article/SB10001424127887324581504578235521252782806.html>.

also predicted that the customers covered by SIPC insurance could be made whole.<sup>296</sup>

The CFTC filed a civil injunctive action against Jon Corzine and a former Assistant Treasurer of MF Global.<sup>297</sup> Corzine was charged with a failure to supervise and with controlling person liability.<sup>298</sup> MF Global was also sued and agreed to settle the CFTC's charges, including 100% restitution of all remaining commodity customer claims, assuming there were any assets available for return.<sup>299</sup> "The proposed order also include[d] the imposition of a \$100 million penalty, which [could] be paid to the extent MF Global ha[d] not fully exhausted all available funds and assets paying customers and then other creditors entitled to priority under bankruptcy law."<sup>300</sup>

### G. PEREGRINE FINANCIAL GROUP AND OTHER SEGREGATION FAILURES

Another large shortfall in customer funds occurred in the failure of Peregrine, an Iowa firm that declared bankruptcy on July 10, 2012.<sup>301</sup> It was discovered that over \$200 million in customer funds that were supposed to be segregated under the CEA had been misappropriated by the owner of that firm: Russell Wasendorf, Sr.<sup>302</sup> That conversion occurred over a period of some twenty years.<sup>303</sup> There were over 17,000 customer accounts affected by this fraud.<sup>304</sup>

Purportedly, Wasendorf had submitted false bank statements to regulators showing that the customer funds were properly segregated.<sup>305</sup> A CFTC complaint charged that "in July 2012 during an NFA examination PFG falsely represented that it held in excess of \$220 million of customer

---

296. Associated Press, *MF Global Trustee: Some Customers Could Be Made Whole After Losing to Collapsed Brokerage*, WASH. POST (Dec. 28, 2012), available at <http://www.rohrintl.com/pdf/TWPartlMFGclientsMOREmoney-121231.pdf>.

297. Complaint at 1, CFTC v. MF Global Inc., No. 13-cv-04463 (S.D.N.Y. filed June 27, 2013), 2013 WL 3231494 [hereinafter MF Global Complaint].

298. Press Release, CFTC, CFTC Charges MF Global Inc. (June 27, 2013) [hereinafter CFTC Press Release], available at <http://www.cftc.gov/PressRoom/PressReleases/pr6626-13>; see MF Global Complaint, *supra* note 297, at 43.

299. CFTC Press Release, *supra* note 298.

300. *Id.*

301. Ann Saphir, *Peregrine Trustee Plans Return of \$123 Million Client Funds*, REUTERS, (Sept. 6, 2012, 2:20 PM), <http://www.reuters.com/article/2012/09/06/us-peregrine-bankruptcy-distribution-idUSBRE88512D20120906>.

302. Jacob Bunge, *Peregrine Founder Hit with 50 Years*, WALL ST. J., Feb. 1, 2013, at C1, available at <http://online.wsj.com/news/articles/SB10001424127887324610504578276021147076476?mg=reno64-wsj>.

303. Saphir, *supra* note 301.

304. *Id.*

305. Michael Rothfeld et al., *Red Flags at Failed Broker—Firm Was Subject of Multiple Actions; Investigators Study 'Incredible Forgeries'*, WALL ST. J., July 13, 2012, at C1, available at <http://online.wsj.com/article/SB10001424052702303644004577523283640238486.html>.

funds when in fact it held approximately \$5.1 million.”<sup>306</sup> Wasendorf, age 64, pleaded guilty to criminal charges and was sentenced to fifty years in prison.<sup>307</sup>

The CFTC filed a civil injunctive action against U.S. Bank, N.A., the depository of Peregrine’s segregated funds.<sup>308</sup> The CFTC charged that the bank had used customer segregated funds as collateral for personal loans to Wasendorf and his wife.<sup>309</sup> The CFTC further charged that the bank allowed Peregrine to treat its customer segregated funds as being held in a commercial bank account that was used to pay for Wasendorf’s personal expenses, including an airplane, a restaurant, and a divorce settlement.<sup>310</sup> Customer funds were also used to fund construction of Peregrine’s offices.<sup>311</sup>

In a separate matter, *Farr Financial Inc.*, the CFTC found by consent that the respondent had invested customer funds in securities not authorized by CFTC Rule 1.25.<sup>312</sup> These investments included a money market mutual fund from which funds could not be withdrawn by the next business day; five savings or money market deposit accounts that were not permitted investments; and a certificate of deposit whose issuer did not meet the then-existing credit rating requirement of Rule 1.25.<sup>313</sup> In another case, *Cantor Fitzgerald & Co.*,<sup>314</sup> the CFTC found by consent that the respondent had failed to maintain adequate funds in segregation when it inadvertently transferred \$3 million from customer-segregated funds to a house account.<sup>315</sup> This under-segregation was only belatedly reported, and a failure to supervise was found.<sup>316</sup> In *ABN AMRO Clearing Chicago LLC*, the CFTC found by consent that the respondent failed to segregate or secure customer funds, meet net capital and bookkeeping requirements, and supervise its employees.<sup>317</sup> In *CFTC v. MBF Clearing Corp.*, a district court by consent found that the defendant had placed customer funds that were not properly segregated in an account at an institution.<sup>318</sup>

---

306. CFTC Proposed Rules, Enhancing Protections, *supra* note 61, at 67,869 (citation and footnote omitted).

307. Bunge, *supra* note 302, at C1.

308. Complaint, CFTC v. U.S. Bank, N.A., No. 13-Civ-2041-EJM (N.D. Iowa filed June 5, 2013), 2013 WL 2421015.

309. *Id.* paras. 51–60, at 13–14.

310. *Id.* paras. 70–79, at 16–17.

311. *Id.* para. 51, at 13.

312. *Farr Fin. Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 32,319 (Oct. 9, 2012).

313. *Id.*

314. *Cantor Fitzgerald & Co.*, Comm. Fut. L. Rep. (CCH) ¶ 32,444 (Nov. 21, 2012).

315. *Id.*

316. *Id.*

317. *ABN AMRO Clearing Chi. LLC*, Comm. Fut. L. Rep. (CCH) ¶ 32,651 (June 18, 2013).

318. *CFTC v. MBF Clearing Corp.*, No. 12-cv-1830 (SAS), 2012 WL 6929415 (S.D.N.Y. Nov. 28, 2012).

## V. REGULATORS ACT TO IMPROVE SEGREGATION

Following the Sentinel and other failures, the CFTC and the industry began working on proposals to prevent such events in the future. In December 2011, the CFTC amended Rule 1.25 to remove from the list of permitted investments for customer segregated funds corporate debt obligations not guaranteed by the United States; foreign sovereign debt; and in-house and affiliate transactions.<sup>319</sup> The CFTC also changed its rules to require that FCMs collect margins on a “gross” basis.<sup>320</sup> This means that FCMs cannot merely transmit the “net” amount of customer margins owed to a clearinghouse after offsetting short and long positions of clearing firm customers. That requirement had been considered by the National Futures Association (the NFA) in 1986 after a series of failures at FCMs raised concerns over losses of customer funds.<sup>321</sup> As that study found, however, the Chicago Mercantile Exchange (the CME) and some of the other exchanges had already imposed such a requirement.<sup>322</sup> Presently, the CME is dominating futures trading in the United States.<sup>323</sup>

The CFTC still allows swap customer funds to be commingled, but those funds must now be treated as individual accounts and protected individually “all the way to the clearinghouse.”<sup>324</sup> This is a change from the preexisting regime for customer funds segregated for trading commodity futures. “Under the traditional futures margining model, [derivatives clearing organizations] hold an FCM’s customer funds on a collective basis and are permitted to use the collective margin funds held for the FCM’s customers to satisfy a margin deficiency caused by a single customer.”<sup>325</sup> This change underscored a flaw that has troubled the industry in the past, i.e., the failure of a customer to meet a margin call will result in a loss to other customer funds held collectively in segregation if the FCM does not have the assets to cover the loss.<sup>326</sup>

Another reform the CFTC imposed was heightened risk management and other responsibilities on SROs, including a requirement that they increase their access to FCM segregation records.<sup>327</sup> The National Futures Association (the NFA) had already acted to require that FCMs no longer

---

319. Investment of Customer Funds, *supra* note 59, at 78,778.

320. 17 C.F.R. § 39.13(g)(8)(i)(A) (2013); Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69,334, 69,374 (Oct. 1, 2012) (to be codified at 17 C.F.R. pts. 1, 21, 39, 140).

321. NAT’L FUTURES ASS’N, CUSTOMER ACCOUNT PROTECTION STUDY 70–78 (1986), available at <http://www.pfghost.com/common/docs/NFACustomerProtectionStudy1986.pdf>.

322. *Id.*

323. *Id.*

324. CFTC Proposed Rules, Enhancing Protections, *supra* note 61, at 67,869.

325. *Id.*

326. See, e.g., CFTC v. Volume Investors Corp., No. 85-cv-2213, 1985 WL 1106284 (S.D.N.Y. Mar. 21, 1985); Incomco, Inc., Comm. Fut. L. Rep. (CCH) ¶ 23,071 (May 12, 1986).

327. Core Principles and Other Requirements for Designated Contract Markets, 77 Fed. Reg. 36,612, 36,648 (June 19, 2012) (to be codified at 17 C.F.R. pts. 1, 16, 38).

use the alternative method in computing the Secured Amount under Rule 30.7.<sup>328</sup> Instead, they were required to use the Net Liquidating Equity Method that is required for domestic futures accounts.<sup>329</sup> The CFTC also proposed such a requirement.<sup>330</sup> It would also eliminate the alternative method for computation of the Secured Amount under Rule 30.7.<sup>331</sup>

The NFA now requires FCMs to create a targeted amount of excess funds held by the FCM as a cushion to assure that segregation is not breached by a customer default.<sup>332</sup> This was already a common practice by many FCMs. Restrictions were also placed on withdrawals by the FCM from segregated accounts that are not for the benefit of customers and are in excess of twenty-five percent of the FCM's excess funds held in segregation.<sup>333</sup>

The NFA further required FCMs to provide their Designated Self-Regulatory Organization with view-only access through the Internet to account information for each of the FCM's customer segregated funds and Secured Amount accounts held at a bank or trust company depository.<sup>334</sup> The NFA planned to use such reports to conduct a daily comparison of what the FCM was reporting as being required to be segregated and the amount actually segregated.<sup>335</sup> The NFA and Chicago Mercantile Group, the industry's other principal SRO, were working to develop a computerized system for monitoring segregation compliance.<sup>336</sup>

The CFTC has further proposed revisions to its FCM reporting requirements for net capital and segregation compliance.<sup>337</sup> It also proposed to add to its own rules a requirement like that of the NFA, which mandates that FCMs set a targeted amount of FCM excess funds to serve as a cushion for customer defaults or withdrawals.<sup>338</sup> The CFTC further proposed a requirement that FCMs establish a risk management program to manage its risks and that a risk management unit independent of the business unit be established to monitor the program.<sup>339</sup>

The CFTC proposed other restrictions, including a mandate of "moment-to-moment" segregation, which means that FCMs could not use customer segregated funds in their operations or to cover a margin call of a

---

328. 17 C.F.R. § 30.7.

329. Interpretive Notice 9066, *supra* note 34.

330. CFTC Proposed Rules, Enhancing Protections, *supra* note 61, at 67,896.

331. *Id.*

332. *Id.*

333. CFTC Proposed Rules, Enhancing Protections, *supra* note 61, at 67,896.

334. *Id.* at 67,915.

335. *Id.* at 67,870–71.

336. Tom Steinert-Trhaskeld, *System for Tracking Customer Funds in Development*, SEC. TECH. MONITOR (Nov. 21, 2012), <http://www.securitiestechologymonitor.com/news/system-for-tracking-customer-funds-in-development-31443-1.html>.

337. See CFTC Proposed Rules, Enhancing Protections, *supra* note 61, at 67,899 n.95.

338. *Id.*

339. *Id.* at 67,874.

customer between daily segregation calculations.<sup>340</sup> Rather, the FCM would have to post its own funds to cover margin deficiencies until the customer meets a margin call.<sup>341</sup> The head of the CME, however, has complained that FCMs do not have the appropriate systems to make moment-to-moment calculations.<sup>342</sup> Rather, margin calls are usually issued and collected overnight.<sup>343</sup> Further, most FCMs do not have the capital to cover every momentary deficit in customer accounts, and they do not wish to incur the expense.<sup>344</sup>

The CFTC proposals would prohibit the FCM from withdrawing its excess funds held in segregation until a calculation of its segregation requirement is made.<sup>345</sup> The proposals would also adopt the NFA requirement restricting withdrawals for the FCM's own purposes of more than twenty-five percent of the FCM's excess funds held in segregation.<sup>346</sup> The CFTC proposals would confirm that FCMs were liable for any losses on investments of customer segregated funds that are made under CFTC Rule 1.25.<sup>347</sup>

## VI. INSURANCE AND OTHER PROPOSALS FOR COMMODITY ACCOUNT CUSTODIANS

Segregation requirements under the CEA are critical to customer protection in the commodity futures industry because there is no insurance, such as that available for securities customers under SIPC.<sup>348</sup> There is thus a disparity of treatment between commodity traders and securities customers, who enjoy the protection of the SEC Customer Protection Rule and are also protected by SIPC insurance.<sup>349</sup> There is some history behind that disparity.

---

340. *Id.* at 67,886.

341. *Id.*

342. Matthew Leising, *CME's Duffy Warns Senate That Proposed CFTC Rule to Hurt Brokers*, BLOOMBERG (July 17, 2013, 2:58 PM), <http://www.bloomberg.com/news/2013-07-17/cme-s-duffy-warns-senate-that-proposed-cftc-rule-to-hurt-brokers.html>.

343. *Id.*

344. *Id.*

345. CFTC Proposed Rules, *Enhancing Protections*, *supra* note 61, at 67,887.

346. *Id.* at 67,870.

347. *Id.* at 67,888. The CFTC adopted some of these proposals just before publication of this Article. Among other things, FCMs will be required to maintain residual interest equal to its customers' aggregate under-margined amounts for the prior trade date. This was a shift from the moment-to-moment proposal, but it raises concerns that FCMs would require pre-funding of margin, a requirement that could increase the cost of hedging by farmers and others. This requirement will be phased in over a period of five years. *See Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*, 78 Fed. Reg. 68,501, (Nov. 14, 2013) (to be codified at 17 C.F.R. pts. 1, 3, 22, 30, 140).

348. *See Holmes v. Sec. Investor Prot. Corp.*, 503 U.S. 258, 261–62 & n.2 (1992) (describing SIPC insurance).

349. *Id.* at 261–62; *see also* Customer Protection Rule, 17 C.F.R. § 240.15c3-3 (2013).

Included in the legislation that created the CFTC in 1975 was a provision that required the CFTC to determine whether account insurance was needed for commodity futures customers, such as that provided to securities customers under SIPA.<sup>350</sup> The CFTC conducted a study on this issue and issued a report in 1976, which examined the failures of FCMs between 1938 and 1974.<sup>351</sup> The CFTC report compared losses to customers in government-sponsored insurance programs with loss ratios for commodity futures accounts.<sup>352</sup> The CFTC found that loss ratios in uninsured commodity futures accounts were substantially lower than those in insured accounts.<sup>353</sup> The CFTC also concluded that the loss rate for customers of FCMs was so low that government account insurance would not be cost-effective.<sup>354</sup>

As described above, the Bankruptcy Act was amended in 1978 to provide customers more protection in the event of their FCM's failure.<sup>355</sup> That legislation was followed by the failure of some FCMs, which raised concerns over the efficacy of the CFTC's segregation requirements. Those failures included Incomco, Inc.; Chicago Discount Commodity Brokers Inc.; and Volume Investors, Inc.<sup>356</sup> Those failures again raised concerns as to whether account insurance was needed for commodity futures customers and resulted in a recommendation by the CFTC staff that further study be given to whether account insurance was needed for commodity futures accounts.<sup>357</sup>

In 1985, the CFTC staff found that failures by FCMs had increased since the CFTC's prior report on account insurance.<sup>358</sup> Twenty-four FCMs failed during that period with losses averaging \$2 million annually.<sup>359</sup> Nevertheless, the estimated losses from FCM bankruptcies between 1938 and 1985 amounted to less than \$10 million, and no action was taken by the CFTC to seek additional legislation for account insurance.<sup>360</sup>

---

350. Commodity Futures Trading Commission Act of 1974, Pub L. No. 93-463, § 417, 88 Stat. 1389, 1415 (codified as amended at 7 U.S.C. § 4(a) (2012)).

351. Report to Congress Concerning Commodity Futures Account Insurance, Comm. Fut. L. Rep. (CCH) ¶ 20,235 (Nov. 1, 1976).

352. *Id.*

353. *Id.*

354. *Id.*

355. CFTC Proposed Rules, Bankruptcy Reform Act, *supra* note 43, at 57,535–36.

356. See MARKHAM, COMMODITY FUTURES TRADING, *supra* note 12, at 88 (describing those events).

357. *Id.*

358. *Id.*

359. 23 JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 5.8, at 5-137 (2012).

360. OFFICE OF TECH. ASSESSMENT, U.S. CONG., PUB. NO. OTA CIT-469, ELECTRONIC BULLS AND BEARS: U.S. SECURITIES MARKETS AND INFORMATION TECHNOLOGY 122 n.61 (1990), available at <http://ota.fas.org/reports/9015.pdf>; see also NAT'L FUTURES ASS'N, *supra* note 321, at 16–36 (listing the abovementioned bankruptcies).

The massive failures that occurred in this century again raised concerns over whether account insurance was needed for commodity accounts. The NFA and other industry groups agreed to conduct a study of the costs and benefits of creating an insurance game for commodity futures investors comparable to that available for securities investors.<sup>361</sup>

The call for account insurance must necessarily clash with concerns over the introduction of more moral hazards into the financial system. FDIC and SIPC insurance pose the threat that customers depositing their funds at an insured institution will no longer monitor the finances of the depository in order to protect their assets. There is no need for such vigilance if the customer is insured. Instead, regulators will assume the role of monitor and adopt more costly regulations that the regulator believes will better allow it to monitor the financial condition of insured funds—a process that, as described above, is already underway.<sup>362</sup>

Another cost issue is the funding of the insurance scheme. That can be done by assessments, as is the case for FDIC and SIPC insurance, but someone will have to bear that cost. Undoubtedly, that someone will ultimately be the consumer. There will also be, undoubtedly, calls for greater assessments on larger financial institutions than those for small operations, as has been the case at the FDIC.<sup>363</sup>

Other proposals include the creation of customer guaranty funds. This proposal is an extension of the current guarantee funds that have been created by clearinghouses to provide a backstop in the event a clearing firm fails. These funds are built up over time through transaction fees, and clearinghouses may also have the power to assess non-defaulting clearing firms additional amounts to cover losses. The CME Group had about \$3 billion in its largest guaranty fund and authority to assess an additional \$8.1 billion at year-end 2011.<sup>364</sup> Presumably, a customer guaranty fund would operate in much the same manner but would be in addition to the clearinghouse funds.

What is unanswered is whether the customer guaranty fund would be firm-specific or industry-wide. It would, in any event, probably be financed through transaction fees paid by customers as they trade. Such fees, if paid to a firm-specific customer guaranty fund, would drive high frequency traders, who are now responsible for a majority of futures transactions, to firms that do not charge such fees. That problem could be solved by

---

361. Ben Kesling, *Futures Industry to Study Insurance Fund*, WALL ST. J., (Dec. 7, 2012, 3:36 PM), <http://online.wsj.com/article/SB10001424127887324640104578165570825700746.html>.

362. See MARKHAM, COMMODITY FUTURES TRADING, *supra* note 12, at 89 (stating causes of volume investor default and the need for additional customer and market protection).

363. See 5 MARKHAM, FINANCIAL HISTORY, *supra* note 235, at 662 (describing disproportionate assessment of large banks in order to increase FDIC insurance fund during the Financial Crisis).

364. See CME GRP., CME CLEARING FINANCIAL SAFEGUARDS 19 (2012), available at <http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>.

mandating such fees and placing them in an industry-wide fund, but that would only drive high-frequency traders offshore.

Another proposal would seek to protect customer funds through tri-party custodial accounts. Section 4d of the CEA creates a bilateral custodian arrangement between the FCM and the bank depository.<sup>365</sup> Presumably, a tri-lateral arrangement would require reporting by the bank to the FCM's customers, telling them how much is held in custody for their account at the bank. This would require that the bank be given access to the customer directly, and the bank would have to be told by the FCM what amounts are to be held in custody for each account. In years past, that would have been a costly task, especially for large FCMs, which may carry over 100,000 accounts.<sup>366</sup> Computerization of records now makes such a process more doable.

Still another proposal concerns the creation of central customer fund repositories. This would replicate in some manner the process used by the Depository Trust and Clearing Corporation (DTCC) for maintaining custody of securities beneficially owned by customers of SEC-regulated broker-dealers. That entity was created after the so-called "paperwork crisis" that occurred at the end of the 1960s and was the result of the requirement to exchange a paper security whenever a security was bought and sold.<sup>367</sup> At that time, the brokerage community was not automated and could not keep up with the paper flow.<sup>368</sup>

The DTCC was created to avoid paperwork by allowing "street name" securities, i.e., securities beneficially owned by a customer but held in the name of the customer's broker-dealer, to be maintained in a central depository so that the paperwork involved in issuing a paper certificate could be eliminated.<sup>369</sup> Centralization also provided more security, whereas before the creation of a central depository theft of securities was endemic to the securities industry.<sup>370</sup> Clearing services, i.e., payment and delivery functions, were also centralized through the DTCC.<sup>371</sup>

The futures industry has long used central clearinghouses that clear and carry all customer trades.<sup>372</sup> Those clearinghouses also hold in custody customer margin funds required by the exchanges to secure customer

---

365. See 7 U.S.C. § 6d(b) (2012).

366. See, e.g., *About R.J. O'Brien*, R.J.O'BRIEN, <http://www.rjobrien.com/about/index> (last visited Nov. 17, 2013); *FXCM MENA*, FXCM, <http://www.fxcmmena.com/about-us/fxcm-mena/> (last visited Nov. 17, 2013).

367. See 2 MARKHAM, FINANCIAL HISTORY, *supra* note 72, at 367–68 (describing the creation of the DTCC).

368. See *id.* at 362–64 (describing that crisis).

369. *Id.* at 366–68.

370. See *id.* at 368.

371. See *id.* at 367–68 (describing the creation of the DTCC).

372. See *id.* at 367.

trades.<sup>373</sup> However, the clearinghouse does not hold in custody excess customer margin funds that are not needed at the clearinghouse level to secure trades.<sup>374</sup> Those excess funds are required to be segregated under the CEA and have been the source of the losses from the FCM failures described above.<sup>375</sup>

Current proposals would expand the role of the clearinghouse to include maintaining custody of excess customer funds, as well as those required for exchange margins.<sup>376</sup> This proposal poses a threat to the revenues of FCMs, which are currently allowed to keep the interest earned on permitted investments for customer segregated funds.<sup>377</sup> Removing customer segregated funds and securities from the control of the FCM to the clearinghouses would threaten that revenue stream. To be effective such an arrangement would also require that the clearinghouse act as a tri-party custodian. Centralization of custody arrangements also increases the risk of systemic failure should a clearinghouse fail.<sup>378</sup>

One troubling problem that arose in the Lehman Brothers and MF Global bankruptcies was the disputes between U.S. and English authorities over customer funds held in London.<sup>379</sup> The Bank of England subsequently agreed to defer to the United States and refrain from seizing London assets when a U.S. financial institution fails.<sup>380</sup> The two countries were also working on a plan to develop procedures for liquidating cross-border financial institutions.<sup>381</sup> James Giddens, the MF Global and Lehman Brothers trustee, wrote an op-ed piece in the *Wall Street Journal* advocating that customer funds held outside of the United States be subject to the same requirements as funds held here and that there should be greater coordination among the international regulatory bodies.<sup>382</sup> He also argued

---

373. See Proposal to Adopt Rules 15c3-3 and 15c3-4 Under the Securities Exchange Act, Securities Exchange Act Release No. 9388, 1971 WL 126121 (Nov. 8, 1971) [hereinafter Proposal Release].

374. *Id.*

375. See 2 MARKHAM, FINANCIAL HISTORY, *supra* note 72, at 368.

376. See Proposal Release, *supra* note 373.

377. 17 C.F.R. § 1.29 (2013).

378. Commodity clearinghouses have already been designated by the Financial Stability Oversight Council as being systemically important. See *Financial Briefing Book*, WALL ST. J., Oct. 3, 2012, at C2, available at <http://online.wsj.com/article/SB20000872396390444592404578032782462036170.html>.

379. Brooke Masters et al., *UK Ready to 'Trust' US in Event of Failing Bank*, FIN. TIMES, Dec. 11, 2012, at 13, available at <http://www.ft.com/cms/s/0/f3383e7e-42c3-11e2-a4e4-00144feabdc0.html>.

380. Brooke Masters & Chris Giles, *US and UK Unveil Plan to Deal with Failed Banks: Shareholders Would Have to Take Losses*, FIN. TIMES, Dec. 10, 2012, at 1, available at <http://www.ft.com/intl/cms/s/0/e1f27d04-41fc-11e2-bb3a-00144feabdc0.html>.

381. *Id.*; Masters et al., *supra* note 379 (describing assurances that shareholders and creditors take losses rather than customers or governments).

382. Giddens, *supra* note 251, at A11.

that company officers should face the risk of personal liability in the event that segregation laws are broken.<sup>383</sup>

The Ponzi scheme problem remains, but some efforts are being undertaken to limit their operation. Many Ponzi schemes have been carried out under the guise of hedge fund investments.<sup>384</sup> The SEC had tried to regulate hedge funds by requiring them to register as investment advisors.<sup>385</sup> Numerous hedge funds registered with the SEC under that rule before it was stricken by the District of Columbia Court of Appeals.<sup>386</sup> Many of those hedge funds then deregistered.<sup>387</sup> Ironically, however, Bernie Madoff, who had registered under that rule, did not resign his registration and continued to carry out his Ponzi scheme under SEC and Financial Industry Regulatory Authority (FINRA) oversight until it collapsed during the Financial Crisis.<sup>388</sup> This did not discourage Congress from including a provision in Dodd-Frank that requires large hedge funds to again register with the SEC under the Investment Advisers Act of 1940.<sup>389</sup>

The International Organization of Securities Commissions (IOSCO) issued a report in 2013 that raised concerns with custodial arrangements in which customers knowingly or unknowingly waive a statutory trust fund protection.<sup>390</sup> That was a matter at issue in litigation arising from the Refco failure.<sup>391</sup> IOSCO was also concerned with instances where a broker deposits customer funds in a foreign jurisdiction.<sup>392</sup> IOSCO recommended that custodians be required to obtain explicit written consent for any waiver or modification of a custodial arrangement.<sup>393</sup> It also recommended that brokers take into account and understand the characteristics of foreign custodial arrangements.<sup>394</sup>

## VII. UNIFYING CUSTODY ARRANGEMENTS FOR SECURITIES AND DERIVATIVES

The reforms presently being proposed in the wake of the MF Global, Madoff, and other failures in this century are all piecemeal attempts to patch a system that has outlived its usefulness. The securities, asset

---

383. *Id.*

384. Gabel, *supra* note 266, at 31–32.

385. Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006).

386. *Id.* at 877, 884.

387. Edward Pekarek, Comment, *Pruning the Hedge: Who is a “Client” and Whom Does an Advisor Advise?*, 12 FORDHAM J. CORP. & FIN. L. 913, 960 (2007).

388. 5 MARKHAM, FINANCIAL HISTORY, *supra* note 235, at 613.

389. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (codified as amended at 12 U.S.C. § 5301 (2012)).

390. Richard Hill, *IOSCO Report Proposes Principles to Protect Client Assets*, 45 SEC. REG. & L. REP. (BNA) 247, 247 (2013).

391. Craig v. Refco, Inc., 816 F.2d 347, 348 (7th Cir. 1987).

392. Hill, *supra* note 390, at 247.

393. *Id.*

394. *Id.*

management, derivatives, and banking custody needs are inextricably intertwined with each other and should be regulated uniformly. As it is now, bank deposits of customers and customer securities and funds of broker-dealers are insured but under different regulatory schemes and in different amounts.<sup>395</sup> In contrast, there is no insurance for the assets of futures and other CEA-regulated derivatives customers or for those managed by an investment advisor.<sup>396</sup> Instead, those customers have only the protection of SEC and CFTC segregation requirements.

These differing regulatory schemes for custody of customer assets may also result in competition among customer classes where a dually regulated entity fails, as was the case in the *Sentinel* bankruptcy.<sup>397</sup> A uniform approach to the protection of customer custody requirements is needed. The first step in that process is to correct the flaws in the existing systems. For example, there should be a uniform requirement that customer funds and assets be kept separate from those of the financial services firm. That rule should extend across all asset classes.

The next requirement should be that customer funds be treated individually at all levels, from FCM/broker-dealer/investment advisers to the clearinghouse and bank depository. This would mean that, if one customer failed to meet a margin call, other customer funds could not be used to meet that call even at the clearinghouse level. This would require a tri-party custody arrangement to assure its efficacy. Another needed reform is third-party reporting to customers. This would involve independent reports to customers of the funds or securities held in custody at either a clearinghouse or at a bank or other custodian.

This arrangement will not assure that intra-day blowups will not occur that will cause customer losses. Nevertheless, if such losses are caused by a shortfall in one customer's account, funds of other customers will not be available to meet that shortage. Where there is a general shortfall from fraud or other reasons, a requirement that losses be shared pro rata should be adopted. Such pro rata sharing would also be appropriate where other statutory trusts are affected by a shortfall, as in the *Sentinel* case.<sup>398</sup>

Of course, these and other reforms will not stop future Ponzi schemes, which flourish during boom times and are exposed on economic downturns. There is simply no way to stop these frauds except through customer vigilance when they are solicited by promises of large repeated gains. Bona fide asset managers can make no such claims because they know markets are unpredictable. Even a favorable track record over a period of years does

---

395. See Kesling, *supra* note 361.

396. See Jim Stack, *How Safe Is Your Brokerage Account?*, FORBES, (Aug. 21, 2008, 4:00 PM) [http://www.forbes.com/2008/08/21/bearstearns-lehman-compliance-pf-ii-in\\_js\\_0821soapbox\\_inl.html](http://www.forbes.com/2008/08/21/bearstearns-lehman-compliance-pf-ii-in_js_0821soapbox_inl.html).

397. See *In re Sentinel Mgmt. Grp., Inc.*, 689 F.3d 855, 857 (7th Cir. 2012).

398. See *In re Sentinel Mgmt. Grp., Inc.*, 398 B.R. 281, 292 (Bankr. N.D. Ill. 2008).

not provide assurance that gains will continue. Any asset manager suggesting otherwise should be avoided. A good example of this reality was Bill Miller's stewardship of the Legg Mason Value Fund.<sup>399</sup> He had made returns for that fund that topped the S&P 500 Index's growth for fifteen years in a row.<sup>400</sup> However, that streak ended in 2006, and in 2008 investors lost fifty-eight percent of their investment.<sup>401</sup> The loss in 2008 wiped out all past gains and turned Miller's fund into the worst performing mutual fund over the prior ten years.<sup>402</sup>

Regulated firms that run off-book operations, like Madoff, that are not reported to their regulators can also evade this net by falsifying documents sent to customers and regulators. There is little that can be done here except to use surprise inspections as a possible deterrent and to look for customer complaints that might reveal the off-the-books arrangements.<sup>403</sup>

## CONCLUSION

The debacles in recent years that resulted in the tying up and loss of customer funds evidence a need for reform. In this era of computers, there is no reason why customer funds cannot be tracked on a per-account basis at depositories, as well as at the FCM. This would better assure customer protection.

---

399. 5 MARKHAM, FINANCIAL HISTORY, *supra* note 235, at 501.

400. *Id.*

401. *Id.*

402. *Id.* In 2011, Miller and a co-manager lost more than thirty percent of the investor funds they had under management. Nevertheless, good fortune returned in 2012, with Miller's co-managed fund gaining over forty percent in value. See Suzanne McGee, *Investing in Funds & ETFs: A Quarterly Analysis — Big Names Bounce Back — Miller and Berkowitz Are Tops in Our Performance Survey for 2012*, WALL ST. J., Jan. 7, 2013, at R5, available at <http://online.wsj.com/article/SB10001424127887323277504578191371146256896.html>.

403. See, e.g., *Emst & Emst v. Hochfelder*, 425 U.S. 185, 189 (1976) (describing an off-the-books investment program operated for a period of almost twenty-five years by the head of a registered broker-dealer until he revealed the scheme in a suicide note).