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NORTH CAROLINA LAW REVIEW

Volume 93 | Number 1 Article 8

12-1-2014

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Valerie M. Hughes, *The Two Hundred Million Dollar Question: Were Letters of Credit as Good as Cash in the MF Global Liquidation*, 93 N.C. L. Rev. 276 (2014).
Available at: http://scholarship.law.unc.edu/nclr/vol93/iss1/8

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The Two Hundred Million Dollar Question: Were Letters of Credit as Good as Cash in the MF Global Liquidation?*

INTRODUCTION

On October 31, 2011, MF Global, Inc. ("MF Global") went bankrupt in the eighth-largest bankruptcy in U.S. history.[1] MF Global was a major futures commission merchant ("FCM") that traded commodity futures contracts on behalf of customers in the commodity futures market.[2] During the European debt crisis, MF Global Holding Co., the parent company of MF Global, got into trouble as a result of prior trading in European sovereign debt.[3] MF Global had illegally used customer funds to pay its trading partners to meet overdrafts and collateral calls.[4] After the bankruptcy, $1.6 billion of customer funds were found to be missing.[5] In the MF Global liquidation, it seemed that customers would not be able to recover all of the funds they lost.[6]

In a bankruptcy of a commodity broker, the bankruptcy trustee pools customer property and then distributes it pro rata among

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1. Richard Strasser, *"Come Monday, It'll Be All Right": Buffett, the U.S. Financial Crisis and the Need for a Reliable, Private Liquidity Consortium*, 10 DEPAUL BUS. & COM. L.J. 291, 344 (2012).

2. *See* Anita K. Krug, *Escaping Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039, 2068 (2013).

3. *See id.* at 2072.

4. *See* RENA S. MILLER, CONG. RESEARCH SERV., R42091, THE MF GLOBAL BANKRUPTCY, MISSING CUSTOMER FUNDS, AND PROPOSALS FOR REFORM 1 (2013), *available at* https://www.fas.org/sgp/crs/misc/R42091.pdf. In the collateral call, MF Global's creditors required MF Global to post higher collateral either because of an increased credit risk of the bonds MF Global had bought or because MF Global's credit rating dropped. *See id.* at 2.

5. *See* Krug, *supra* note 2, at 2074.

6. *See* Ben Protess, *MF Global Customers Will Recover All They Lost*, N.Y. TIMES DEALBOOK (Nov. 5, 2013), http://dealbook.nytimes.com/2013/11/05/mf-global-customers-will-recover-all-they-lost/ (quoting Judge Martin Glenn, a bankruptcy judge who handled the case and stated that "[a]t the outset of the case, nobody thought that customers would recover everything they lost"). The bankruptcy trustee has recovered all missing funds, and customers have finally recovered their lost money through the bankruptcy proceeding. *See id.*; Roger Parloff, *How MF Global's "Missing" $1.5 Billion Was Lost—and Found*, FORTUNE (Nov. 15, 2013), http://fortune.com/2013/11/15/how-mf-globals-missing-1-5-billion-was-lost-and-found/.

customers.[7] During the MF Global bankruptcy proceedings, two customers, ConocoPhillips and Koch Supply & Trading ("Koch"), argued that the letters of credit[8] they posted as margin[9] for commodity trades with MF Global should not be considered part of the customer property that the trustee pooled in the bankruptcy.[10] ConocoPhillips had $205 million at stake in letters of credit held by MF Global at the time of the liquidation, and Koch had $20 million.[11] By avoiding characterization of the letters of credit as customer property, ConocoPhillips and Koch could avoid possible liability to MF Global's estate while also receiving a larger share of the customer property. The Commodity Futures Trading Commission ("CFTC") argued in the litigation that one of its regulations meant that the face value of letters of credit constituted customer property in a bankruptcy.[12] ConocoPhillips and Koch raised numerous arguments that the court should ignore the CFTC's interpretation of the regulation, including arguments that the CFTC's opinion was not entitled to deference and that the CFTC's interpretation conflicted with and did not preempt state law.[13]

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7. *See* 11 U.S.C. § 766(h) (2012).

8. A letter of credit is a promise on the part of the issuer (generally a bank) to pay to the beneficiary the amount stated in the letter if the applicant defaults. *See infra* notes 63–65 and accompanying text.

9. For a discussion of margin in futures trades, see *infra* notes 34–66 and accompanying text.

10. *See* ConocoPhillips' Brief in Opposition to the Trustee's Amended Motion to Confirm his Treatment of Letters of Credit Provided by ConocoPhillips at 1, ConocoPhillips Co. v. Giddens (*In re* MF Global Inc.), No. 12 Civ. 6014 (S.D.N.Y. Nov. 23, 2012) [hereinafter ConocoPhillips Brief], *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/conocobriefopposition112812.pdf; Memorandum of Law in Support of Motion of Koch Supply & Trading, LP for Summary Judgment at 1, Koch Supply & Trading, LP v. Giddens (*In re* MF Global Inc.), No. 11-2790 (Bankr. S.D.N.Y. Oct. 26, 2012) [hereinafter Koch Memorandum], *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobalmemoisokstsjmotion1026.pdf.

11. *See* ConocoPhillips Brief, *supra* note 10, at 5–6; Koch Memorandum, *supra* note 10, at 2.

12. *See* Reply Brief of the Commodity Futures Trading Commission in Support of the Trustee's Motion for Summary Judgment at 1, Koch Supply & Trading, LP v. Giddens, No. 12-05596 (Bankr. S.D.N.Y. Jan. 7, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/024cftcreplygiddens010713.pdf; Reply Brief of the Commodity Futures Trading Commission in Support of the Trustee's Motion to Confirm at 1–2, ConocoPhillips Co. v. Giddens, No. 12 Civ. 06014 (S.D.N.Y. Dec. 3, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcreply120312.pdf.

13. *See* ConocoPhillips Brief, *supra* note 10, at 2, 16–18.

The case ultimately settled, leaving unresolved the issue of whether courts will treat letters of credit posted as margin the same as cash margin in bankruptcy proceedings involving FCMs. This issue nevertheless remains important because of the amount of money at stake in such a bankruptcy, the likelihood of another FCM bankruptcy, and the possible impact that a ruling on this issue could have on general letter of credit law.

In terms of the money at stake, FCMs are often huge firms. For example, JP Morgan, Goldman Sachs, Barclays, Citigroup, Deutsche Bank, and Credit Suisse are all FCMs with billions of dollars in adjusted net capital.[14] MF Global also had billions of dollars in assets, and its bankruptcy was the eighth largest in U.S. history.[15] When companies like ConocoPhillips have hundreds of millions of dollars in the form of letters of credit with these firms, the determination of whether these letters of credit are customer property will have significant financial consequences.

In addition, the MF Global liquidation is not the only recent bankruptcy of a large FCM: Peregrine lost $215 million in customer funds less than a year after MF Global filed for bankruptcy.[16] Terrence A. Duffy, the Executive Chairman and President of CME Group, the industry's self-regulating body in charge of regulating MF Global, said Peregrine's fraud, coming on the heels of MF Global's bankruptcy, "has shaken the very core of our industry."[17] As shown by the occurrence of the Peregrine bankruptcy, there is a distinct

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14. *See Selected FCM Financial Data as of May 31, 2014*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/ucm/groups/public/@financialdataforfcms/documents/file/fcmdata0514.pdf (last visited Aug. 3, 2014).

15. *See* Krug, *supra* note 2, at 2074; Strasser, *supra* note 1, at 344.

16. *See* Halah Touryalai, *Peregrine Files for Bankruptcy After $215 Million Goes Missing, Where Were the Regulators?*, FORBES (July 11, 2012), http://www.forbes.com/sites/halahtouryalai/2012/07/11/peregrine-files-for-bankruptcy-after-215m-goes-missing-where-were-the-regulators/.

17. *Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine Financial Group: Hearing Before the S. Comm. on Agric., Nutrition and Forestry*, 112th Cong. 33 (2012) (statement of Terrence A. Duffy, Executive Chairman and President, CME Inc.). Prior to these recent bankruptcies, another large FCM, Refco, filed for bankruptcy in 2005. *See* Jenny Anderson, *Refco Sells Futures Unit and Seeks Bankruptcy*, N.Y. TIMES (Oct. 18, 2005), http://www.nytimes.com/2005/10/18/business/18refco.html. The 1980s also saw some high-profile FCM insolvencies, including Volume Investors Corporation's default in 1985. *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, 852 (1987).

likelihood that future FCM bankruptcies will arise and revive the issue of how to treat letters of credit posted as margin.[18]

A determination on this issue could also have broader implications for letter of credit law because the treatment of letters of credit in bankruptcy could affect their viability as margin deposits in commodity futures trading.[19] Based on bankruptcy and other policy considerations, the CFTC could also prohibit the use of letters of credit as margin for futures and options trades, as the CFTC has already prohibited the use of letters of credit as margin for swaps.[20]

Although the parties raised numerous arguments in the litigation, this Recent Development focuses on the question of administrative deference. If this litigation had gone to trial, the trustee should have prevailed based on the plain meaning of "full proceeds of a letter of credit" in 17 C.F.R. § 190.08(a)(1)(i)(E). However, if the court determined that "proceeds" had no plain meaning, the court would have to consider whether to give deference to the CFTC's interpretation of the regulation. In that case, the court should apply *Auer* deference[21] to the agency's decision and uphold the CFTC's interpretation. Even if a court did not apply *Auer*

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18. However, in the wake of the MF Global and Peregrine bankruptcies, the CFTC has written regulations addressing some of the regulatory loopholes that contributed to those bankruptcies. *See* Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,506, 68,572 (Nov. 14, 2013) (to be codified at 17 C.F.R. pt. 1, 3, 22, 30, 140) (eliminating the "Alternative Method" for calculating the secured amount that an FCM must have in reserves for a transaction on a foreign exchange, reducing the amount of funds an FCM can hold in non-U.S. depositories, and reducing the commingling of customer funds); *see also* Ann Saphir, *U.S. CFTC Looks Set to Keep Margin Rules Despite Industry Outcry*, REUTERS (June 25, 2013), http://www.reuters.com/article/2013/07/25/financial-regulation-cftc-margins-idUSL1N0FV1HD20130725. These regulations address many of the actions that MF Global took in the days preceding its bankruptcy that led to the loss of customer funds, and these regulations may help to reduce the risk of a FCM bankruptcy in the future. *See* Parloff, *supra* note 6 (describing MF Global's use of the Alternative Method to take customer funds to cover its proprietary investment positions and the problems associated with the approximately $725 million in customer funds that were trapped in the U.K. after the bankruptcy).

19. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. § 190(a)(1)(i)(E)).

20. *See* Statement of the Commodity Futures Trading Commission in Response to ConocoPhillips' Motion to Withdraw the Reference at 3, *In re* MF Global Inc. No. 12-06014 (S.D.N.Y. Aug. 23, 2012), *available at* http://www.cftc.gov/vcm/groups/public/@newsroom/documents/file/cftcstatement082312.pdf (stating that the CFTC continues to allow, but does not encourage, the use of letters of credit as margin in futures and options contracts).

21. Auer v. Robbins, 519 U.S. 452 (1997). Under *Auer* deference, a court defers to an agency's interpretation of its own regulation. *See id.* at 461.

deference, the court would probably find that the letters of credit should receive the same treatment as cash margin because of strong policy considerations.

The analysis proceeds in four parts. Part I gives background on commodity futures trading and the CFTC. Part II discusses the litigation and its settlement prior to a determination on the merits as well as the parties' arguments in support of their positions. Part III analyzes the CFTC's interpretation of its own regulation, 17 C.F.R. § 190.08, and argues that this interpretation would most likely have been entitled to *Auer* deference if the case had gone to trial. Part IV discusses the policy implications of this issue and argues that the trustee should have prevailed if the case had gone to trial. This Part also discusses possible negative impact on letter of credit law that could result from treating letters of credit the same as cash in bankruptcy. However, these concerns do not outweigh the equitable and legal arguments in favor of the trustee's position in the MF Global liquidation. A brief conclusion follows.

I. BACKGROUND ON COMMODITY FUTURES TRADING AND THE CFTC

This Part provides background information on commodity futures trading in general. Subpart A describes commodity futures trading. Subpart B discusses the CFTC and its regulation of commodity broker bankruptcies.

A. *Commodity Futures Trading*

FCMs often serve as brokers for trades on the commodity futures market.[22] Generally, a futures contract creates an obligation for the purchaser to buy, at a price agreed upon today, a specified amount of a commodity at a determined point in the future.[23] In a physically-settled futures contract, the seller of the contract is obligated to make delivery at the date specified.[24] More frequently, instead of taking delivery of the commodity, a trader in the commodity futures market offsets a futures contract by later making an equal and opposite

22. *See* Jill Gustafson & Anne E. Melley, *Who Must Register as Merchants, Brokers, Advisors, and Pool Operators*, *in* 7 FEDERAL PROCEDURE, LAWYERS EDITION § 13:2 (2014).

23. *See* Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, 62 (1991).

24. *See id.*

trade.[25] For example, if a trader enters into a contract to buy a certain amount of wheat in October, the trader can speculate by later entering into a contract to sell that amount of wheat in October.[26] If the price of wheat increases in the time between when the trader enters into the first contract and the second contract, then the trader makes a profit.[27] This system of offsetting contracts allows non-end users, such as financial entities, to participate in the market.[28]

Traders in commodity futures include hedgers as well as speculators. Hedgers are generally those who produce or use the goods that are sold on the futures market.[29] Hedgers use futures contracts to insure against loss when there is fluctuation in the price of the commodities they buy or sell.[30] For example, a merchandiser or producer of a commodity may own inventory in a commodity and could hedge against the risk of the price of the commodity going down by entering a futures contract to sell the commodity at a certain price.[31] In addition, if a party must buy a commodity, such as a producer of livestock buying grain, the party can buy futures contracts to hedge, or insure, against an increase in the price of grain that would otherwise threaten business.[32] However, hedgers represent a small proportion of commodity traders, and ninety-five percent of all futures contracts are offset rather than delivered.[33]

Margin is vital to commodity futures trading, though it serves a different function than margin in securities trading. In securities trading, margin represents the minimum amount that a buyer of a

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25. 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION § 1.02[4], at 28 (2004).

26. *Id.*

27. *See id.* § 1.02[4], at 28–29.

28. The debate over whether speculation in the commodity futures market harms the economy by making commodity prices more volatile has continued for decades. *See id.* § 1.03[4], at 127, 129 (discussing the "debate between 'good' investing and 'bad' speculation" and referring to non-hedging traders in commodity markets as "investors" rather than as "speculators"); *Dr. Evil, or Drivel? The Charge-Sheet Against Commodity Speculators Is Flimsy*, ECONOMIST (Nov. 11, 2010), http://www.economist.com/node/17465323.

29. Bd. of Trade v. L.A. Kinsey Co., 130 F. 507, 508–09 (7th Cir. 1904).

30. *Id.* ("The object of such hedging is to insure against loss by fluctuation in the market in the commodity which the principal is carrying, or which he has sold in advance of purchase and manufacture upon a time contract.").

31. *See* 1 JOHNSON & HAZEN, *supra* note 25, § 1.03[2], at 120.

32. *See* Annotation, *Nature and Validity of "Hedging" Transactions on the Commodity Market*, 20 A.L.R. ANN. 1422, 1423 (1922).

33. 1 JOHNSON & HAZEN, *supra* note 25, § 1.02[4], at 28. A common hedging alternative for producers and end users of commodities is a "forward contract," in which a sale occurs immediately but delivery is delayed. *See id.* § 1.02[3], at 23–24.

security must give to a broker in order for the buyer to take title to the securities.[34] The broker lends the buyer the remaining amount needed to buy the security.[35] In commodity futures trading, margin secures the obligations of buyers and sellers.[36] Margin serves as a deposit that customers on both sides of the trade (both buyers and sellers) make toward the total price of the futures contract.[37] In contrast to securities trading, title to a commodity does not transfer until the customer provides the full contract price for the trade, and a commodity broker does not lend money to the customer.[38] Commodity exchanges determine the amount of margin that must be posted for each trade that occurs on the exchange.[39] The amount of margin an exchange requires varies "depending on the stage of the transaction, the nature of the trading involved, and the volatility of market prices."[40] "Initial margin" represents the deposit that a buyer or seller in a futures trade must make in order to enter into a futures contract.[41]

While the exchange sets the level of margin required for each trade, other entities are also involved in determining how much margin a customer must post in order to complete a trade. One such entity is a clearinghouse, which conducts trades on an exchange and serves the important function of making futures contracts fungible.[42] A clearinghouse makes contracts fungible by matching identical, offsetting futures contracts and then "substitut[ing] itself for the direct parties, eliminating any need for a prospective offsetter to search out his original counterpart."[43] If a party to a futures contract defaults, the clearinghouse may be obligated to pay losses to the other party (buyer or seller).[44] Commodity traders must trade through FCMs, and FCMs conduct trades with clearinghouses.[45]

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34. *Id.* § 1.02[13], at 110.

35. *Id.*

36. *See* Markham, *supra* note 23, at 63 ("By imposing margin requirements, the clearinghouse seeks to assure that the contracting parties will meet their obligations, so that it will never be required to fulfill its guaranty.").

37. 1 JOHNSON & HAZEN, *supra* note 25, § 1.02[13], at 111.

38. *Id.*

39. *Id.* § 1.02[13], at 112.

40. *Id.*

41. *Id.* § 1.02[13], at 111.

42. *See id.* § 1.02[5], at 29.

43. *Id.*

44. *See id.* § 1.02[13], at 113.

45. *See* Markham, *supra* note 23, at 63.

To reduce the risk that either party to a trade will default, clearinghouses require FCMs to post margin above the initial margin required by the exchange.[46] This type of margin is a "variation" or "maintenance" margin and depends on market movement.[47] As the price of the underlying commodity changes on a day-to-day basis, each trader's position will show a loss or a profit.[48] Based on this fluctuation, each trader's position is "marked-to-market" every day to determine what the trader's gain or loss is for that day.[49] If the trader has a loss, then the FCM must post additional margin commensurate with the loss sustained, and if the trader has a profit, the FCM may make withdrawals on behalf of the trader from the initial margin posted.[50]

FCMs have the initial "responsibility for any trading losses sustained and not honored by its customers," and the clearinghouse only becomes liable for the trade if the FCM "is unable to satisfy those obligations."[51] Margin often must be posted quickly, as clearinghouses can make margin calls overnight or more than once a day.[52] FCMs, therefore, may have to post billions of dollars in margin overnight in the case of a market crash, as occurred in 1987.[53] Because the FCM is liable to the clearinghouse even if a customer defaults, FCMs require their customers to post margin with them.[54] This margin secures the margin that the FCM has posted with the clearinghouse on the customer's behalf.[55] To better protect itself, the FCM can require higher margin rates from customers than the clearinghouse requires from the FCM.[56] In addition, a commodity broker can sue a customer for any amount owed in an unmet margin call, as the factual background of *Commodity Futures Trading Commission v. Schor*[57] illustrated.[58] FCMs can also use the customer

46. *See* 1 JOHNSON & HAZEN, *supra* note 25, § 1.02[13], at 113.
47. *See* Markham, *supra* note 23, at 64.
48. *See* 1 JOHNSON & HAZEN, *supra* note 25, § 1.02[13], at 114.
49. *See id.*
50. *See id.* § 1.02[13], at 112, 114.
51. *Id.* § 1.02[13], at 112.
52. *See* Markham, *supra* note 23, at 65.
53. *See id.*
54. *See id.*
55. *See id.*
56. *See id.* at 65–66.
57. 478 U.S. 833 (1986).
58. *See id.* at 837–41.

margin that they hold to earn interest for themselves through other investments.[59]

Generally, FCMs require small customers to post cash as margin.[60] In contrast, FCMs allow larger customers to instead post standby letters of credit as margin,[61] as ConocoPhillips and Koch both did with MF Global.[62] An obligor in virtually any type of transaction can use a standby letter of credit to back up a payment obligation.[63] Traditionally, a standby letter of credit provides a "cash-like assurance of payment in the event of nonperformance."[64] The party making the undertaking to perform, the applicant, obtains the letter of credit from a bank, the issuer, in favor of the party to whom performance is owed, the beneficiary.[65] In the case of commodity futures trading, the customer is the applicant, the issuer is the applicant's bank, and the commodity broker is the beneficiary of the standby letter of credit. The beneficiary can draw on the letter of credit in the case of nonperformance.[66] In the context of commodity trading, nonperformance is a customer's default, which is the customer's inability to meet the FCM's margin call.

The Uniform Commercial Code ("UCC") governs letters of credit under state law in states that have adopted it.[67] Under the UCC, a beneficiary of a letter of credit, such as a commodity futures broker, could only recover from an issuer the value of a letter of credit that "appears on its face strictly to comply with the terms and conditions of the letter of credit."[68] In the context of commodity trading, the terms and conditions of the letter would most likely specify that the value of the letter is due to the commodity broker in the event of a customer default, as the ConocoPhillips and Koch

59. 17 C.F.R. § 1.29 (2014) ("The investment of customer funds in [qualified investments] shall not prevent the futures commission merchant or derivatives clearing organization so investing such funds from receiving and retaining as its own any incremental income or interest income resulting therefrom.").

60. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. § 190.08(a)(1)(i)(E)).

61. *See id.*

62. *See* ConocoPhillips Brief, *supra* note 10, at 4; Koch Memorandum, *supra* note 10, at 2.

63. Roslyn K. Meyers, *Introduction* to 5A WEST'S MCKINNEY'S FORMS UNIFORM COMMERCIAL CODE (2014).

64. *See Uses of Letters of Credit (Nonsales Transactions)*, *in* INTERNATIONAL LETTER OF CREDIT LAW AND PRACTICE § 1:23 (2014).

65. *See id.*

66. *See id.*

67. *See* Meyers, *supra* note 63.

68. U.C.C. § 5-108(a) (2013).

letters specified.[69] Letters of credit under the UCC expire, and the UCC specifies when a letter of credit expires if the letter does not specify an expiration date.[70] The ConocoPhillips and Koch letters of credit specified expiration dates that passed before the bankruptcy proceedings, allowing ConocoPhillips and Koch to argue that the bankruptcy trustee could not have drawn on the letters of credit because they were expired.[71]

B. *The CFTC and Its Regulation of Commodity Broker Bankruptcy*

Under Chapter 7 of the Bankruptcy Code, in a liquidation of a commodity broker, "customer property" is pooled and distributed pro rata to customers before other creditors are paid out from the estate.[72] The Bankruptcy Code states that "the trustee shall distribute customer property ratably to customers on the basis and to the extent of such customers' allowed net equity claims, and in priority to all other claims."[73] The Bankruptcy Code defines "customer property" as "cash, a security, or other property, or proceeds of such . . . property" that is held by the debtor for the customer "including . . . property received, acquired, or held to margin, guarantee, secure, purchase, or sell a commodity contract."[74]

The Commodity Exchange Act gives the CFTC the power to promulgate regulations concerning the bankruptcy of commodity brokers.[75] In particular, the CFTC has the power, "[n]otwithstanding Title 11 [of the Bankruptcy Code]," to determine "that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property."[76] Pursuant to this authority, the CFTC has promulgated Rule 190.08, dealing with allocation of

69. *See* ConocoPhillips Brief, *supra* note 10, at 4 ("The customer agreement . . . require[d] an event of default on the part of ConocoPhillips before MF Global [could] present any of these letters of credit or otherwise dispose of collateral."); Koch Memorandum, *supra* note 10, at 2 (stating that payment under the letter of credit was conditioned on MF Global providing the issuing bank with a "written statement that [Koch] was in default under [the] agreement with [MF Global]").

70. U.C.C. § 5-106(c) (2013) ("If there is no stated expiration date or other provision that determines its duration, a letter of credit expires one year after its stated date of issuance or, if none is stated, after the date on which it is issued.").

71. *See* ConocoPhillips Brief, *supra* note 10, at 4–5; Koch Memorandum, *supra* note 10, at 2.

72. 11 U.S.C. § 766(h) (2012).

73. *Id.*

74. *Id.* § 761(10).

75. 7 U.S.C. § 24 (2012).

76. *Id.* § 24(a).

customer property.[77] This rule states that customer property includes "[t]he full proceeds of a letter of credit if such letter of credit was received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract."[78]

Before this regulation was approved, the CFTC clarified what it meant by the "full proceeds" of a letter of credit.[79] The CFTC stated that, under the proposed regulation, "the trustee would be required to draw the full value of a letter of credit posted as margin and treat the funds received as customer property, irrespective of the margin obligation secured thereby."[80] The CFTC drafted this regulation through a standard notice and comment process,[81] and it mentioned that "[s]everal of the commentators requested that the Commission amend its proposal to provide that letters of credit be drawn upon only in accordance with their terms and only to the extent of the margin owing by the depositor."[82] The commentators also argued "that the proposed rule would require a trustee to draw the full proceeds of letters of credit irrespective of their terms even though they generally condition payment on delivery of a certification that additional funds are required to margin or to cover a default with respect to a contract."[83] The CFTC rejected this argument because it wanted letters of credit to be treated the same in bankruptcy as other forms of non-cash margin.[84] By allowing the trustee to draw the face value of the letter of credit, the CFTC would not incentivize the use of letters of credit as a means to avoid pro rata distribution of margin funds in bankruptcy.[85]

With this background on commodity futures trading and the CFTC's regulation of letters of credit in FCM bankruptcies in mind, the specifics of the MF Global bankruptcy litigation become clearer.

II. THE PARTIES' POSITIONS IN THE LITIGATION

In the MF Global bankruptcy litigation, ConocoPhillips and Koch made a variety of arguments to support their questionable

77. *See* 17 C.F.R. § 190.08 (2013).

78. *Id.* § 190.08(a)(1)(i)(E).

79. Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

80. *Id.*

81. *See* 5 U.S.C. § 553(b) (2012).

82. Supplementary Information, 48 Fed. Reg. at 8718.

83. *Id.*

84. *Id.*

85. *Id.*

position that letters of credit should not constitute a part of customer property. This Part discusses the parties to this litigation and the arguments each party made before the settlement. Subpart A describes the factual background of the litigation including the circumstances surrounding MF Global's bankruptcy. Subpart B discusses each party's main arguments in the litigation.

A. ConocoPhillips, Koch Supply & Trading, and MF Global's Liquidation

ConocoPhillips and Koch Supply & Trading were two large customers of MF Global at the time it filed for bankruptcy.[86] MF Global allowed only nine of its tens of thousands of customers to post letters of credit as margin, and ConocoPhillips and Koch were two of those nine customers.[87] ConocoPhillips had a total of $205 million in standby letters of credit with MF Global that the bankruptcy trustee claimed were customer property.[88] These letters of credit constituted $135 million in letters of credit for domestic commodity trading, $60 million in letters of credit for foreign trading, and a $10 million letter of credit posted by ConocoPhillips Canada.[89] The foreign letters of credit expired by their terms on November 23, 2011, after MF Global filed for bankruptcy on October 31, 2011.[90] Koch had one letter of credit with MF Global at the time of the bankruptcy, and that letter of credit had a face value of $20 million.[91] That letter expired on December 31, 2011,[92] just two months after MF Global filed for bankruptcy.[93]

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86. *See supra* text accompanying notes 8–11; *infra* text accompanying notes 87–101.

87. *See* Koch Supply & Trading, LP v. Giddens (*In re* MF Global Inc.), 484 B.R. 18, 20 (S.D.N.Y. 2012); Memorandum of Law in Support of Trustee's Amended Motion for an Order Confirming the Trustee's Determination of ConocoPhillips' Claims to Customer Accounts Margined with Letters of Credit at 2, ConocoPhillips Co. v. Giddens (*In re* MF Global Inc.), No. 12 Civ. 6014, (S.D.N.Y. Dec. 3, 2012) [hereinafter Trustee Memorandum], *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/trusteereply120312.pdf; Koch Memorandum, *supra* note 10, at 4 n.6 ("As of the Filing Date, the Debtor was a beneficiary under a total of nine letters of credit."). ConocoPhillips is a large oil producer, and Koch is an oil trader. *See Trading*, KOCH SUPPLY & TRADING, http://www.ksandt.com/default3.asp?Section=Services&location3=here (last visited Nov. 21, 2014); *Who We Are*, CONOCOPHILLIPS, http://www.conocophillips.com/who-we-are/Pages/default.aspx (last visited Nov. 21, 2014).

88. *See* ConocoPhillips Brief, *supra* note 10, at 5–6.

89. *See id.*

90. *See id.* at 5.

91. *See* Koch Memorandum, *supra* note 10, at 2.

92. *Id.*

93. *See id.* at 1.

The trustee for the MF Global bankruptcy, James W. Giddens, returned the letters of credit to ConocoPhillips while letting Koch's letter expire, but the trustee considered their return and expiration a payment of customer property from the estate equal to the face value of the letters of credit.[94] This treatment meant that any amount that MF Global's estate owed either ConocoPhillips or Koch as customer property was reduced by the face value of the letters of credit.[95] Thus, ConocoPhillips' and Koch's recoveries would be reduced, and ConocoPhillips could have even owed money to the estate if there had been a shortfall and not enough customer property had been recovered to cover all customer claims.[96] Facing this reduction in its bankruptcy recovery, ConocoPhillips moved to have the question of the treatment of the letters of credit removed from the bankruptcy court through "withdrawal of the reference."[97] ConocoPhillips argued that a district court should consider the issue separately as "other law," independent of the bankruptcy litigation.[98] The district court granted ConocoPhillips' motion, and this litigation began.[99] Koch filed a similar motion, and the district court also granted that motion.[100] Since the cases dealt with the interpretation of a CFTC regulation on which the CFTC had already published its interpretation, the CFTC intervened in both the ConocoPhillips and Koch cases.[101]

94. *See* ConocoPhillips Brief, *supra* note 10, at 6–7; Koch Memorandum, *supra* note 10, at 5.

95. *See* ConocoPhillips Brief, *supra* note 10, at 6–7; Koch Memorandum, *supra* note 10, at 5.

96. *See* ConocoPhillips Brief, *supra* note 10, at 7 ("[T]he Trustee's [calculations], if accepted, could result in an affirmative claim against ConocoPhillips for alleged excess recoveries.").

97. *See* Memorandum of Law in Support of ConocoPhillips' Motion to Withdraw the Reference with Respect to the Trustee's Motion to Confirm His Treatment of Letters of Credit Provided by ConocoPhillips at 9, *In re* MF Global Inc., No. 11-2790 (S.D.N.Y. Aug. 6, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/conocomemo080612.pdf.

98. *See id.* at 11 ("Here, there can be no question that the CFTC Part 190 Rules, on which the Trustee has predicated his motion, are non-title 11 'laws of the United States regulating organizations or activities affecting interstate commerce.' ").

99. *See* ConocoPhillips Co. v. Giddens (*In re* MF Global Inc.), No. 12 Civ. 6014, 2012 WL 4757866, at *1 (S.D.N.Y. Oct. 4, 2012).

100. *See* Koch Supply & Trading, LP v. Giddens (*In re* MF Global Inc.), 484 B.R. 18, 25 (S.D.N.Y. 2012).

101. *See* Notice of Consent Motion to Intervene, Koch Supply & Trading, LP v. Giddens, No. 12-05596 (S.D.N.Y. Dec. 27, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/019grantingmoting122712.pdf; Memorandum of the Commodity Futures Trading Commission in Support of Its Consent Motion to Intervene, Koch Supply & Trading, LP v. Giddens, No. 12-05596 (S.D.N.Y. Dec. 21, 2012),

B. The Parties' Arguments

Both ConocoPhillips and Koch argued that the trustee should not have included the face value of the letters of credit as customer property so that ConocoPhillips and Koch would receive an amount of customer property that would not be reduced by the value of the letters of credit.[102] ConocoPhillips argued that, since it had not defaulted on its letters of credit, the trustee could not have drawn on the letters of credit.[103] Because the trustee could not have drawn on the letters of credit from a bank, ConocoPhillips argued, the trustee should not have included the letters of credit in the customer property.[104] Koch made a similar argument.[105] As the basis for this argument, ConocoPhillips and Koch contended that the meaning of "full proceeds" in the CFTC's regulation at 17 C.F.R. § 190.08(a) did not mean the face value of the letter of credit.[106] ConocoPhillips and Koch both argued that, instead, the plain meaning of "full proceeds" in 17 C.F.R. § 190.08 was the money that the issuing bank would pay upon a beneficiary's draw of a letter of credit.[107] Thus, the trustee must have drawn on the letters of credit before their expiration dates by presenting them to their issuers in order to consider them part of the customer property.[108] However, the trustee could not have done so legally by the terms of the letters of credit because neither ConocoPhillips nor Koch had defaulted on any margin calls.[109]

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available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcmemsuppmot122112.pdf; Notice of Unopposed Motion to Intervene, ConocoPhillips Co. v. Giddens, No. 12-6014 (S.D.N.Y. Oct. 19, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/noticemotionintervene101912.pdf.

102. *See* ConocoPhillips Brief, *supra* note 10, at 7–8; Koch Memorandum, *supra* note 10, at 1.

103. *See* ConocoPhillips Brief, *supra* note 10, at 7–8.

104. *See id.* at 7.

105. *See* Koch Memorandum, *supra* note 10, at 9.

106. *See* ConocoPhillips Brief, *supra* note 10, at 8; Koch Memorandum, *supra* note 10, at 7.

107. *See* ConocoPhillips Brief, *supra* note 10, at 9; Koch Memorandum, *supra* note 10, at 8 (citing U.C.C. § 5-114(a)) ("Of course, 'proceeds' of a letter of credit are the funds that the beneficiary receives from the issuing bank when it draws on the letter of credit.").

108. *See* ConocoPhillips Brief, *supra* note 10, at 8; Koch Memorandum, *supra* note 10, at 8–9.

109. *See* ConocoPhillips Brief, *supra* note 10, at 4; Koch Memorandum, *supra* note 10, at 2–4. ConocoPhillips made numerous other arguments: (1) that state law defines property, and that the CFTC incorrectly defined letters of credit as customer property; (2) that even if 17 C.F.R. § 190.08 did mean that the face value of the letters of credit were customer property, the CFTC lacked the legal authority under the Legal Certainty for Bank Products Act to promulgate it; and (3) that the CFTC regulation did not preempt state law on letters of credit, particularly the UCC. *See* ConocoPhillips Brief, *supra* note

In contrast, the trustee argued that the face value of the letters of credit was customer property.[110] The likely purpose of this argument was to make the estate as large as possible for customer property to be distributed pro rata. The trustee needed to make the estate as large as possible because, at the time of this litigation, $1.6 billion in customer funds were missing, creating a serious shortfall in customer property.[111] The trustee argued that the plain meaning of 17 C.F.R. § 190.08 was that the face value of the letters of credit constituted customer property.[112] The trustee also argued that the CFTC's interpretation of the regulation, clarified both in its Supplementary Information at the time of the regulation's promulgation and for its brief in this litigation, was entitled to judicial deference.[113] The CFTC similarly argued that its interpretation of its own regulation was consistent with the regulation's plain meaning and that the CFTC's interpretation of its regulation was entitled to judicial deference under *Auer v. Robbins*.[114]

Although the case settled, ConocoPhillips' and Koch's arguments could have been made by any customer that posted letters of credit as margin. In another FCM bankruptcy, it seems likely that parties would make similar arguments. Therefore, the issue of how 17 C.F.R. § 190.08 should be interpreted remains relevant. The level of deference afforded to the CFTC's interpretation of this regulation could determine the outcome of future litigation in this area.

III. THE APPLICABLE LEVEL OF JUDICIAL DEFERENCE FOR THE CFTC'S INTERPRETATION OF ITS REGULATION

The CFTC and the trustee both argued that the CFTC's interpretation of 17 C.F.R. § 190.08 in its Supplementary Information and in its briefs in the ConocoPhillips and Koch litigation was entitled to strong judicial deference under *Auer v. Robbins*. ConocoPhillips, in contrast, argued that neither the CFTC's brief nor its Supplementary Information on the regulation was entitled to deference.

10, at 12, 18–19, 25–26. Koch argued that various provisions of the Bankruptcy Code prevented the trustee from treating its letter of credit as customer property. *See* Koch Memorandum, *supra* note 10, at 12–19.

110. *See* Trustee Memorandum, *supra* note 87, at 9.

111. *See supra* text accompanying notes 5–6.

112. *See* Trustee Memorandum, *supra* note 87, at 9–10.

113. *See id.* at 12–13 ("As a federal agency interpreting its own regulations, the CFTC is entitled to substantial deference.").

114. 519 U.S. 452 (1997); *see* Reply Brief of the Commodity Futures Trading Commission in Support of the Trustee's Motion to Confirm, *supra* note 12, at 8–10.

ConocoPhillips' argument that the CFTC interpretation should not receive much, if any, judicial deference has some support from cases such as *Christensen v. Harris County*.[115] Koch, oddly, argued that the Supplementary Information was entitled to *Auer* deference but that it supported Koch's interpretation of the regulation.[116] This interpretation of the Supplementary Information is hard to square with the statement in the Supplementary Information that the CFTC rejected commentators' suggestions that "the Commission amend its proposal to provide that letters of credit be drawn upon only in accordance with their terms and only to the extent of the margin owing by the depositor."[117]

Because ConocoPhillips' arguments on this issue are better supported, this Part will consider only ConocoPhillips' arguments against deference and the trustee's and the CFTC's arguments in favor of deference to the agency's interpretation of its regulation. This Part will not address Koch's argument. Subpart A will outline the standard of review created by *Auer* and *Christensen*. Subpart B will discuss the parties' arguments about the plain meaning of the regulation to determine whether a plain meaning controls and precludes judicial deference. Subpart C will argue that, if the regulation is ambiguous, *Auer* deference should apply.

A. *Judicial Deference to Agency Interpretations Under* Auer *and* Christensen

Auer v. Robbins involved an agency's interpretation of its own regulation and afforded the agency what some have deemed "super-deference."[118] In *Auer*, employees of the St. Louis Police Department argued that they were entitled to overtime pay under the Fair Labor Standards Act.[119] The Secretary of Labor had promulgated regulations stating that an employee must meet a certain salary basis in order to qualify as exempt from overtime pay.[120]

In deciding whether the police officers were exempt, the Court looked to the Secretary of Labor's interpretation of the Department

115. 529 U.S. 576 (2000).

116. *See* Koch Memorandum, *supra* note 10, at 8.

117. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

118. *See* J. Lyn Entrikin Goering, *Tailoring Deference to Variety with a Wink and a Nod to* Chevron*: The Roberts Court and the Amorphous Doctrine of Judicial Review of Agency Interpretations of Law*, 36 J. LEGIS. 18, 47 (2010).

119. Auer v. Robbins, 519 U.S. 452, 454–55 (1997).

120. *See id.*

of Labor's regulation.[121] The Court reasoned that "[b]ecause the salary-basis test is a creature of the Secretary's own regulations, his interpretation of it is, under our jurisprudence, controlling unless 'plainly erroneous or inconsistent with the regulation.' "[122] The Secretary provided his opinion in an amicus brief that the Court had requested in the course of the litigation.[123] Notably, the fact that the interpretation was given pursuant to litigation, rather than through formal notice and comment procedures, did not bother the Court.[124] The Court stated that the source of this opinion as an amicus brief did not "make it unworthy of deference" because it was not a " '*post hoc* rationalizatio[n]' advanced by an agency seeking to defend past agency action against attack."[125] As long as the agency does not engage in a post hoc rationalization of a prior action, *Auer* creates a high level of deference for an agency's interpretation of its own regulation, regardless of what form that interpretation takes.

Christensen v. Harris County involved a very similar fact pattern to *Auer*, but the Court in *Christensen* took a step away from *Auer*'s broad deference.[126] *Christensen* limits deference in cases where a regulation has an unambiguous meaning that contrasts with the agency's interpretation.[127] In *Christensen*, employees of a sheriff's department argued that Harris County's policy requiring employees to schedule time off in order to reduce accrued compensatory time violated the Fair Labor Standards Act.[128] In response to the litigation, the Department of Labor issued an opinion letter stating that, under its interpretation of its regulations, this policy violated the regulations.[129]

Despite the factual similarity of this case to *Auer*, the Court distinguished *Auer*, stating that "*Auer* deference is warranted only when the language of the regulation is ambiguous. The regulation in this case, however, is not ambiguous."[130] The Court stated that the agency in this case was merely "[s]eeking to overcome the

121. *See id.* at 461.
122. *Id.*
123. *See id.*
124. *See* Goering, *supra* note 118, at 49 ("What set *Auer* apart was that it granted super-deference to an informal agency interpretation expressed in an amicus brief that the Court had specifically requested.").
125. *Auer*, 519 U.S. at 462.
126. *See* Goering, *supra* note 118, at 52.
127. *See id.*
128. *See* Christensen v. Harris County, 529 U.S. 576, 578 (2000).
129. *See id.* at 586.
130. *Id.* at 588.

regulation's obvious meaning" by asserting that *Auer* deference applied.[131] In determining that the regulation was unambiguous, the Court conducted its own interpretation of the regulation and the statute it implemented.[132] If the regulation is unambiguous, then an agency's informal interpretation of it is entitled to less deference, and courts should consider the agency's interpretation only to the extent that it has the "power to persuade."[133] Although the formality of the agency interpretation was not at issue in *Auer*, lower courts have interpreted *Christensen* to mean that strong deference to agency interpretations should not apply to an agency's informal interpretations.[134] After *Christensen*, the formality of an agency interpretation may affect the level of deference it will receive. However, in the wake of both *Christensen* and *Auer*, the main question to answer in deciding which level of deference to apply to an informal agency interpretation is whether the regulation contains an unambiguous plain meaning.

B. The Plain Meaning of "Proceeds" in 17 C.F.R. § 190.08

To determine whether the CFTC's interpretation is entitled to strong deference under *Auer* or much weaker deference under *Christensen*, the regulation must be defined as either ambiguous or unambiguous. ConocoPhillips and Koch argued that 17 C.F.R. § 190.08 had a plain meaning that was the opposite of the trustee's contended plain meaning.[135]

Both ConocoPhillips and Koch invoked the definition of "proceeds" in U.C.C. § 5-114(a), which defines the proceeds of a letter of credit as "the cash, check, accepted draft, or other item of value paid or delivered upon honor or giving of value by the issuer."[136] This definition could support their position because it refers to the issuer's action of honoring the letter in defining "proceeds" of a

131. *See id.*

132. *See id.*; Goering, *supra* note 118, at 52.

133. *See Christensen*, 529 U.S. at 587.

134. *See* Naaman Asir Fiola, Note, Christensen v. Harris County: *Pumping* Chevron *for All It's Worth—Defining the Limits of* Chevron *Deference*, 21 J. NAT'L ASS'N ADMIN. L. JUDGES 151, 168–69 (2001) (stating that courts interpreting *Christensen* have held that informal agency interpretations were not entitled to *Chevron* deference); *see also* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–44 (1984) (establishing deference for agency decisions where Congress has not "directly spoken to the precise question at issue" and the agency's interpretation of the statute is reasonable).

135. *See supra* text accompanying notes 102–12.

136. U.C.C. § 5-114(a) (2013); *see* ConocoPhillips Brief, *supra* note 10, at 8–9; Koch Memorandum, *supra* note 10, at 8.

letter of credit. ConocoPhillips further argued that the term "proceeds" was not defined by the Bankruptcy Code and that, since Congress has left the determination of property rights to states, state law under the UCC should govern its meaning.[137]

However, ConocoPhillips' argument has weaknesses. The state-law definition under the UCC does not necessarily apply to a bankruptcy issue regulated by the CFTC, especially when the CFTC's own interpretation differs from the UCC definition.[138] ConocoPhillips' argument also uses the UCC state law definition of letter of credit proceeds to argue that the UCC and state law should govern.[139] The UCC does not extend its own jurisdiction that far,[140] so ConocoPhillips' argument as to the plain meaning of "full proceeds" in 17 C.F.R. § 190.08 receives little support from the UCC.

ConocoPhillips also argued that the letters of credit it posted expired by the time the bankruptcy trustee could have drawn on them, so they were not part of customer property in the bankruptcy.[141] If this argument prevailed, then the pace and timing of bankruptcy litigation could mean that any customer's letter of credit could expire by its terms before a bankruptcy trustee would have the chance to draw on it. This argument contradicts policy consideration of fairness because it would mean that any letter of credit a customer posted could be exempted from constituting customer property in bankruptcy.

The trustee's argument that the plain meaning of "full proceeds" is the face value of the letter of credit is more convincing and logical. The trustee argued that ConocoPhillips' definition would mean that it would be ultimately impossible for a letter of credit to be customer property.[142] If a letter of credit in bankruptcy can only be drawn on according to its terms, then the only event that would allow the trustee to draw on the letter of credit would be a default triggered by ConocoPhillips' failure to meet a margin call.[143] MF Global, through the trustee, would then have to declare a default, liquidate

137. *See* ConocoPhillips Brief, *supra* note 10, at 9.

138. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

139. *See* ConocoPhillips Brief, *supra* note 10, at 9.

140. *See* U.C.C. § 5-102 (2002) cmt. (stating that the purpose of this provision of the UCC is to "indicate that the rules stated are not intended to be exhaustive of the law applicable to letters of credit").

141. *See* ConocoPhillips Brief, *supra* note 10, at 9.

142. *See* Trustee Memorandum, *supra* note 87, at 9–10.

143. *See id.* at 9.

ConocoPhillips' commodity futures positions, and only then access ConocoPhillips' margin if it suffered a loss in the liquidation.[144] The trustee would then go to the issuer of the letters of credit and draw on them, but the trustee would be drawing on them only to make MF Global whole.[145] The "proceeds" in that case would not be customer property at all since the funds would no longer rightfully belong to any customer.[146] Logically, the CFTC would not give the term "proceeds" a meaning that would preclude a letter of credit from ever constituting customer property in a bankruptcy. The argument that "proceeds" means the face value of a letter of credit is stronger than than ConocoPhillips' or Koch's arguments in favor of their interpretation of the plain meaning. Thus, if the regulation does have a plain meaning, the trustee's meaning seems the more likely and reasonable interpretation.

C. *The CFTC's Interpretation of Its Regulation Should Receive* Auer *Deference*

As demonstrated above, if the regulation has a plain meaning, the trustee has the more convincing argument for the plain meaning of "proceeds" as "face value" of a letter of credit. ConocoPhillips' and Koch's arguments seem at least credible, though, if weaker, so a court may find that the regulation was ambiguous. The district court, in granting Koch's motion to withdraw the reference from the bankruptcy court, stated that, "[r]egardless of CFTC intent, the regulation speaks only in terms of 'full proceeds,' and not 'face value.' "[147] Thus, "more than a simple and straightforward application of the language of Regulation 190.08(a)(i)(1)(E) would be required for the Trustee to prevail."[148] Although the court rejected the trustee's argument as to the plain meaning of "full proceeds," the court's statement indicated that a court would have to do more than simply apply the plain meaning of that term in order to rule in the case. Based on this district court's opinion, it seems likely that a court would find the plain meaning of "full proceeds" ambiguous. If a court found the regulation ambiguous, the court should grant the CFTC

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144. *See id.*
145. *See id.* at 9–10.
146. *See id.* at 10.
147. Koch Supply & Trading, LP v. Giddens (*In re* MF Global Inc.), 484 B.R. 18, 24 (S.D.N.Y. 2012).
148. *Id.*

Auer deference and defer to the agency's interpretation of its own regulation.

There were two informal agency interpretations involved in this case. First, there was the 1983 Supplementary Information that the CFTC published prior to promulgating this regulation.[149] In the Supplementary Information, the CFTC described the meaning of "full proceeds" in a manner consistent with the trustee's interpretation here.[150] Second, there were the CFTC's briefs as an intervener in both the ConocoPhillips and Koch litigations.[151] In its briefs, the CFTC clarified that its interpretation of the regulation was consistent with the trustee's position and with the 1983 Supplementary Information.[152] The Supplementary Information is arguably somewhat formal because it addressed comments that the CFTC received in the notice and comment process for promulgating 17 C.F.R. § 190.08.[153] Although formality may be required for deference under *Christensen*, it is not required for *Auer* deference, and even a brief prepared for some particular litigation can meet the requirements of *Auer*.[154]

ConocoPhillips argued that, because the regulation is unambiguous, the Supplementary Information is an attempt by the CFTC to rewrite the regulation it adopted.[155] However, the timing of the writing *prior to* the promulgation of the regulation belies this argument. If the CFTC had wanted a different meaning for the regulation, it could have written one at that time. As the trustee argued, the CFTC "gave extensive time for public comment, considered from public commentators the exact position that ConocoPhillips puts forth today, sought advice from multiple sources on the best path forward, and then rejected the ConocoPhillips position with sound policy considerations."[156] The consistency between the CFTC's current interpretation of the regulation and its interpretation in its Supplementary Information also supports the

149. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

150. *See id.*

151. *See* Reply Brief of the Commodity Futures Trading Commission in Support of the Trustee's Motion for Summary Judgment, *supra* note 12, at 4–5; Reply Brief of the Commodity Futures Trading Commission in Support of the Trustee's Motion to Confirm, *supra* note 12, at 9.

152. *See id.*

153. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

154. *See supra* text accompanying notes 123–25.

155. *See* ConocoPhillips Brief, *supra* note 10, at 15–17.

156. Trustee Memorandum, *supra* note 87, at 13.

argument that the interpretation is not a post hoc rationalization for past agency action.[157] Rather, from the time of the regulation's promulgation to thirty years later, the CFTC's interpretation of its regulation has remained the same.

One potential issue that might have prevented a court from applying *Auer* deference is that *Auer* deference has lost favor in the wake of *Christensen* and subsequent decisions that have limited *Auer*'s application.[158] However, "the Court continues to apply *Auer* deference when an agency interprets its own regulations."[159] Thus, at least at the time of this litigation, courts would have been likely to apply *Auer* deference to these facts and defer to the CFTC's interpretation of 17 C.F.R. § 190.08.

A court interpreting 17 C.F.R. § 190.08 should hold that the regulation either has the plain meaning that the CFTC and the trustee advocated, or it should find that the CFTC's interpretation of the regulation is entitled to *Auer* deference. The CFTC's interpretation is not a post hoc rationalization, so *Auer* deference should apply if the regulation is ambiguous.

IV. IMPLICATIONS OF THE MF GLOBAL LITIGATION AND THE ISSUE OF LETTERS OF CREDIT AS CUSTOMER PROPERTY

Although this case settled before a court could rule on the many issues at stake in the litigation, the issue of whether letters of credit posted as margin constitute customer property in bankruptcy continues to be relevant. Even if *Auer* deference had not applied, a court should have found for the trustee based on persuasive policy arguments. Subpart A discusses the policy arguments in favor of deeming the face value of a letter of credit to be customer property. Subpart B discusses the possible implications this treatment of letters of credit could have on letter of credit law generally.

A. *Policy Arguments in Favor of the Face Value of a Letter of Credit Constituting Customer Property*

Several policy arguments favor treating the face value of a letter of credit as customer property. One reason that bankruptcy trustees should be able to draw letters of credit at face value is that letters of

157. *See supra* text accompanying note 125.
158. *See* Fiola, *supra* note 134, at 168–69 (discussing the impact of *Christensen* on lower courts and arguing that *Christensen* has had the effect of limiting deference to agency opinions).
159. *See* Goering, *supra* note 118, at 50.

credit function like cash when they are posted as margin. Both the CFTC and the trustee in this litigation recognized that letters of credit function in the exact same way as cash for margin purposes.[160] Unlike other forms of non-cash margin, letters of credit allow a trader to borrow dollar-for-dollar with any amount that the face value of the letter of credit states.[161] Thus, in fairness, a letter of credit that is worth its face value as margin should also be worth its face value as customer property in bankruptcy. Giving letters of credit an advantage over other types of non-cash margin, which are included in customer property, also seems unfair, as the CFTC recognized in drafting its regulation.[162]

Based on the use of letters of credit as margin, the CFTC determined that making letters of credit constitute customer property at their face value would have benefits for clearinghouses as well, even if such a rule discouraged the use of letters of credit.[163] The CFTC even asked some clearinghouses whether they would prefer to have letters of credit constitute customer property at their face value or have letters of credit drawn only according to their terms.[164] Those clearinghouses responded that they would prefer to be able to draw letters of credit at face value, regardless of their terms and regardless of whether traders had used the letters as original margin or as variation margin.[165] Clearinghouses worried that if they had to consult the terms of a letter of credit to draw on it in the case of the bankruptcy of an FCM, then they might not be able to obtain payment of any amounts they were ultimately owed.[166] This possibility could "hamper[] the viability of [letters of credit] as margin deposits."[167]

The clearinghouses' concern also relates to a fundamental principle of letter of credit law. A letter of credit is a documentary payment mechanism, meaning that the obligation of the issuer to pay is "triggered by the presentation of [the letter], not the happening of

160. *See* Trustee Memorandum, *supra* note 87, at 14.

161. *See id.* at 4.

162. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718–19 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

163. *See id.* at 8718.

164. *See id.*

165. *See id.*

166. *See id.*

167. *Id.*

an event."[168] Thus, the presentation of the letter of credit to the issuing bank would trigger the obligation to pay for the issuer of a commodity trader's letter of credit.[169] The FCM presenting the letter of credit would not have to prove the actual default of the customer.[170] The fact that letters of credit create a documentary obligation makes them "swift and certain payment mechanisms" because the presenter does not have to prove any underlying facts to the issuer to receive payment.[171] Making a letter of credit payable in the bankruptcy of an FCM even beyond the letter's terms supports the use of letters of credit as certain payment mechanisms that deserve to be considered as good as cash. In light of the advantages of letters of credit generally, it seems logical that clearinghouses would support the CFTC's rule ensuring the swift and certain function of letters of credit as payment mechanisms.

Lastly, excluding letters of credit from customer property in bankruptcy would give preference to large FCM customers over small customers. Out of MF Global's thousands of customers, ConocoPhillips and Koch were two of only nine large customers that MF Global allowed to post letters of credit as margin.[172] Thus, only the largest commodity traders can post letters of credit as margin.[173] The CFTC recognized when it promulgated 17 C.F.R. § 190.08 that, if the face value of letters of credit was not included in customer property, large traders would have an unfair advantage over smaller traders in recovering their property following the bankruptcy of a commodity broker.[174] The CFTC also cited statutory authority supporting its position that the law should not give large customers advantages over smaller customers in bankruptcy.[175]

When so many policy arguments stack up in favor of treating letters of credit as customer property at face value, the fact that this

168. Gerald T. McLaughlin, *Remembering the Bay of Pigs: Using Letters of Credit to Facilitate the Resolution of International Disputes*, 32 GA. J. INT'L & COMP. L. 743, 752 (2004).

169. *See id.*

170. *See id.*

171. *See id.*

172. *See supra* note 87 and accompanying text.

173. *See* Supplementary Information, 48 Fed. Reg. 8716, 8719 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

174. *See id.*

175. *See id.* (stating that giving an advantage to large customers "would contravene the spirit and intent of the [Bankruptcy] Code's limitations on the return of specifically identifiable property which were intended to assure parity between customers with margining power and those without it").

case settled becomes troubling. The settlement of this case shows that a large commodity trader, like ConocoPhillips, can potentially avoid having the full face value of its letters of credit included in customer property by bringing suit. The outcome of this case thus could encourage other large traders to fight to escape this liability in the future.

B. The Effect on Letter of Credit Law of Treating the Full Face Value of a Letter of Credit as Customer Property

Letters of credit are commonly used in financial transactions, so the treatment of letters of credit in an FCM bankruptcy could have an impact on letter of credit law generally. "There are as many uses of standby [letters of credit] as there are commercial transactions requiring third-party assurance of payment."[176] Financial standby letters of credit, such as those at issue in the MF Global liquidation, account for more than eighty-five percent of outstanding standbys.[177] With the prevalence of standby letters of credit, the CFTC's interpretation of its regulation that the full face value of a letter of credit constitutes customer property could have a broader impact on letter of credit law.

ConocoPhillips made a final argument that even if the CFTC's interpretation of 17 C.F.R. § 190.08 were enforceable, some of their letters of credit still should not constitute customer property in the MF Global litigation because the letters had expired.[178] ConocoPhillips argued that the CFTC's position in the litigation would mean that "letters of credit *never expire*."[179] Ignoring the terms of letters of credit, including their expiration dates, could certainly make letters of credit less appealing to use as margin in commodity deals. In 1983, the CFTC recognized this potential but showed little concern over discouraging the use of letters of credit as margin and even stated that this discouragement could be positive.[180] Letters of credit were "not subject to banking reserve requirements and [could] be uncollateralized," and the CFTC expressed concern that banks could too freely issue letters of credit, implying that the unrestricted issuance of standby letters of credit could destabilize banks.[181]

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176. *Uses of Letters of Credit (Nonsales Transactions)*, *supra* note 64, § 1:23.

177. *See id.*

178. *See* ConocoPhillips Brief, *supra* note 10, at 31.

179. *Id.* at 33.

180. *See* Supplementary Information, 48 Fed. Reg. 8716, 8718–19 (Mar. 1, 1983) (to be codified at 17 C.F.R. pt. 190).

181. *See id.*

In recent years, though, the use of "structured" or "syndicated" letters of credit has arisen in commodity futures trading.[182] A syndicated letter of credit involves multiple issuers.[183] Generally one bank serves as the lead bank or agent, and each issuer is liable only for its pro rata share of the face amount of the credit.[184] With structured letters of credit, commodity brokers use their leverage to provide financing to banks.[185] In the MF Global litigation, the CFTC argued consistently with its 1983 opinion that the face value of all the letters of credit should constitute customer property, regardless of their terms.[186] The CFTC has generally remained opposed to the use of letters of credit as margin and has prohibited their use as margin for swaps.[187] However, the CFTC's traditional position of discouraging the use of letters of credit may require further justification now that commodity brokers are using letters of credit in new and complex contexts. Discouraging the use of letters of credit in commodity transactions by increasing bankruptcy liability could reduce investment, creating a larger negative economic impact.

On the other hand, discouraging the use of letters of credit as margin might not have a major negative economic impact on any of the entities engaged in futures trading. Clearinghouses might not object to decreased use of letters of credit as margin as long as the number of trades that occur on exchanges does not significantly decline as a result. Since only the largest customers can use letters of credit as margin, the number of trades affected may not be great in proportion to the total number of trades. FCMs could have more reason to object to the CFTC's position because their biggest customers could take trades off of regulated exchanges and into over-the-counter derivatives or other types of investments if letters of credit became less appealing as a form of margin. However, FCMs might still retain these customers' business by serving as brokers to these unregulated transactions. Thus, a reduction in the use of letters of credit as margin could have a relatively small effect on investment in relation to its policy benefits.

Despite the possible negative impact on investment, the CFTC's position overall still seems preferable in light of the strong policy

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182. *See Uses of Letters of Credit (Nonsales Transactions)*, *supra* note 64.

183. *See* McLaughlin, *supra* note 168, at 755.

184. *See id.*

185. *See Uses of Letters of Credit (Nonsales Transactions)*, *supra* note 64.

186. *See* Reply Brief of the Commodity Futures Trading Commission in Support of the Trustee's Motion for Summary Judgment, *supra* note 12, at 1.

187. *See supra* note 20 and accompanying text.

considerations in its favor. When standby letters of credit are "as good as cash,"[188] it makes sense to treat them the same as cash in the bankruptcy of an FCM. Allowing letters of credit to be honored past their expiration date in a bankruptcy could have a chilling effect on the use of letters of credit in commodity transactions. However, this negative effect may be outweighed by the benefit of ensuring that letters of credit remain reliable payment instruments in commodity transactions. ConocoPhillips' and Koch's arguments seem weak in the context of the use of letters of credit overall in commodity transactions.

CONCLUSION

The MF Global liquidation was one of the largest bankruptcies in U.S. history. Though another FCM collapse on this scale may not happen in the near future, commodity brokers do face bankruptcy with some regularity. The chance that an FCM will go bankrupt while in possession of customers' letters of credit thus seems fairly high. When this issue arises again, the CFTC's interpretation of its regulation should prevail in any litigation. The position the trustee took in the MF Global liquidation—that the face value of letters of credit constitutes customer property—is legally correct and is supported by strong policy arguments. Letters of credit are as good as cash when used as margin, and they should be as good as cash in bankruptcy. A contrary rule would give an unfair advantage to large traders over small traders. ConocoPhillips and Koch raised creative but unpersuasive arguments in their attempts to avoid having millions of dollars in letters of credit included in customer property during MF Global's liquidation. The settlement of this litigation leaves the CFTC's regulation on letters of credit open to similar future attack.

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188. *See* Paul R. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 720 (1973) ("[I]t is the 'hallmark' of the letter of credit that at a certain point it becomes as good as cash.").

** The author would like to thank Professor Thomas Lee Hazen for his guidance through multiple stages of the writing process. The guidance of Isabelle Corbett and Stephen M. Humenik particularly on the CFTC issues was also very helpful and greatly appreciated. Lastly, the author would like to thank Kelsey Hendrickson for her careful and insightful editing.

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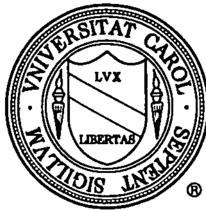
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