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RESPONSIBILITY FOR CUSTOMER LOSSES DUE TO FAILURE OF CORRESPONDENT BROKERS AND OTHER DEPOSITORY INSTITUTIONS

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INTRODUCTION

The default of Barings plc in February 1995¹ focused world attention on the dangers to futures exchanges² and brokerage firms posed by nonmarket, or systemic, risk. In particular, the Barings crisis underscored the difficulty in confining such risk to a single exchange, especially in an environment characterized by growing interrelationships between and among futures exchanges worldwide. Nevertheless, the Barings crisis revealed a strong willingness on the part of both regulatory and self-regulatory authorities to work together to coordinate the liquidation and transfer of positions and margin collateral from Barings to other brokers with minimal market disruption.³ Dire predictions of a chain reaction of defaults spreading to other markets and triggering a global financial meltdown did not materialize.⁴ Instead, confidence in futures exchanges substantially remained intact and market activity continued without significant interruption.⁵

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1. Following the Barings default, both the Bank of England and the Singapore Ministry of Finance commissioned investigations into the causes of the default. The final reports prepared by the investigators contain a detailed analysis of the events leading up to the collapse. See BANK OF ENGLAND, REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS (1995); MICHAEL LIM CHOO SAN & NICKY TAN NG KUANG, BARINGS FUTURES (SINGAPORE) PTE LTD: THE REPORT OF THE INSPECTORS APPOINTED BY THE MINISTER FOR FINANCE (1995).

2. Unless otherwise noted, use herein of the term "futures exchanges" refers to exchanges on which both futures and options on futures contracts are traded. In addition, unless otherwise noted, any reference to "futures" or "options" is intended to refer to futures and options on futures contracts traded on exchange markets, as opposed to similar instruments traded on over-the-counter markets.

3. See Philip Coggan, *Barings Crisis Tests Market*, FIN. TIMES, Feb. 8, 1996, at 5.

4. See *id.*

5. During 1995, exchange volume on the Singapore International Monetary Exchange Ltd. ("SIMEX") actually increased by 0.8 percent, less than previous years' growth rates, but still ahead of other world futures exchanges, some of which recorded double-digit declines. See *id.*

The success of futures exchanges and their regulators in managing systemic risk, and in averting lasting adverse consequences following the Barings default must, however, be qualified by the key role played by Internationale Nederlanden Groep N.V. ("ING"). Immediately following the collapse, a United Kingdom bankruptcy court ordered a freeze on Barings' assets worldwide, including those used to collateralize positions on futures exchanges, thereby depriving the exchanges of a major source of liquidity provided by an important market participant. ING's agreement to purchase major portions of Barings' assets and liabilities enabled the United Kingdom bankruptcy court to rescind its order, thus forestalling more serious consequences.⁶ The intervention of ING, however, effectively precluded the resolution of an important issue raised by the crisis: the question of a broker's responsibility to its customers for the loss of customer funds following the default of another ("correspondent") broker, an exchange clearing organization, or a bank (hereinafter referred to collectively as "depository institutions"). No clear consensus with respect to the resolution of this issue exists and, absent such consensus, there remains a level of uncertainty in a future default situation.

Existing regulatory systems rely on depository institutions to hold funds and other property used to collateralize positions. The potential delay in transferring positions and property used to margin such positions following the failure of depository institutions may impair the short-term liquidity of both brokers and exchanges. To restore liquidity, positions must be remargined; however, issues regarding the source of the additional funds necessary to remargin such positions are complex and subject to distinctly divergent interpretations.⁷

* * * * *

This Article will examine the alternative legal theories and arguments likely to be advanced in any dispute involving issues of a broker's responsibility for customer margin property following the default of a depository institution holding such property. To fully appreciate the context of this debate, Part I will summarize the chain of

6. See, e.g., Joseph B. Dial, *Status Report on Regulatory and Self-Regulatory Responses to the Barings Bankruptcy*, 18TH ANN. COMMODITIES L. INST. AND 4TH ANN. FIN. SERVICES L. INST. (1995) ("[A] little luck - in the form of the Dutch firm, ING, . . . [was] successful in confining the disaster to Barings and avoiding any wider, systemic consequences."); Eric Bettelheim, *Betrayal of Trust*, MANAGED DERIVATIVES, Sept. 1995, at 18 ("[B]ut for . . . ING Bank . . . there would have been a failure of other financial institutions which dealt with Barings and a landslide of litigation that would have made the tin crisis and Hammersmith and Fulham look like small beer.").

7. See, e.g., David Nusbaum, *When Banks Go Bust*, FUTURES, July 1995, at 62.

transactions created in the course of effecting futures and options transactions on both domestic and foreign exchanges. Part I also will summarize the regulations imposed by United States and United Kingdom regulatory authorities applicable at each link in the chain. Despite extensive regulation, customer property is not immune from invasion and Part II will examine these dangers and discuss regulatory efforts aimed at mitigating them.

Included among the threats to customer property described in Part II is the potential default of the customer's broker. The rules applicable in the United States to commodity broker defaults provide that customer property includes the assets of the broker to the extent that the amount of funds segregated on customers' behalf is insufficient to meet all customer losses. At least one factual circumstance may arise, however, that complicates the application of the default rules. To limit the scope of their duties, implied or otherwise, many brokers have inserted clauses into their customer agreements exculpating the broker from liability for losses caused by events beyond the broker's control, such as the default of a depository institution. The general enforceability of such clauses in a default context has never been tested.

Additionally, where a broker possesses sufficient capital reserves to meet its minimum financial requirements and remains in operation following the default of a depository institution, the default rules do not apply and the solvent broker may be able to argue that it bears no liability to its customers to make up any shortfall in such customers' segregated accounts, particularly if it has a valid exculpatory clause in its customer agreement. Customers arguing in favor of imposing liability on the broker may rely on several sources, including the common law treatment of the relationship between brokers and their customers, the legislative history of the segregation provisions of the Commodity Exchange Act (the "Act")⁸ and subsequent judicial and administrative pronouncements. Part III will examine each of these sources as well as evaluate the general enforceability of exculpatory clauses and the effect an enforceable exculpatory clause may have on a broker's obligations to its customers.

8. 7 U.S.C. §§ 1-26 (1994).

I. CUSTOMER MARGIN AND SEGREGATION: THE "CHAIN" OF TRANSACTIONS IN THE UNITED STATES AND THE UNITED KINGDOM

Before analyzing the arguments surrounding a broker's liability for a customer's margin property following the default of a depository institution, it is necessary first to have an understanding of the complex chain of relationships created in effecting futures transactions both on domestic and foreign futures exchanges. Prior to the Barings collapse, many brokerage firms and banks engaging in the brokerage business marketed their ability to provide "seamless access" to the world's futures exchanges. A single phone call to a domestic account executive was all that was necessary to trade on any foreign or domestic futures exchange, with the attendant margin transaction handled domestically in the home currency and confirmed on the customer's combined statement. While emphasizing the relationship between the customer and the initiating broker with its worldwide reach, the concept of seamless access blurred the existence of an underlying chain of relationships among correspondent brokers, clearing organizations and bank depositories. The Barings collapse focused attention on this network of relationships and compelled a new appreciation of the presence of systemic risk at each link in the chain. In addition, the collapse highlighted major differences among exchanges in the manner of calculating margin, in segregation requirements, and in the level of regulatory oversight,⁹ while underscoring the potential problems created by conflicting bankruptcy regimes in different jurisdictions.¹⁰ This Section will describe the movement of customer funds from the customer through various depository institutions to margin futures transactions on both domestic and nondomestic exchanges. The applicable regulations at each stage also will be summarized to provide an understanding of the safeguards imposed by the regulatory system in both the United States and the United Kingdom.

A. *The United States Regulatory Environment*

1. Futures and Options Transactions by United States Persons on Domestic Exchanges

United States customers placing orders on domestic contract markets must first have deposited sufficient funds, securities or other

9. See Nicholas Denton, *Barings Sparks Tougher Line in Singapore*, FIN. TIMES, Nov. 6, 1995, at 24.

10. See Bettelheim, *supra* note 6, at 18.

property¹¹ to meet the initial margin requirements for the particular contract traded. The exchange clearing organization¹² establishes different minimum initial margin amounts for different contracts based on several factors, including historical price volatilities, current and anticipated market conditions, and other relevant information. The initial margin amount established by a futures commission merchant ("FCM")¹³ may be greater than the minimum levels established by the exchange. In establishing the initial margin amount for its customers, an FCM normally considers several factors, including, for example, the amount of margin the FCM itself will have to place with the clearing organization or a correspondent FCM, the customer's purpose in engaging in the trade (i.e., whether for speculative or for hedging purposes), the customer's creditworthiness, and the credit risk assumed by the FCM resulting from the volatility inherent in the contract and/or trading strategy selected by the customer. Subsequent adverse movements in daily settlement prices will result in customers being required to post additional collateral, known as variation margin. Favorable price movements, on the other hand, result in credits to the customer's account, which amount may be withdrawn thereafter. After the customer closes the position, the FCM will return the initial margin amount, along with any additional margin amounts, to the customer.

If the customer's FCM is a clearing member¹⁴ of the exchange on which the customer's order is executed, the FCM will post margin di-

11. The regulations prohibit the use of certain property as segregated funds, including:

a) Money invested in obligations or stocks of any clearing organization or in memberships in or obligations of any contract market; or (b) money held by any clearing organization which it may use for any purpose other than to purchase, margin, guarantee, secure, transfer, adjust, or settle the contracts, trades, or commodity options of the commodity or option customers of such futures commission merchant.

17 C.F.R. § 1.24 (1996).

12. "Clearing organization" is defined as "the person or organization which acts as a medium for clearing transactions in commodities for future delivery or commodity option transactions, or for effecting settlements of contracts for future delivery or commodity option transactions, for and between members of any contract market." *Id.* § 1.3(d).

13. The Commodity Futures Trading Commission ("CFTC") defines a "futures commission merchant" as:

Individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee or secure any trades or contracts that result or may result therefrom

Id. § 1.3(p).

14. A "clearing member" is defined as "any person who is a member of, or enjoys the privilege of clearing trades in his own name through, the clearing organization of a contract market." *Id.* § 1.3(c).

rectly with the clearing organization. If the customer's FCM is not a clearing member, then the FCM will effect the trade through another FCM that is such a member. The clearing member FCM will collect margin from the nonclearing member and post the requisite margin amount with the clearing organization.

The rules of each exchange govern the amount of margin required to be deposited by the clearing member with the clearing organization in connection with each contract traded on such exchange, and the manner in which margin is calculated and collected. The manner in which margin is calculated and collected is important in determining the sources and the amount of liquidity available to the system upon the default of a broker. For example, clearing members of the Chicago Mercantile Exchange ("CME") collect margin from correspondent brokers and customers and deposit such margin with the CME Clearing House on a "gross" basis, that is, without regard to whether the positions from various sources for which margin is collected offset one another.¹⁵ Other exchanges, like the Chicago Board of Trade ("CBOT"), also require that member firms collect margin from customers on a gross basis.¹⁶

However, in calculating the amount of margin to be deposited by clearing members with the clearing organization, these exchanges permit clearing members to net the margin requirements of offsetting trades. For example, a clearing member required to deposit margin with the clearing organization on a net basis and which carried positions that were long 99 contracts and short 100 of the same contracts would only need to deposit with the clearing organization the margin obligation associated with 1 contract. In contrast, under a gross margin system, the clearing member would have to deposit the margin required by 199 contracts. Exchange rules that calculate the required margin deposit based on a clearing member's gross positions will, all else being equal, result in a greater amount of margin to be deposited with the clearing organization and will "provide[] greater immediate assurance that market participants have the financial ability to support their market activity."¹⁷ Where clearing members are allowed to net their positions before calculating their margin obligation, the clearing organization will hold correspondingly less margin. Consequently, in the event of a broker default, the clearing organization may find it

15. See Chicago Mercantile Exchange, *The Financial Safeguard Systems of the Chicago Mercantile Exchange*, at 3 (1995).

16. See Board of Trade Clearing Corp. Bylaws 504, 508 (Mar. 11, 1996).

17. Chicago Mercantile Exchange, *supra* note 15, at 3.

more difficult to transfer positions without requiring the posting of additional margin. In addition, some exchange rules permit clearing members to net their customers' positions against their own proprietary or "house" positions. This may result in an even smaller margin amount deposited with the clearing organization.¹⁸

The Act and the regulations promulgated thereunder¹⁹ establish neither the amount of margin that must be collected from customers by FCMs or from clearing members by clearing organizations, nor whether clearing organizations may collect margin from clearing members on a gross or net basis. Rather, § 4d(2) of the Act²⁰ and the associated regulations require FCMs to account separately for and segregate customer positions and property from those belonging to the FCM. These so-called "segregation rules" prohibit FCMs from using customer property to margin the trades of other customers or of the FCM itself.²¹ For trades on domestic markets, each FCM and clearing organization in the chain of transactions outlined above must adhere to the segregation rules.²² In addition to requiring the segregation of customer funds, the regulations further limit the scope of permissible uses for such funds. Each FCM may deposit customer property with another (or "correspondent") FCM, with the clearing organization, or with a bank or trust company.²³ The deposit must be

18. This issue became significant in the Barings collapse as Barings Securities (Japan) Limited, a clearing member of both the Osaka Securities Exchange and the Tokyo Stock Exchange, was required under exchange rules to collect client margin on a gross basis, but could net the margin required by offsetting proprietary positions before depositing margin with the clearing organization. See *BANK OF ENGLAND*, *supra* note 1 at 202. Other exchanges do not permit customer and house positions to be netted against one another. See, e.g., Board of Trade Clearing Corp. Bylaw, *supra* note 16, at 511 ("[T]rades designated by the member as for his customer shall not be offset under Bylaw 504 against trades designated by the member as for his own account.").

19. 17 C.F.R. §§ 1.1-190.10.

20. 7 U.S.C. § 4d(2) (1994).

21. See *id.*; 17 C.F.R. §§ 1.20(a), 1.22.

22. Each [FCM] shall treat and deal with the customer funds of a commodity customer . . . as belonging to such commodity or option customer. All customer funds shall be separately accounted for, and shall not be commingled with the money, securities or property of a[n FCM] or of any other person, or be used to secure or guarantee the trades, contracts or commodity options, or to secure or extend the credit, of any person other than the one for whom the same are held.

17 C.F.R. § 1.20(c).

23. Neither the Act nor the regulations define the terms "bank" or "trust company." In contrast, the Securities Exchange Act defines a "bank" as:

(A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency pursuant to section 92a of title 12, and which is supervised and examined by State or Federal authority having supervision over banks, and which

in an account name that clearly identifies the property as belonging to the customer and indicates that the funds are segregated as required by the Act and regulations.²⁴ In addition, FCMs depositing customer funds must receive from the depository an acknowledgment that the depository was informed that the deposits belong to customers of the FCM and are being held in accordance with the provisions of the Act and regulations.²⁵

Instead of depositing customer funds with a bank, the regulations also allow FCMs to invest such funds in certain "permitted investments," including obligations of the United States, general obligations of any state or any political subdivision thereof, or obligations fully guaranteed as to principal and interest by the United States.²⁶ Moreover, FCMs may use customer segregated funds to purchase certain permitted investments from a bank or other qualifying entity (the "repo counterparty") pursuant to a repurchase agreement wherein the repo counterparty agrees to buy back the securities at a fixed time and price in the future or a reverse repurchase agreement wherein the repo counterparty agrees to sell back the securities at a fixed time and price in the future. FCMs may enter into such agreements only if certain conditions prescribed by the CFTC's Division of Trading and Markets have been met.²⁷

Similar to the regulations applicable to bank deposits, FCMs that invest customer funds in permitted investments must separately account for and segregate such investments from the FCM's own property.²⁸ In addition, the depository (whether a bank, trust company, correspondent FCM, or clearing organization) must permit represent-

is not operated for the purpose of evading the provisions of this chapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

15 U.S.C. § 78(c)(6) (1994).

24. See 17 C.F.R. § 1.20(a).

25. The regulations also prohibit any person, including any clearing organization or any depository, that has received customer property for deposit in a segregated account from holding, disposing of, or using any such property as belonging to any person other than the customers of the FCM that made the deposit. See *id.*

26. See 17 C.F.R. § 1.25.

27. The specific conditions are detailed in Division of Trading and Markets, Financial and Segregation Interpretation No. 2-1, [1992-1994 Transfer Binder] 1 Comm. Fut. L. Rep. (CCH) ¶ 7112A (Dec. 15, 1993).

28. See 17 C.F.R. § 1.26(a). If the FCM subsequently deposits such permitted investments with a bank, trust company, clearing organization or other FCM, it must do so under an account name that clearly identifies the obligations as belonging to customers and the deposits must be segregated as required by the Act and the regulations. See *id.* Upon opening such an account, the FCM must obtain and retain in its files, in accordance with 17 C.F.R. § 1.31, an acknowledgment from the depository that the depository was informed that the obligations belong to the FCM's customers and are being held in accordance with the Act and regulations. See *id.*

atives of the CFTC to inspect the FCM's investment of customer funds at any reasonable time.²⁹

2. Futures and Options Transactions by United States Persons on Foreign Exchanges

The CFTC's regulations with respect to trading on foreign futures exchanges embody a concept that is similar, but not identical to, segregation.³⁰ Under the CFTC's regulations, an FCM must separately segregate sufficient customer funds to meet the obligations of United States domiciled customers trading on foreign markets (the "Secured Amount"). The Secured Amount, in general, is equal to the lesser of: (a) the net liquidating equity; or (b) the sum of margin required, plus or minus open trade equity and options premiums in respect of positions held for all such customers.³¹ Secured Amount funds may not be commingled with customer funds required to be segregated under

29. *See id.*

30. In general, the Act imposes no restrictions on foreign futures products which may be offered or sold to United States customers. Certain special procedures, however, are required for the offer or sale to United States customers of foreign stock index futures and options contracts based on foreign government debt obligations. For foreign stock index futures and options, the CFTC's Office of General Counsel issues no-action letters to allow the offer and sale of each such contract to a United States person. *See, e.g.,* Tokyo Stock Exch. Futures Contract Based on the Tokyo Stock Price Index, CFTC-OGC Interpretative Letter No. 92-2, [1990-1992 Transfer Binder] 2 Comm. Fut. L. Rep. (CCH) ¶ 25,210 (Jan. 16, 1992); Osaka Securities Exch. Nikkei Stock Average Futures Contract, CFTC-OGC Interpretative Letter No. 92-1, [1990-1992 Transfer Binder] 2 Comm. Fut. L. Rep. (CCH) ¶ 25,209 (Jan. 16, 1992). Debt obligations of a foreign country must be designated as an exempted security by the United States Securities and Exchange Commission ("SEC") under SEC Rule 3a12-8 before a futures contract, or option contract based thereon, can be offered or sold to a United States person. *See generally,* William J. Brodsky, *The Globalization of Stock Index Futures: A Summary of the Market and Regulatory Developments in Stock Index Futures and the Regulatory Hurdles Which Exist for Foreign Stock Index Futures in the United States*, 15 Nw. J. INT'L L. & Bus. 248 (1994).

Effective March 18, 1996, the CFTC amended rule § 30.3(a) to eliminate the requirement that the CFTC issue an order authorizing the offer and sale of a particular foreign exchange-traded commodity option before it can be offered or sold in the United States. *See* Foreign Commodity Options, 61 Fed. Reg. 10,891 (CFTC 1996) (to be codified at 17 C.F.R. § 30.3). While a formal CFTC order approving a foreign option under rule § 30.3(a) is no longer required under any circumstances, the rule change does not affect existing Act restrictions related to stock indices and foreign government debt. *See id.* However, if the underlying foreign exchange-traded futures product (including futures on stock indices and foreign government debt) may be offered or sold in the United States, the foreign option based on that futures contract may be offered or sold as well without further action. *See id.*

31. *See* 17 C.F.R. § 30.7(a). An FCM may commingle with the Secured Amount funds held for or on behalf of other customers of the FCM who wish to trade foreign futures or options (e.g., foreign domiciled customers). If the Secured Amount is commingled with the funds of such other customers, the amount that must be deposited in the separate account must be no less than the greater of:

- 1) the . . . secured amount plus the amount that would be required to be on deposit if all such customers were [United States domiciled customers], or 2) the . . . secured amount plus the amount required to be held in a separate account . . . for or on behalf of customers pursuant to any law, or rule, regulation or order thereunder, or any rule of

§ 4d of the Act.³² Like segregated funds, the Secured Amount must be held and accounted for apart from an FCM's own funds in a separate account located at an acceptable depository (the "Separate Account").³³ The account name must indicate clearly that the account contains the funds of the FCM's customers.³⁴ In addition, the FCM must obtain from the depository a written acknowledgment stating that the depository has been informed that the funds in the account belong to the commodity futures and options customers of the FCM and are being held in accordance with the CFTC's rules.³⁵

An FCM may invest Secured Amount funds in the same instruments as permitted under the segregation rules,³⁶ as well as: (a) equity and debt securities traded on a United States securities exchange; and (b) commercial paper and other debt instruments rated in one of the top two rating categories by Standard & Poor's Corporation or Moody's Investor Services, Inc. In addition, each FCM must compute on a daily basis: (a) the total amount of funds on deposit in the Separate Account; (b) the total Secured Amount required to be on deposit; and (c) the amount of the FCM's residual interest in such funds.³⁷

3. Minimum Financial Requirements

The primary safeguard against the loss of customer funds resulting from the financial failure of an FCM is the segregation requirements; however, these requirements protect customers only if followed by the FCM. To help insulate commodity futures customers from losses resulting from the financial failure of FCMs, the CFTC has established minimum financial requirements with which FCMs must comply to retain their registration. Moreover, the CFTC has stated that the minimum net capital amount required to be main-

any self-regulatory organization authorized thereunder, in the jurisdiction in which the depository or the customer, as appropriate, is located.

17 C.F.R. § 30.7(b). Accordingly, the calculation of the Secured Amount depends on the following factors: a) whether or not the foreign contract market is subject to a segregation rule; b) whether the account containing the Secured Amount contains funds pertaining only to United States domiciled customers or also contains funds related to foreign domiciled customers; and c) whether the FCM chooses to set aside additional funds.

32. See 17 C.F.R. § 30.7(d).

33. A Separate Account may be maintained at the following depositories: a) a bank or trust company located in the United States or as designated by the CFTC; b) another FCM; c) a clearing organization of any foreign contract market; d) any member of such foreign contract market; or e) such member or clearing organization's depository. See *id.* § 30.7(c).

34. See *id.*

35. See *id.* § 30.7(c)(5).

36. See *supra* text accompanying note 26.

37. See 17 C.F.R. § 30.7(f).

tained is intended to be sufficient to provide commodity customers with adequate protection in light of current industry conditions.³⁸ A detailed discussion of the CFTC's minimum financial requirements is beyond the scope of this article.³⁹ Nevertheless, several points should be noted.

Generally speaking, an FCM must maintain "adjusted net capital" in an amount equal to or greater than four percent of the combined amount of customer segregated funds and the aggregate Secured Amount held by the FCM (less the market value of customer commodity options).⁴⁰ "Net capital" is broadly defined as the excess of current assets over liabilities.⁴¹ If adjusted net capital were to decline to six percent of the combined amount of customer segregated funds and the Secured Amount (less the value of customer commodity options), the so-called "early warning" level, the FCM would be required to notify the CFTC.⁴² If adjusted net capital were to decline below the four percent minimum level discussed above, the FCM would be required to notify the CFTC within twenty-four hours⁴³ and, within another twenty-four hours thereafter, file a statement of financial condition, a statement showing the minimum net capital calculation, and a statement of its segregation and Secured Amount requirements and the funds held in segregated accounts and Separate Accounts.⁴⁴ Furthermore, an FCM unable to maintain the minimum

38. See Futures Commission Merchants: Minimum Financial Requirements, 42 Fed. Reg. 27,166, 27,166 (CFTC 1977) (to be codified at 17 C.F.R. pt. 1) (proposed May 26, 1977).

39. For a detailed discussion, see Jerry W. Markham & Thomas Lee Hazen, *Broker-Dealer Operations Under Securities and Commodities Law* § 5.13 (Clark Boardman Callaghan Securities Law Series vol. 23A, 1995).

40. See Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers, 61 Fed. Reg. 19,177, 19,186 (CFTC 1996) (to be codified at 17 C.F.R. § 1.17(a)(1)(i)). The reduction for the market value of commodity options is limited to the amount of customer funds in such customer(s) accounts and Secured Amounts. See *id.* For FCMs that also are securities broker-dealers, the adjusted net capital amount must equal or exceed the amount of net capital required by 17 C.F.R. § 240.15c3-1(a). See *id.* 17 C.F.R. § 1.17(a)(2)(i) excludes an FCM from the foregoing adjusted net capital requirements so long as the FCM is a member of a Designated Self-Regulatory Organization ("DSRO") and conforms to that DSRO's minimum financial standards and reporting requirements. Note, however, that such financial standards and reporting requirements never result in a "lower" minimum net capital requirement.

41. See *id.* § 1.17(c)(1). "Current assets" includes cash and other assets expected to be realized in cash or sold within the next twelve months. See *id.* § 1.17(c)(2).

42. The "early warning" level is triggered if adjusted net capital falls below 150% of the amount specified in 17 C.F.R. § 1.17(a)(1)(i) or 6% of the combined amount of customer segregated funds and the foreign futures and options Secured Amount (less the market value of commodity options), whichever is greater. See Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers, 61 Fed. Reg. 19,177, 19,185 (CFTC 1996) (to be codified at 17 C.F.R. § 1.12(b)).

43. See 17 C.F.R. § 1.12(a)(1).

44. See *id.* § 1.12(a)(2).

amount of adjusted net capital must transfer all customer accounts and immediately cease doing business as an FCM until it can demonstrate compliance.⁴⁵

The CFTC's minimum financial requirements are important in tracing the consequences of a depository institution default on an FCM. As more fully discussed below, FCMs that have placed customer funds with a depository institution will, following the default of such institution, have to exclude the value of such deposits from the current asset portion of its adjusted net capital calculation. If such FCM lacks adequate capital reserves to offset the deposit, the FCM may have to cease doing business. Though specific as to the direct consequences to an FCM of the default of a depository institution, the CFTC's minimum financial requirements do not address the responsibility of an FCM for customer losses stemming from such default.

B. The United Kingdom Regulatory Environment

1. Futures and Options Transactions on Domestic and Foreign Exchanges

Commodity brokerage firms in the United Kingdom must follow the "Client Money Rules" issued by the Securities and Futures Authority ("SFA"), a "self-regulating organization" which derives authority from the United Kingdom's Financial Services Act 1986 ("FSA").⁴⁶ In contrast to the CFTC's segregation rules, the Client

45. *See id.* § 1.17(a)(4). Note that if the FCM immediately demonstrates to the CFTC's or appropriate DSRO's satisfaction the ability to comply with the minimum capital requirements, then the CFTC may, in its discretion, allow a 10-business-day grace period during which positions need not be transferred and the FCM need not cease doing business.

46. *See Securities and Futures Authority ("SFA") Rules, published in 3 Fin. Servs. Rep. (CCH) at 222,001 et seq., as amended by SFA Board Notice 297 (Dec. 20, 1995).* The Securities and Investment Board ("SIB") "dedesignated" its Client Money Regulations in November 1994. *See SFA Board Notice 297 (Dec. 20, 1995) (on file with authors).* The SFA's new Client Money Rules are a response to that redesignation and completely replace the SFA Client Money Regulations in effect as of December 20, 1995. The new SFA Client Money Rules went into effect on February 1, 1996. Firms, however, had until June 30, 1996, to begin operating under the new Client Money Rules. *See id.*

Under section 55 of the FSA, brokerage firms must keep "client money" in accordance with rules and regulations issued by the "Secretary of State," who is given authority by the FSA to "make regulations" regarding "clients' money." The Secretary's role has been reduced since the FSA's enactment, and many of its duties, including those involving client money, have since been transferred to the United Kingdom Treasury. *See Transfer of Functions (Financial Services) Order 1992, (SI 1992 No. 1315) (June 4, 1992), published in 2 Fin. Servs. Rep. (CCH) at 161,662.* Powers are further delegated to the United Kingdom's SIB, akin to both the United States SEC and the CFTC. *See Financial Services Act 1986 (Delegation) Order 1987, (SI 1987 No. 942) (May 18, 1987), published in 2 Fin. Servs. Rep. (CCH) at 160,304; see also 1 Fin. Servs. Rep. (CCH) ¶ 2-350.*

Money Rules permit certain customers to “opt out” of the restrictions on the disposition of client money under certain circumstances.⁴⁷

SFA Rules permit a “non-private customer”⁴⁸ to “opt out” if such customer has entered into a two-way customer agreement with the brokerage firm stating that the customer’s money “will not be subject to the protections conferred by the Client Money Rules.”⁴⁹ The agreement must further state that because of the customer’s election to “opt out,” the customer’s money “will not be separated from the money of the firm, and will be used by the firm in the course of the ‘firm’s’ business, and the customer will therefore rank as a general creditor of the firm.”⁵⁰ Additionally, a customer may “opt out” of the Client Money Rules if such customer is an ordinary business investor⁵¹ or a market counterparty,⁵² and the broker has sent to the customer a separate written notice containing the same statements as those found in the two-way customer agreement described above.⁵³

If the customer elects not to “opt out” of the Client Money Rules, “client money” must be held in a “client bank account” with an “approved bank.”⁵⁴ Client money and the client bank account must be designated as such on the bank’s records, thereby ensuring its segrega-

Like the United States, the United Kingdom depends on self-regulatory organizations (“self-regulating organizations” or “SROs”) to enforce its commodities and securities laws. Thus, commodity firms obtain authority to operate by membership in the SFA. *See* FSA § 8, *published in* 2 Fin. Servs. Rep. (CCH) at 100,101; 1 Fin. Servs. Rep. (CCH) ¶ 2-600.

Hereinafter, “Rules” will refer to those of the SFA, and “Regulations” will refer to those of the SIB.

47. *See* SFA Rule 4-52.

48. The term “private customer” includes both a customer who is an individual and who is not acting in the course of carrying on investment business, and a customer who is a small business investor not acting in the course of carrying on investment business. *See* SFA Rule 9-1.

49. SFA Rule 4-52.

50. *Id.*

51. An ordinary business investor includes, among other things, governmental entities, as well as companies, partnerships and trusts that meet certain size and net asset requirements. *See* SFA Rule 9-1.

52. A market counterparty means “a person dealing with a firm as principal or as agent for an unidentified business of the same description as that in the course of which the firm acts.” SFA Rule 9-1.

53. *See* SFA Rule 4-52(2).

54. “Client money” is that customer money held for investment by the firm. *See* SFA Board Notice 297, sched. 2, ch. 9 (Dec. 20, 1995). A “client bank account” is an account at an approved bank held in the firm’s name but with a title that distinguishes it from the firm’s proprietary account. *See id.* An “approved bank” includes, among others, the Bank of England or a bank operating under the United Kingdom’s Bank Act 1987. It also may include institutions outside the United Kingdom, including central banks within the European Community (“EC”) and depositories both within and without the EC. *See id.*; *see also* SFA Rules, App. 6 (list of SFA approved institutions outside the United Kingdom).

A firm, however, cannot hold client money outside the United Kingdom unless such an arrangement is disclosed to the customer. *See* SFA Rule 4-60. The customer must give written consent to the arrangement unless the customer “ordinarily” resides outside the United King-

tion from the firm's proprietary account. The firm must give written notice to the bank requesting that the bank provide written acknowledgment that the money is held by the firm as "trustee" and, therefore, is not subject to setoff or counterclaim by the bank against the firm.⁵⁵

Before the brokerage firm transfers client money to an exchange, clearinghouse, or correspondent broker in order to effect margined trades, the firm must notify such transferee that the firm is under an obligation to deposit client money in a client bank account; instruct the transferee that such money should be credited to the firm's client account; and, as is the case with an approved bank, require the transferee to provide written acknowledgment that the client account will not be combined with any other account and is not subject to setoff in satisfaction of a debt owed to the transferee under any other account.⁵⁶

If either the approved bank, correspondent broker, or a settlement agent entrusted with client money or property "defaults," the firm must notify the SFA as soon as it learns of the default.⁵⁷ The firm must also notify the SFA "as soon as practically reasonable, of its intention regarding making good any shortfall that has arisen or may arise and the amounts involved."⁵⁸

dom and the firm has "reasonable grounds" to believe that the customer consents but does not wish to give consent in writing. *See id.*

55. *See* SFA Rule 4-53(1) (money to be held in an "approved bank"); SFA Rule 4-54(1) (notification to an approved bank); SFA Rule 4-55 (money segregated from firm's); SFA Rule 4-56 ("general client bank accounts" and "designated client bank accounts").

Chapter 9 of the SFA Rules defines a "general client bank account" as an account which holds client money of one or more customers. Upon the default of the bank, accounts in the United Kingdom are pooled with all other client bank accounts of the firm except designated client bank accounts. A "designated client bank account" is an account in which client money of one or more customers is deposited, each customer having consented in writing to the use of the approved bank holding the client money; and, upon bank failure, the account is *not* pooled with any other account or type of account. It is questionable whether a designated account adds any greater protection to customers when the depositor bank is an affiliate of the firm or acting in the role of broker itself. *See* Bettelheim, *supra* note 6, at 18 (suggesting the possibility that "designated trust accounts will be pooled with other deposits and will be available for the bank's general creditors").

56. *See* SFA Rule 4-62. The same rule generally applies when "customers' approved collateral" is transferred to the exchange, clearinghouse, or intermediate broker. SFA Rule 4-63. When the collateral must be liquidated to satisfy margin requirements, the intermediate broker must transfer any excess to the client bank account identified by the firm in its notice to the broker. *See* SFA Rule 4-63(b)(ii). An exchange or clearinghouse, however, is entitled to treat the excess in accordance with its own rules. *See* SFA Rule 4-63(b)(iii).

57. *See* SFA Rule 4-64(a).

58. SFA Rule 4-64(b). Nothing in the SFA Rules provides that a firm has a duty to make up the shortfall.

A United Kingdom firm dealing with United States customers typically does so through the exemption provided under CFTC Rule § 30.10.⁵⁹ In 1989, the CFTC granted an exemption under Rule § 30.10 to firms designated by the United Kingdom's Association of Futures Brokers and Dealers ("AFBD"),⁶⁰ the predecessor to the SFA.⁶¹ Prior to issuing this "Part 30 Exemption," the CFTC had to evaluate the AFBD and its "regulating program" to determine whether these provided "substituted compliance," for example, whether the SRO's rules and the regulatory scheme under which it operated met the requirements of Rule § 30.10 and Appendix A to the Part 30 Rules. Those requirements included, among other things, whether United Kingdom law, Securities and Investments Board ("SIB") regulations and AFBD rules provided sufficient "protection of customer funds from misapplication."⁶² United Kingdom firms individually exempted under Part 30 are permitted to forgo registration with the CFTC, the separate account requirements under Rule § 30.7, and the CFTC financial regulations under 17 C.F.R. Part 1.⁶³

In addition, United Kingdom firms granted Part 30 relief must abide by the SFA's Client Money Rules⁶⁴ and agree

to refuse customers resident in the United States the option of not segregating funds notwithstanding relevant provisions of the United Kingdom regulatory system and otherwise consent to provide all customers resident in the United States no less stringent regulatory protection than United Kingdom customers under all relevant provisions of United Kingdom law.⁶⁵

Thus, a United States customer cannot "opt out" of the Client Money Rules.⁶⁶

59. 17 C.F.R. § 30.10 (1996).

60. See Foreign Futures and Option Transactions, CFTC Order, 54 Fed. Reg. 21,604 (1989); see also Limited Marketing Activities From a United States Location, CFTC Order, 57 Fed. Reg. 49,644, 49,645 (1992).

61. AFBD merged with The Securities Association to form the SFA. See SFA Rules, App. 36 ¶ 2.

62. Foreign Futures and Option Transactions, CFTC Order, 54 Fed. Reg. at 21,604; see also Interpretative Statement With Respect to the Commission's Exemptive Authority Under § 30.10 of Its Rules, 17 C.F.R. pt. 30, App. A.

63. See Foreign Futures and Option Transactions, CFTC Order, 54 Fed. Reg. at 21,605.

64. Under SFA Rule 4-72, a United States customer's money must be "treat[ed] as client money . . . which is held or received in respect of transactions on non U.S. exchanges."

65. Foreign Futures and Option Transactions, CFTC Order, 54 Fed. Reg. at 21,606.

66. In addition to the Part 30 Exemption for SFA, SFA Rule 4-72 prohibits a United States resident firm from opting out of the client money rules.

II. SOURCES OF SYSTEMIC RISK

As illustrated by the Barings collapse, notwithstanding the detailed rules and procedures in the United States and the United Kingdom governing the treatment of customer property used to trade futures and options contracts, the safety of such property cannot be presumed. Customer property may be invaded at several points through, for example, fraud or negligence (whether such fraud or negligence was that of the customer's own broker or of a correspondent broker selected by the customer's broker), or a correspondent broker's default. This Section will identify and discuss sources of systemic risk and regulatory efforts to control such risk. This section also will identify one source of risk not directly addressed by regulation—the risk of the default of a third party depository of customer margin.

A. *Negligence and Fraud*

The customer's broker or a correspondent broker utilized by the customer's broker may invade customer property through its own negligence or fraud. For violations of the Act's segregation requirements, § 6c⁶⁷ authorizes the CFTC to institute proceedings against the FCM. A decision in favor of the CFTC may result in a civil penalty of not more than one hundred thousand dollars or triple the FCM's monetary gain, and an order to cease and desist from the prohibited activity. In addition, such decision may result in the suspension or revocation of the FCM's registration, and the denial of the FCM's trading privileges on any contract market.⁶⁸ Furthermore, § 9(a)(1)⁶⁹ authorizes criminal prosecutions for flagrant violations of the Act's segregation requirements. FCMs that "embezzle, steal, purloin, or with criminal intent convert" customer property may be found guilty of a felony punishable by a fine of not more than one million dollars (or five hundred thousand dollars in the case of an individual) or imprisonment of not more than five years.⁷⁰

An example of fraudulent conduct occurred in *In re Incomco, Inc.*⁷¹ In *Incomco*, among other things, the FCM transferred funds from a customer account to its own general account at a time when the FCM knew it held insufficient funds to cover its customers' trading

67. 7 U.S.C. § 13a-1 (1994).

68. *See id.*

69. *See id.* § 13(a).

70. *Id.*

71. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,483 (Sept. 20, 1982).

activities.⁷² For this and other violations, the administrative law judge invoked the CFTC's maximum sanction by revoking Incomco's registrations as an FCM commodity trading advisor and commodity pool operator; prohibiting Incomco from trading on or subject to any contract market; requiring all contract markets to refuse Incomco all trading privileges; and requiring Incomco to cease and desist from violating the Act and regulations.⁷³

B. Default of a United States FCM

Another risk to customer property arises in the potential default of an FCM carrying such property. The CFTC's Part 190 regulations dealing with bankruptcy and the Bankruptcy Code (the "Code")⁷⁴ contain specific procedures designed to protect customer property in the event of an FCM's bankruptcy. Nevertheless, as illustrated by the default of Volume Investors Corporation, these procedures may not thoroughly shield customers from all losses.⁷⁵

Like the CFTC's segregation requirements, the rules governing the treatment of customer property following an FCM's bankruptcy strive to protect such property while insulating the market from a default-induced chain reaction.⁷⁶ Article IV of Chapter 7 of the Code⁷⁷ defines "customer property" to include "other property of the [FCM] that any applicable law, rule or regulation requires to be set aside or held for the benefit of a customer."⁷⁸ If the FCM has undersegregated

72. See *id.* at 26,244-445.

73. See *id.* at 26,249.

74. 17 C.F.R. pt. 190 (1996); 11 U.S.C. §§ 761-766.

75. 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 (1987); Andrea M. Corcoran, *Risk-Avoidance Strategies for Large Market Participants*, SEC. & COMMODITIES REG., Aug. 27, 1986, at 173; William F. Tueting & Christopher Q. King, *Funds Protections: An Overview of What Happens When a Commodity Broker Becomes Insolvent*, 7 J. FUTURES MARKETS 93 (1987). For a detailed discussion of the factual circumstances surrounding the Volume case, see Perry L. Taylor, Jr. & David J. Gelfand, *The Default of a Clearing Member: Revisiting the Financial Collapse of Volume Investors Corporation*, 8TH ANN. COMMODITIES L. INST. (1985).

76. The default of one FCM may potentially tie up funds required by other FCMs to meet their own obligations to other customers, FCMs or the clearinghouse. The inability of solvent FCMs to access their funds in a timely manner may cause additional defaults which could further jeopardize customer funds and the market as a whole. See *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong. 2377, 2393-95 (1976) (statement of William T. Bagley, CFTC Chairman, explaining the difference between "gross" and "net" margin systems and their effect on segregation requirements), reprinted in 4 COLLIER ON BANKRUPTCY ¶ 761.15 (Lawrence P. King ed., 15th ed. 1995).

77. 11 U.S.C. §§ 761-766.

78. 11 U.S.C. § 761(10).

or improperly commingled funds in its customer account, the expansive definition of customer property allows the inclusion of other assets belonging to the FCM to the extent necessary to restore customer margin to required levels. The CFTC's definition of customer property is consistent with the Code's definition and includes "cash, securities or other property of the [FCM's] estate, including the [FCM's] trading or operating accounts and commodities of the [FCM] held in inventory," to the extent that available segregated amounts are "insufficient to satisfy in full all claims of public customers."⁷⁹ The Code and regulations assure that difficulties in tracing customer property will not unfairly disadvantage customers to the benefit of the defaulting FCM's general creditors.⁸⁰ Once the extent of the FCM's property available for distribution to customers is established, § 766(h) of the Code specifies the formula for distributing such property. Under this section, the bankruptcy trustee is required to distribute customer property "ratably to customers on the basis and to the extent of such customers' allowed net equity claims, and in priority to all other claims, except claims . . . attributable to the administration of customer property."⁸¹

From the customer's perspective, the Code and CFTC regulations only provide a partial solution. Customers have interests both in their property deposited with their FCM and in the trading positions collateralized by such property. When the customer trades for hedging, as opposed to speculative purposes, the customer bears the additional risk associated with being unable to adjust the hedge position in the futures market when the cash position changes. Hence, the Code and regulations contain special provisions authorizing the trustee to trans-

79. 17 C.F.R. § 190.08(a)(1)(ii)(J).

80. See Corcoran & Ervin, *supra* note 75, at 875.

81. 11 U.S.C. § 766(h). Section 190.07 of the CFTC's regulations specifies the steps in calculating a customer's *pro rata* share of available customer property. 17 C.F.R. § 190.07. Certain contracts on foreign financial instruments or indices traded on United States exchanges are priced and settled in the currency of the underlying instrument or index in order to enhance the effectiveness of the contracts for hedging purposes. Subject to certain conditions, FCMs may carry the segregated funds of domestic customers in certain foreign depositories. Among these conditions is the requirement that FCMs, before placing a customer's funds overseas, obtain from the customer a subordination agreement. The subordination agreement effectively creates a "hierarchy" of segregated funds accounts by authorizing

the subordination of a customer's claims attributable to funds held offshore in a particular foreign currency to the claims of customers whose funds are held in dollars or other foreign currencies in the event that the FCM is placed in bankruptcy of receivership and there are insufficient funds to satisfy all customer claims against those funds.

Financial and Segregation Interpretation No. 12 - Deposit of Customer Funds in Foreign Depositories, [1988-1990 Transfer Binder] 1 Comm. Fut. L. Rep. (CCH) ¶ 7122, at 7139 (Nov. 16, 1988). Hence, the subordination agreement will preclude the dilution of customer funds held in dollars or in a foreign currency caused by insufficient funds in another foreign currency. See *id.*

fer open trading positions of the failed FCM's customers.⁸² Effecting position transfers, however, may be difficult under circumstances where the FCM possesses insufficient margin to support the positions. Other FCMs may be unwilling to contribute their own capital to bring transferred positions up to minimum margin standards. Note, however, that the CFTC's Part 190 regulations relate to the default of the customer's FCM, and may not come into play if an FCM is not forced into default following the default of a depository institution.

C. Default of a United Kingdom Commodity Broker

In the United Kingdom, the insolvency or default⁸³ of a firm or correspondent broker obligated under an exchange-traded futures or option on a futures contract⁸⁴ invokes both statutory and exchange or clearinghouse rules⁸⁵ that supplant certain of the normal insolvency rules.⁸⁶ Such rules provide for the protection of market participants and the liquidity of the markets in times of crisis.⁸⁷ Thus, under the Companies Act 1989, as is true in some respects under United States bankruptcy law, the clearinghouse is entitled, after insolvency, to set off obligations running from the defaulting party to the clearinghouse

82. For example, § 764(b) of the Code "insulates from the trustee's avoidance power transfers of commodity contracts . . . made within five days after the order for relief, if the transfer is approved by the [CFTC] by rule or order, either before or after the transfer." Corcoran & Ervin, *supra* note 75, at 878. CFTC regulations require that it be notified no later than the third business day after the order for relief as to whether a transfer under § 764(b) of the Code will be made. See 17 C.F.R. § 190.02(a)(2). If such transfer is not disapproved by the CFTC, it may not be avoided by the trustee. See *id.* § 190.06(g).

83. Under United Kingdom law, a brokerage firm in financial difficulty may be placed in liquidation, administration, administrative receivership, or, if an individual, bankruptcy. The form of proceeding is, for the most part, irrelevant to the application of the special default rules under the Companies Act, its regulations, and the exchange and clearinghouse rules.

84. The Companies Act uses the term "market contract." See Companies Act, 1989, § 155 (Eng.).

85. Section 156 of the Companies Act incorporates the requirements found in that Act's Schedule 21 (regarding additional requirements for recognition of an exchange or clearinghouse) into the FSA. Companies Act, 1989, § 156 (Eng.). Under Schedule 21, an exchange or clearinghouse, in order to be "recognized" under the FSA, must have default rules which provide, among other things, that a defaulting party's obligations under open positions, or "market contracts," are set off against rights to payment under those market contracts. See *id.* sched. 21.

Regulations with respect to Part VII of the Companies Act are found in Financial Markets and Insolvency Regulations 1991, (S.I. 1991 No. 880) (Mar. 27, 1991), reproduced in 2 Fin. Servs. Rep. (CCH) at 161,583.

86. Provisions for insolvency, receivership, and administration are found in the Insolvency Act 1986. Part VII of the United Kingdom's Companies Act 1989 alters these provisions and some rules of equity with respect to "market contracts." See Companies Act, 1989, §§ 154-155 (Eng.).

87. See 1 Fin. Servs. Rep. (CCH) ¶¶ 94-100 for comments of the Secretary of State for Trade and Industry (Lord Young) upon the introduction of Part VII of the Companies Act 1989 ("[I]f one member of a market defaults, it is vital to prevent a domino effect which could bring down other members.").

against reciprocal obligations regardless of whether one such obligation was incurred pre-insolvency and the other post-insolvency. This right of setoff, or netting out, is inconsistent with the equitable principles developed under United Kingdom insolvency law.⁸⁸

In addition, the power of a liquidator or trustee in bankruptcy to repudiate or "disclaim" onerous contracts cannot be exercised when the contract is a market contract or "a contract effected by the exchange or clearinghouse for the purpose of realising property provided as margin."⁸⁹ Nor can the liquidator or trustee avoid a post-insolvency disposition (i.e., a transfer or sale) of the property under the default rules of the exchange or clearinghouse when that property is either the market contract itself or collateral for margin purposes.⁹⁰ Pre-insolvency transactions with respect to market contracts, property "in pursuance of such contract," or margin cannot be voided on grounds that such transactions might be considered "preferences," "transactions at an undervalue," or "transactions defrauding creditors."⁹¹ Finally, "market charges" (security interests held by the exchange or clearinghouse) on the defaulting party's property survive the avoiding provisions of the Insolvency Act.⁹² Thus, the exchange or clearinghouse can realize on collateral put up by the debtor without violating Insolvency Act provisions regarding restrictions on the enforcement of a security interest and the power of the administrator to control and dispose of the property.

D. Default of a Depository Institution

An area of systemic risk not directly addressed by regulation is the failure of a depository institution holding customer funds. For example, the customer's broker, correspondent brokers, and clearing or-

88. In *British Eagle Int'l Air Lines Ltd. v. Compagnie Nationale Air France*, 1 W.L.R. 758 (1975), the House of Lords declared post-insolvency setoff unlawful when exercised against a pre-insolvency obligation because to permit such a setoff would constitute a preference of certain creditors over others. The case involved a clearinghouse to which several airlines belonged and which settled the accounts of participating airlines on a monthly basis. Under the rule announced in *British Eagle*, were it not for the exceptions provided by the Companies Act, it might be impossible for a clearinghouse or exchange to net out the positions of defaulting parties. See Companies Act, 1989, sched. 21; see also The London Clearing House Risk Management Circular No. 582/95, Default Rule 8 (June 8, 1995).

89. Companies Act, 1989, § 164(1) ("disapplying" §§ 178, 186, 315, and 345 of the Insolvency Act 1986).

90. See *id.* § 164(3) ("disapplying" §§ 127 and 284 of the Insolvency Act 1986).

91. See *id.* § 165 ("disapplying" §§ 238, 239, 340, and 423 of the Insolvency Act 1986).

92. Section 173 of the Companies Act defines "market charge"; Section 175 provides for the disapplication of various provisions of the Insolvency Act 1986.

ganizations all may use banks to deposit customer funds.⁹³ Banks therefore represent an important source of liquidity to the exchange mechanism. Nevertheless, customer margin deposits in the United States receive no special treatment in comparison to any other deposits in insolvency proceedings and the relationship created between an FCM and the bank does not differ from that of any other depositor (i.e., a debtor-creditor relationship is created). Hence, in any insolvency proceeding, a temporary stay on the bank's assets will prevent depositors from removing funds. Such an action directly impairs the bank's ability to provide liquidity to the exchanges. A particularly problematic variant of this scenario arises when the defaulting broker is affiliated with or, as permitted under some jurisdictions, is a bank.

This situation is illustrated by the Barings collapse. Barings plc, the Barings Group parent company, conducted its futures trading business through Barings Securities Limited ("BSL"). BSL maintained customer agreements, provided liquidity to its various subsidiaries to enable them to engage in futures transactions, and held deposits of customer funds. BSL operated several subsidiaries, including Barings Futures (Singapore) Pte Limited ("BFS"), a clearing member of SIMEX, and Baring Securities (Japan) Limited ("BSJ"), which handled trades on several major Japanese futures markets.⁹⁴ Both BFS and BSJ traded on their own behalf and on behalf of customers, which included individuals, corporations, and other brokers who themselves were trading for their own and their customers' accounts. For example, a United States person placing a trade on SIMEX would normally place the order with a United States FCM who, in turn, would place the order with BFS. After executing the order, BFS would pass the appropriate instructions to BSL to reflect the trade on the United States broker's customer omnibus account on BSL's books.

Like the default of Volume Investors Co., the default of BFS required exchange clearing organizations to step in and effect position transfers to other brokers. Initially, positions belonging to BFS customers were moved along with the required margin deposits held at BSL. However, a problem developed when Ernst & Young, the Barings Group administrator in London, ordered a freeze on all asset transfers. Citing the holding in *Space Investments Ltd. v. Canadian*

93. See *supra* text accompanying note 23.

94. BSJ was a full clearing member of TSE and OSE, and was a trading but nonclearing member of TIFFE. See BANK OF ENGLAND, *supra* note 1, at 3.6. BSJ traded contracts on the OSE, the TSE and the TIFFE.

Imperial Bank of Commerce Trust Co.,⁹⁵ the Barings administrator argued that client money placed with BSL was an asset of the bank and therefore subject to the claims of the bank's general creditors.⁹⁶ In addition, the administrator argued that the margin and open positions under BSL's name but held for customers were assets of the bank and attempted to force the turnover of those assets by intermediary brokers, investment exchanges, and their clearinghouses.⁹⁷

With BSL unable to supply the necessary liquidity to support position transfers, customers looked to their brokers to supply the necessary funds out of their own capital. Brokers, in turn, claimed that doing so would seriously cripple, if not destroy, their ability to continue doing business. The inability of such brokers to continue business would have threatened additional defaults on other exchanges and affected customers with no relation either to Barings or the exchange clearing organizations holding Barings' positions.⁹⁸

95. 3 All E.R. 75 (P.C. 1986) (appeal taken from Bah.).

96. See Bettelheim, *supra* note 6, at 18.

97. See *id.*; see also Ginger Szala et al., *Barings Abyss*, *FUTURES*, May 1995, at 68-69 (Ernst & Young, the Barings administrator, instructed SIMEX, OSE, and TIFFE to hold all money attributed to Barings); Sheila C. Bair, *Lessons from the Barings Collapse*, 64 *FORDHAM L. REV.* 1, 7-8 (1995).

The SIB's Client Money Regulations, then in force, may have been a source of the problem for they did not yet apply to situations in which an authorized person, also a bank, holds client money in an account with itself. Thus, client money held at Barings by BSL for its customers was, for a time after the failure, considered by the administrator to be simply the bank's assets. See The Financial Services (Client Money) Regulations 1991, SIB Rules ch. VI, *reproduced in* 2 *Fin. Servs. Rep.* (CCH) at 185,761, 185,744 ("Where a bank which is authorized under the [Financial Services] Act in respect of its investment business holds money on behalf of its clients, it does so as the clients' banker and such money is not subject to the [Client Money] Regulations."); Szala et al., *supra*, at 74 ("The client money is safe from the securities firm that's handling it, but it is not safe from failure of the bank in which the securities firm deposited the money.") (quoting Richard Farrant, an SFA officer). This result has not changed under the new SFA Client Money Rules. When a bank acts as broker, the Client Money Rules do not apply. See SFA Rule 4-50(2)(b).

98. See Bettelheim, *supra* note 6, at 19. Even if a United Kingdom bank administrator properly recognized a client bank account as a deposit, the deposit insurance available to the customer would be a much smaller sum than is available in the United States under the Federal Deposit Insurance Act. The United Kingdom's Banking Act 1987 provides, at a maximum, for £ 15,000. Section 58(1) of the Banking Act provides insurance for "three-quarters" of the amount of the "protected deposit." However, § 60 limits that deposit amount to £ 20,000. See *Deposit Protection Board v. Dalia*, 1 All E.R. 539, 543 (C.A. 1994); 3(1) *HALSBURY'S LAWS OF ENGLAND* ¶¶ 115-117 (4th ed. 1989).

The Banking Act does provide a type of "pass-through" deposit insurance. Thus, under § 61(7) each client in a client bank account would be entitled to up to £ 15,000 in insurance determined by the client's *pro rata* share of the account. However, a client's share of deposit insurance will be reduced by whatever amount he would be entitled to as an investor under the FSA. See Banking Act, 1987, § 58(3) (Eng.).

The maximum amount that any one investor can recover under the "Investor Compensation Scheme" is £ 48,000, but the fund is further limited to expending £ 100 million in any one year.

The issue of a broker's responsibility for providing additional liquidity from its own capital was never resolved in the Barings crisis due to the intervention of ING. But for ING's purchase of most of Barings' assets and guarantee of most of its obligations, the chances of resolving the default without major market consequences would have decreased. Arguments for and against the imposition of liability on FCMs for customer losses caused by the default of another depository institution could draw support from several sources, including the common law treatment of the relationship between brokers and their customers, the legislative history of the segregation provisions of the Act, and subsequent judicial and administrative opinions. The next Section will present and analyze these sources in detail as well as assess efforts by customers and FCMs to better define the scope of liability for third-party defaults via contract.

III. THE NATURE OF THE BROKER-CUSTOMER RELATIONSHIP

The Barings collapse raised the issue of whether and, if so, to what extent brokers are responsible to their customers for the loss of customer property caused by the default of a depository institution selected by the customer's broker. While the CFTC's bankruptcy regulations affirmatively obligate an insolvent FCM to apply its own assets to make up any shortfall in funds segregated on behalf of customers, no United States regulatory provision directly addresses a solvent FCM's responsibility to return such margin, despite the threat to exchange liquidity posed by the default of a major depository institution of customer margin. In the absence of clear regulatory guidance on this issue, competing arguments likely will derive from several fundamental sources, including the nature of the relationship between customers and their brokers and the legislative history of relevant portions of the Act.

Part A of this section will review the common law treatment of the relationship between brokers and their customers. Part B will examine the legislative history of segregation requirements of § 4d(2) of the Act, as well as judicial and administrative interpretations of the relevant legislative history. Part C will assess the duties owed by brokers to their customers as a result of this relationship. Part D will evaluate efforts by the broker to modify the scope of such duties via the inclusion of exculpatory clauses in their customer account agreements. Finally, Part E will examine the potential interrelationship be-

tween exculpatory clauses and the CFTC's minimum financial requirements.

A. *The Common Law Treatment of Brokers*

The common law generally characterized the relationship between brokers and their customers as fiduciary in nature.⁹⁹ As fiduciaries, brokers owe to their customers certain duties inherent in their relationship. Among these duties are the duty to exercise the requisite level of care and skill,¹⁰⁰ the duty to keep and render accounts,¹⁰¹ the duty to act within the scope of authority,¹⁰² and the duty to segregate property belonging to the principal from other property belonging to the agent or under its control.¹⁰³

Many of these same concepts are reflected in the Act and the regulations.¹⁰⁴ For example, discussed above,¹⁰⁵ the Act contains detailed provisions requiring the segregation of customer property,¹⁰⁶ including the requirement that the deposit account name clearly identify the funds as belonging to the customers of the depositing FCM.¹⁰⁷

99. The leading case in this area held that an agency relationship existed between a customer and a broker executing orders on such customer's behalf. *Markham v. Jaudon*, 41 N.Y. 235, 244-45 (1869). The court ruled that the relationship was governed by fiduciary, in addition to contractual, principles. *See id.* The Restatement of Agency defines a fiduciary relationship as one wherein one of the parties acts "primarily for the benefit of another in matters connected with [the subject matter of the agency]." *RESTATEMENT (SECOND) OF AGENCY* § 13 cmt. a (1958). *Accord In re Rosenbaum Grain Corp.*, 103 F.2d 656, 660 (7th Cir. 1939) ("On the stock and commodity exchanges, the broker and his customer stand to each other as principal and agent. This relation, contemplating as it does the holding by the broker of the customer's money and other property, is primarily fiduciary in nature.").

100. *See* *RESTATEMENT (SECOND) OF AGENCY* § 379(1) (1958).

101. *See id.* § 382.

102. *See id.* § 383.

103. *See id.* § 398 ("[A]n agent receiving or holding things on behalf of the principal is subject to a duty to the principal not to receive or deal with them so that they will appear to be his own, and not so to mingle them with his own things as to destroy their identity."); *see also* *RESTATEMENT (SECOND) OF TRUSTS* § 179 (1959) ("The trustee is under a duty to the beneficiary to keep the trust property separate from his individual property, and, so far as it is reasonable that he should do so, to keep it separate from other property not subject to the trust, and to see that the property is designated as property of the trust.").

104. For an extensive treatment of the fiduciary duties arising under the Commodity Futures Act, see Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 *NOTRE DAME L. REV.* 199 (1992).

105. *See supra* text accompanying note 21.

106. *See* 7 U.S.C. § 4d(2) (1994); 17 C.F.R. §§ 1.20(a), 1.22 (1996). *See also* *Hibberd v. Furlong*, 257 N.W. 737, 738-39 (Mich. 1934) (holding agent not liable for loss of principal's funds upon failure of depository where course of dealing and necessity of situation justified deposit of principal's money in the agent's own name).

107. "[T]rust property should be ordinarily so earmarked as to indicate not only that it is trust property but that it is property of the particular trust upon which it is held." *RESTATEMENT (SECOND) OF TRUSTS* § 179 cmt. d (1959). An FCM also must obtain from the depository a written acknowledgment that the funds belong to the FCM's customers. *See* 17 C.F.R. § 1.20(a).

This requirement prevents the bank from later claiming a right of offset—an arguable position if the transaction were for the FCM's own account.¹⁰⁸ Like common law fiduciaries, FCMs are under a duty to keep and render accurate accounts.¹⁰⁹ Aside from the similarities between duties placed on common law fiduciaries and those placed on FCMs by the Act and regulations promulgated thereunder, customers and FCMs alike may support their positions based on the legislative history of the segregation provisions of the Act.

B. *The Legislative History of Section 4d(2)*

Safeguards covering the treatment of customer funds were first introduced in the Commodity Exchange Act of 1936.¹¹⁰ The Act's predecessor, the Grain Futures Act,¹¹¹ did not require commodity brokers to segregate their own funds from those belonging to individual customers. The practice of commingling funds led to two types of abuse. First, some commodity brokers used customer funds to extend credit to certain favored customers, typically large speculators. These speculators often took market positions opposite that of smaller customers and, because of their ability to control large positions, were able to favorably influence prices. In effect, smaller customers were financing large speculators who were allegedly manipulating the market against them.¹¹²

A fiduciary that fails to properly segregate its customer's assets from its own before depositing those assets in a depository risks being treated as a debtor of the beneficiary. *See, e.g., Williams v. Lowe*, 113 N.E. 471, 473 (Ind. App. 1916) (holding that an agent depositing his principal's money in a bank can escape the risk of its loss by the failure of the bank "only by making the deposit in his principal's name, or by so distinguishing it on the books of the bank as to indicate in some way that it is the principal's money").

108. *See* RESTATEMENT (SECOND) OF AGENCY § 398 cmt. a (1958). Moreover, "it is ordinarily not sufficient that the trustee should take title to the property in the name of the trustee 'as trustee' without indicating the particular trust upon which it is held. It should be taken in the name of the trustee as . . . 'trustee for' certain beneficiaries." RESTATEMENT (SECOND) OF TRUSTS § 179 cmt. d (1959). This requirement parallels the account titling regulations in 17 C.F.R. § 1.20(a).

109. *See* RESTATEMENT (SECOND) OF TRUSTS § 172 (1959). The Act also imposes certain accounting and recordkeeping requirements on FCMs with respect to deposits of customer funds. *See, e.g.,* 17 C.F.R. § 1.33.

110. Pub. L. No. 675, 49 Stat. 1491 (codified as amended at 7 U.S.C. §§ 1-25) (1936).

111. From 1922 to 1935, the nation's grain markets were regulated by the Grain Futures Act, 42 Stat. 998, enacted Sept. 21, 1922.

112. *See, e.g.,* 80 CONG. REC. 6162 (1936) (Remarks of Sen. Pope citing failures of the E.F. Carlston Co. and Rosenbaum Grain Co., commission merchants, resulting from commingling of customer and proprietary funds); 80 CONG. REC. 7856 (1936) (Remarks of Sen. Pope); 80 CONG. REC. 7911-12 (1936) (Remarks of Sen. Norris); 80 CONG. REC. 7858 (1936) (Remarks of Sen. Murray citing common practice of commission merchants to use excess margin deposits contributed by small speculators to finance trading of large speculators).

A second, related problem involved commodity brokers' use of customer funds for proprietary trading purposes. If a broker using customer property in such a manner subsequently defaulted on its margin obligations, the margin amount deposited with the clearing organization would be paid to those clearing members holding opposite positions in the market, not to the defaulted broker's customers who originally supplied the funds.¹¹³ As a result, customers bore the risk of the broker's proprietary activities.

To curb these and other perceived abuses in the grain futures markets, Congress made several efforts to reform the Grain Futures Act. H.R. 7608, introduced on January 13, 1932, was the first bill to contain specific language requiring commodity brokers to segregate and separately account for customer funds.¹¹⁴ Bills introduced in subsequent legislative sessions further defined the relationship, requiring commodity brokers to "treat and deal with *as trust funds*" all customer property used to margin futures positions.¹¹⁵ Members of the commodities industry strongly objected to the apparent creation of a statutory trust between commodity brokers and their customers.¹¹⁶ This sentiment was echoed by several members of Congress who, in the minority report to one of the bills containing "trust funds" language, stated:

The use of a technical legal phrase such as "trust funds", connoting as it does a wealth of legal literature and conflicting court decisions, is dangerous until careful study is made of the effect of the phrase

113. During the early 1930s, two defaults focused Congressional attention on the problems associated with using customer funds to support a broker's own trading activities. The first, the Rosenbaum Grain Elevator Company, defaulted while holding customer margins of approximately \$750,000. See 80 CONG. REC. 6162 (1936) (Remarks of Sen. Pope). The second major default occurred in 1935 and involved the E.F. Carlston Company of Minneapolis. Customers of E.F. Carlston Company reportedly were offered a settlement of thirty cents on the dollar in satisfaction of their claims. See *id.*

114. H.R. 7608, 72d Cong. § 4C (1932):

It shall be unlawful for any person to engage in soliciting or accepting orders . . . involving contracts of sale or to sell grain for future delivery . . . unless such person . . . shall keep separate and shall not commingle with his own any of the money, securities, or property received by such person to margin or guarantee the trades or contracts of the customers of such person

115. H.R. 9623, 73d Cong. § 4d (1934) (Emphasis added). See, e.g., S. 3180, 73d Cong. § 4d (1934); H.R. 9471, 73d Cong. § 4 (1934).

116. Arthur F. Lindley, President of the Board of Trade Clearing Corporation, stated in a hearing on H.R. 8829: "[A] system devised to extend legal trust treatment to customers' margin deposits could not operate with the required flexible latitude and would be most cumbersome and difficult to operate if indeed not impossible." *Regulation of Grain Exchanges: Hearings on H.R. 8829 Before the House Comm. on Agric.*, 73d Cong. 149 (1934). Accord H.R. REP. NO. 73-1637, at 40-41 (1934) (rejecting implication of common law trust in § 4d).

on the complicated machinery of the market and auxiliary institutions such as clearing houses and banks.¹¹⁷

The bills submitted in subsequent legislative sessions, including H.R. 6772 (the bill that ultimately became the Commodity Exchange Act), dropped the specific language referring to customer funds as "trust funds." Nevertheless, in several instances during the floor debates, members of Congress indicated their perception that H.R. 6772 did in fact create a trust relationship between the commodity broker and its client.¹¹⁸

Though not expressly making FCMs trustees of their customers, the view that the regulatory system enacted by Congress and by the CFTC nevertheless requires FCMs to fulfill certain fiduciary duties finds support in the few court decisions that have analyzed the legislative history in this area. For example, in *In re Lincolnwood Commodities, Inc.*,¹¹⁹ an administrative law judge expressed in dicta his view that the legislative history of § 4d(2) created a trust relationship between the FCM and its customer, stating that "[i]n 1936, Congress wanted customer funds to be viewed as 'trust funds,' and recognized the danger that persons having close relationships with an FCM might enjoy economic benefits from the relationship at the expense of other customers."¹²⁰ The view in *Lincolnwood* is consistent with Interpretative Letter No. 79-1 in which the CFTC's Office of General Counsel, in discussing the responsibilities of banks as depositories of customer segregated funds, stated that

[s]ection 4d(2) . . . essentially requires that futures commission merchants treat as belonging to their customers all money, securities and property received to margin, guarantee or secure customers' trades or contracts or accruing to customers as a result of such trades or contracts - in effect, establishing the futures commission merchant as a trustee of the customers' property.¹²¹

Courts have disputed the characterization of FCMs as trustees in allowing FCMs to retain interest earned on deposits of customer funds. At common law, trustees were precluded from retaining inter-

117. H.R. REP. NO. 73-1522, pt. 2, at 23 (1934).

118. See 80 CONG. REC. 7858 (1936) (statement of Sen. Murray); 80 CONG. REC. 7911 (1936) (statement of Sen. Norris); see also Comment, *The Commodity Exchange Act of 1936*, 85 U. PA. L. REV. 614, 618 (1937).

119. [1982-1984 Transfer Binder] 2 Comm. Fut. L. Rep. (CCH) ¶ 21,986 (Jan. 31, 1984).

120. *Id.* at 28,232 (citation omitted).

121. CFTC Office of General Counsel, Interpretative Letter No. 79-1, [1977-1980 Transfer Binder] 2 Comm. Fut. L. Rep. (CCH) ¶ 20,835, at 23,416 (May 29, 1979) (emphasis added).

est or other accretions earned on trust property for their own use.¹²² The CFTC's regulations, however, permit FCMs to retain the interest earned on deposits of customer funds.¹²³ In affirming an FCM's right to retain the interest earned on customer property, the court in *Marchese v. Shearson Hayden Stone, Inc.*,¹²⁴ interpreted the deletion of the reference to 'trust funds' in the final bill as an indication that "Congress specifically rejected the formation of a 'trust' relationship."¹²⁵ Regardless of whether the legislative history of § 4d(2) may or may not be interpreted to incorporate the fiduciary duties imposed on common law brokers, it is clear that the Act and regulations promulgated thereunder nevertheless require FCMs to undertake certain duties that are similar to those expected of fiduciaries under common law.

C. *The Duties Owed to Customers by FCMs*

While neither the Act nor the regulations specify the standard of care applicable to FCMs in conducting activities on behalf of their customers, common law fiduciaries were subject to a general duty of skill and care. Specifically, a common law fiduciary must "use reasonable care in selecting the bank, and properly . . . earmark the deposit."¹²⁶ The care and skill required is that "which is standard in the locality for the kind of work which [the agent] is employed to perform."¹²⁷ In the context of the FCM-customer relationship, an integral aspect of this standard of care is manifested in the FCM's selection of depository institutions for customer funds.

While the CFTC has never opined on the requisite level of care in selecting depository institutions, the Commodity Exchange Authority

122. See RESTATEMENT (SECOND) OF AGENCY § 388 (1958) ("[A]n agent who makes a profit in connection with transactions conducted by him . . . is under a duty to give such profit to the principal.").

123. See 17 C.F.R. § 1.29 (1996) ("The investment of customer funds in obligations described in § 1.25 shall not prevent the futures commission merchant or clearing organization so investing such funds from receiving and retaining as its own any increment or interest resulting therefrom.").

124. 644 F. Supp. 1381, 1389 n.22 (C.D. Cal. 1986), *aff'd*, 822 F.2d 876 (9th Cir. 1987).

125. *Marchese*, 822 F.2d at 878 ("The legislative history of the Act makes it clear that section 4d establishes a specific statutory trust, as opposed to a common law trust, and this fact has long been recognized."); *Accord* *Craig v. Refco, Inc.*, 816 F.2d 347 (7th Cir. 1987); *Crabtree Inv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 577 F. Supp. 1466 (M.D. La.), *aff'd*, 738 F.2d 434 (5th Cir. 1984).

126. RESTATEMENT (SECOND) OF TRUSTS § 180 (1959).

127. RESTATEMENT (SECOND) OF AGENCY § 379(1) (1958). An agent "represents that he has at least the skill and undertakes to exercise the care which is standard for that kind of employment in the community. A business agent represents that he understands the usages of the business and undertakes to conduct transactions in accordance with them . . ." *Id.* at cmt. c.

("CEA"), the CFTC's predecessor agency, stated in an internal memorandum:

If a futures commission merchant or a clearing association deposits regulated commodity customers' funds in a bank and the bank is later closed and unable to repay the funds the liability of the futures commission merchant or clearing association would depend on the manner in which the account was handled. It would not be liable if it had used due care in selecting the bank, had not otherwise breached its fiduciary responsibilities toward the customers, and had fully complied with the requirements of the Commodity Exchange Act and the regulations thereunder relating to the handling of customers' funds. If two banks were available in a particular city only one of which was a member of FDIC and the futures commission merchant or clearing association without a compelling reason elected to use the nonmember bank, we would contend that it had not used due care in its selection.¹²⁸

At a minimum, then, an FCM should not deposit or leave on deposit customer funds in a depository which it knows or should know to be insolvent or likely to become so.¹²⁹ The prospective depository also should be an approved, regulated entity. Moreover, an FCM might prudently consider undertaking an analysis of the creditworthiness of the depository to assess its viability. Such analysis should occur before using a depository for the first time and periodically thereafter.¹³⁰ The extent of this analysis is unclear, but might include some

128. Commodity Exchange Authority Administrative Determination No. 230 (Liability of Futures Commission Merchants and Clearing Associations) (Nov. 23, 1971). While instructive as to the CEA's view on FCM responsibility, the weight accorded such determinations is questionable. For example, in *Stoller v. CFTC*, 834 F.2d 262, 265 (2d Cir. 1987), the court disregarded an Administrative Determination on the grounds that it did "not consider these documents to be sufficient to apprise the public at large of the rule interpretation." The court further justified its position by pointing to the fact that the CEA pronouncement apparently had not been enforced as the proscribed conduct (wash sales) remained commonplace. *See id.* Unlike the determination in *Stoller*, however, the CFTC has never been in a position to adjudicate the question of an FCM's negligence in selecting a depository and no industry standard defining the requisite level of conduct apparently exists.

129. *See* RESTATEMENT (SECOND) OF TRUSTS § 180 cmt. b (1959); *United States v. Howard*, 58 S. Ct. 309 (1938).

130. *See, e.g., Zimmerman v. Coblenz*, 185 A. 342, 346 (Md. 1936), *noted in* 15 CHL.-KENT L. REV. 74 (1936). In *Zimmerman*, Coblenz, a bank president also functioning as a co-trustee was held to have violated his fiduciary duties in permitting funds belonging to the trust to be deposited with his bank after it should have been apparent to the trustee that his bank was in financial difficulty in that it lacked sufficient assets to support the trust deposit. *Zimmerman*, 185 A. at 349-50. The other trustee, Fulton, was not found liable. As the president of a bank purchased by Coblenz's bank, the court reasoned that Fulton possessed neither authority over the trust operations of the new entity nor, based on publicly-available state-tested and approved statements containing financial information about the new entity, information that would lead a prudent investor to question the safety of the institution. *See id.* at 346. In Fulton's case, "[i]t could not be required that he examine the bank for himself, or look for better protection in private information and assurances from trust company officials." *Id.*

review of publicly available information regarding the depository's financial condition and of credit ratings by national rating agencies.

This conclusion is consistent with the recommendations published by the Futures Industry Association (the "FIA Recommendations") following the Barings collapse.¹³¹ The FIA Recommendations suggest that brokers "should consider and monitor on an ongoing basis the depositories utilized for customer property."¹³² Included among the factors to be considered are "the financial condition of the depositories, including their credit standing, and the nature of their operations."¹³³

This conclusion also is consistent with the obligations placed on brokers in the United Kingdom. Under United Kingdom law, the selection of an "approved bank" for client funds places a "duty of care" running from the firm to its customer requiring the firm to "undertake[] . . . appropriate and continuing risk assessment" with regard to the bank selected. In order to conduct proper risk assessment, the firm is expected to examine, at the very least,

- (a) the capital of the bank; (b) the client money deposit as a proportion of the bank's capital and deposits; (c) the credit rating of the bank (if available); and (d) to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the bank and its affiliated companies.¹³⁴

When the bank and the broker are affiliated,¹³⁵ the United Kingdom rules require that the broker not consider the affiliated bank any more favorably than an unaffiliated one and impose a continuing duty to periodically monitor and assess risk. In addition, the broker must disclose the affiliation to the customer in writing. If the customer objects, the broker can either return the money to the customer or deposit the money in a designated client bank account with another approved bank.¹³⁶ However, when the bank is itself the broker, the Client Money Rules do not apply.¹³⁷

131. See Futures Industry Association Global Task Force on Financial Integrity, *Financial Integrity Recommendations for Futures and Options Markets and Market Participants* (June 1995).

132. *Id.* ¶ 16.

133. *Id.* ¶¶ 15-17.

134. SFA Rule 4-53 and Guidance to that rule. In SFA Board Notice 297, sched. 1, ¶ 9 (Dec. 20, 1995), the SFA announced that it "intends to develop a form of standard client money management policy which firms will be expected to implement."

135. See SFA Rule 4-53(2). A firm is presumed to be "in the same group" as the bank if the bank owns twenty percent or more of the firm. See FSA, 1986, sched. 1, ¶ 30, *published in* 2 *Fin. Servs. Rep. (CCH)* at 102,574.

136. See SFA Rule 4-53(2)-(3).

137. See SFA Rule 4-50(2)(b).

A similar set of considerations applies to the selection of correspondent brokers for the deposit of customer property. The FIA Recommendations also enumerate guidelines to assist in the evaluation of correspondent brokers. An analysis based on these guidelines ought to be considered by FCMs in their evaluation of correspondent brokers, especially where the FCM's relationship with such entity may be at less than arm's length.

The primary considerations recommended by the FIA include the correspondent broker's credit standing, capital adequacy, and overall financial condition, as well as the clearing organizations and/or exchanges, if any, of which it is a member. Another primary factor to consider involves whether the correspondent broker is also part of a bank, securities broker, or insurance company.¹³⁸ The FIA suggests an evaluation of the correspondent broker's management experience and capabilities, its margin policies and customer credit procedures, its operational capacity, risk management systems and disaster recovery procedures, and whether or not it engages in proprietary trading.¹³⁹ Included among the factors to consider in evaluating a correspondent broker is the risk that the correspondent broker may default as a result of the following:

- (1) the trading activities of the correspondent broker or its affiliates;
- (2) the trading activities of other customers of the correspondent broker;
- (3) the procedures used by the correspondent broker in establishing customer accounts and in the monitoring and management of credit and other risks arising from its carrying of such accounts; and
- (4) the default of a clearing broker or depository utilized by the correspondent broker.¹⁴⁰

On the basis of this evaluation, certain procedures may be implemented to protect against the risk of executing and/or clearing transactions through certain correspondent brokers.¹⁴¹ The FIA Recommendations suggest that users of correspondent brokers "may wish to consider obtaining from the correspondent broker a form of

138. Futures Industry Association Global Task Force on Financial Integrity, *supra* note 131, ¶ 29.

139. *See id.*

140. *See id.* ¶ 28.

141. *See id.* ¶ 29.

credit enhancement, such as an affiliate guarantee or the guarantee (or letter of credit) of a third party."¹⁴²

D. Exculpatory Clauses in Customer Agreements

To clarify the scope of their responsibilities to customers, many FCMs have drafted into their customer agreements exculpatory clauses relieving the FCM from responsibility for customer losses due to the misconduct of third parties beyond the FCM's control. For example, a typical clause might read:

FCM is acting solely as Customer's *agent* in connection with Customer's account and neither FCM nor its affiliates shall have any responsibility or liability to Customer hereunder in connection with the performance or nonperformance of any contract market, clearinghouse, clearing firm, or other party of its obligations in respect of any contract or any property of the Customer.

At common law, a fiduciary's duty of care could be modified by the mutual agreement of the parties, subject to the proviso that a fiduciary could not exculpate itself from liability for negligence of a gross character.¹⁴³ In addition, absent a contrary legislative directive, courts generally permit the enforcement of exculpatory clauses in customer agreements.¹⁴⁴

Customers, however, may challenge the enforceability of such exculpatory provisions based on several decisions denying the enforceability of such clauses under certain circumstances. For example, in *Resolution Trust Corp. v. Krantz*,¹⁴⁵ the defendants sought to avoid liability for the allegedly fraudulent conduct of a guaranteed Introducing Broker ("IB") by invoking an exculpatory clause providing:

142. See *id.* ¶ 1. If such credit enhancement devices are used, users or correspondent brokers should ensure their understanding of the terms and scope of such credit enhancements as well as their legal enforceability.

143. See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 222 (1959).

144. See *Rothwell Cotton Co. v. Rosenthal & Co.*, 827 F.2d 246, 250 (7th Cir.), *as amended*, 835 F.2d 710 (7th Cir. 1987); *Wolf v. Ford*, 644 A.2d 522, 525 (Md. 1994); see also RESTATEMENT (SECOND) OF CONTRACTS § 195 cmt. a (1981) ("[A] party to a contract can ordinarily exempt himself from liability for harm caused by his failure to observe the standard of reasonable care imposed by the law of negligence.").

Under certain circumstances, however, public policy concerns preclude the enforcement of certain exculpatory clauses. For example, a party may not exculpate itself for liability for intentional harm or for more extreme forms of negligence. See *Winterstein v. Wilcom*, 293 A.2d 821, 824-25 (Md. Ct. Spec. App. 1972); RESTATEMENT (SECOND) OF CONTRACTS § 195(1) (1981). Moreover, the contract containing the exculpatory clause may not be the result of "grossly unequal bargaining power." *Wolf*, 644 A.2d at 526. Finally, exculpatory provisions will not be enforced in transactions affecting the public interest. This category includes such public service obligations as public utilities, common carriers, innkeepers, and public warehousemen. See *id.*

145. No. 89-C166, 1991 U.S. Dist. LEXIS 10171 (N.D. Ill. July 22, 1991).

Customer[] acknowledges that [defendant's] performance hereunder, as principals, may result from activities of independent agents or Introducing Broker's [sic] for whose activities [defendant] may be technically legally liable. Customer agrees to waive any claims against, and to indemnify, defend, save and hold free and harmless [defendant] for any activities of its independent agents, Introducing Brokers or their employees of which [defendant] has no actual prior knowledge or participation¹⁴⁶

The court noted that the section of the Act at issue¹⁴⁷ imposed strict liability on principals for the misdeeds of agents conducted in furtherance of the scope of their agency.¹⁴⁸ In addition, the Act specifically described the legal relationship between IBs and FCMs as one of agency.¹⁴⁹ Under the circumstances, the court found that the exculpatory clause in the customer agreement shifted "the risk from the FCM, where Congress delegated the risk, to the customer," where the customer is itself the victim of the wrongful acts. Hence, the court found the clause void and unenforceable "as being against the strong public policy laid out by Congress."¹⁵⁰

*Myron v. Hauser*¹⁵¹ contains another example of an invalid exculpatory clause. The clause at issue stated that the customer would not hold the FCM liable for losses incurred as a result of the FCM's trading recommendations. The court found the clause invalid on the grounds that the FCM's sales representative failed to explain properly to the customer the risks and mechanics of trading, or the fact that the particular strategy recommended could result in the total loss of the customer's investment.¹⁵² In finding the clause a term of adhesion,¹⁵³ the court stated, "[Petitioner] cannot use the customer agreement as a contractual shield against valid federal regulation and liability for violation of such regulation, or as an 'advance exoneration of contemplated fraudulent conduct.'"¹⁵⁴

146. *Id.* at *2-*3.

147. See 7 U.S.C. § 4 (1994) ("[T]he act, omission or failure of any official, agent, or other person acting for [an entity regulated by the CFTC] within the scope of his employment or office shall be deemed the act, omission, or failure of" the entity itself.").

148. See *Resolution Trust Corp.*, 1991 LEXIS 10171, at *8.

149. See *id.* at *8-*9. A different outcome was reached in *Nyhart v. Ancil*, No. 88-C938, U.S. Dist. LEXIS 9995 (N.D. Ill. Sept. 1, 1988), where the relationship involved was less direct (employee of an IB and an FCM that was the owner of another FCM affiliated with the IB).

150. *Resolution Trust Corp.*, 1991 LEXIS 10171, at *10.

151. 673 F.2d 994 (8th Cir. 1982).

152. See *id.* at 996.

153. A "standardized contract [term] offered to consumers of . . . services on essentially 'take it or leave it' basis without affording consumer realistic opportunity to bargain and under such conditions that consumer cannot obtain desired . . . services except by acquiescing in form contract." BLACK'S LAW DICTIONARY 38 (5th ed. 1979).

154. *Myron*, 673 F.2d at 1007 (citations omitted).

Although courts disfavor exculpatory provisions that expressly contradict a provision of the Act, certain other exculpatory provisions generally are enforced. For example, in *Rothwell Cotton Co. v. Rosenthal & Co.*,¹⁵⁵ a customer claimed against a clearing member FCM for the allegedly fraudulent sales practices of another, nonclearing member FCM that introduced the account. The court ruled that the exculpatory clause contained in the clearing member FCM's agreement with the customer, which relieved itself from all liability not related to the execution and clearing of contracts, was enforceable.¹⁵⁶ The court in *Nyhart v. Anctil*¹⁵⁷ reached a similar conclusion. In *Nyhart*, a customer sought to recover losses from an employee of an IB, the IB, the IB's FCM, and another entity (itself an FCM) that wholly-owned the IB's FCM ("Index Futures"). Index Futures sought to have the complaint dismissed against itself insofar as the customer entered into an agreement containing an exculpatory clause relieving Index Futures from liability for customer losses "incurred as a result of other than its own gross negligence or willful misconduct concerning the execution of trades for the [customer's] [a]ccount."¹⁵⁸ The court based its holding on the conclusion that the provision in the customer agreement was in plain language and was highlighted in boldface. Moreover, the court noted that the complaint did not allege that either the IB or the IB's FCM were agents of Index Futures. According to the court, "[i]n the absence of an agency relationship, the exculpatory clause merely limit[ed Index Futures'] liability to conduct for which [it] was responsible: the execution and clearing of trades."¹⁵⁹ As a result, the court held that the exculpatory clause was not inconsistent with the Act.¹⁶⁰

FCMs could therefore argue that a customer agreement provision exculpating itself from liability for the acts of third parties should be enforced because it is not contrary to the expressed intent of Congress. Unenforceable exculpatory clauses, like those in *Krantz* and *Myron*, involved attempts by the FCM to avoid liability for acts of agents or for failing to adequately disclose the risks of a particular trading strategy, both required by specific provisions of the Act.¹⁶¹

155. 827 F.2d 246 (7th Cir. 1987).

156. *See id.* at 250.

157. *See* 1988 LEXIS 9995 at *6.

158. *Id.* at *5.

159. *Id.* at *7.

160. *See id.* at *6.

161. As stated above, the relationship between an FCM and its deposit of customer property with a correspondent broker or bank depository may be characterized as one of creditor-debtor, and not one of agency. *See supra* text accompanying note 107.

Based on the holding in *Nyhart*, an FCM could argue that its exculpatory clause does no more than limit its responsibility to its own conduct, and as such, should be enforceable.

E. The Interrelationship Between Exculpatory Clauses and Net Capital Requirements

As discussed above,¹⁶² minimum financial requirements exclude current assets that are “doubtful of collection or realization” from the calculation of an FCM’s assets for net capital purposes.¹⁶³ In the event of the default of a depository institution, the operation of these rules may significantly impair the viability of an FCM that has placed a portion of its customers’ funds with such depository.

To illustrate the operation of the minimum financial requirements, consider the following example. FCM XYZ with total capital of \$50 million is required, as a result of its customer’s trading activities, to maintain a minimum adjusted net capital balance equal to \$40 million. FCM XYZ therefore has \$10 million in excess capital. Twenty million dollars represents the Secured Amount balance generated by customers trading on non-United States exchanges through FCM XYZ. In the ordinary course of its business, FCM XYZ will reflect this activity on its balance sheet as a liability to its customers of \$20 million and as a \$20 million asset in the form of a deposit with a foreign depository institution. Thus, the overseas deposit has no net balance sheet effect and the only change to required net capital is the charge for the deposit (i.e., four percent of \$20 million).

The default of a foreign depository institution holding the \$20 million Separate Account deposit would, absent the intervention of another institution to assume the obligations of the foreign depository, cause the deposit to be treated as an “asset doubtful of collection or realization.” Hence, FCM XYZ would have to exclude the \$20 million Separate Account from its assets in calculating adjusted net capital. The \$20 million liability to customers, however, would remain and FCM XYZ would have to rely on other sources of capital to meet its minimum financial requirement. Based on the assumption described above, since FCM XYZ only has \$10 million in excess net capital, the requirement of balancing the \$20 million owed to customers with a corresponding asset would exhaust the FCM XYZ’s excess capital and

162. See *supra* text accompanying notes 38-45.

163. 17 C.F.R. § 1.17(c)(2)(iv) (1995).

result in its undercapitalization. Absent additional capital infusions from other sources FCM XYZ would have to cease doing business.

If FCM XYZ were to go into bankruptcy, the distribution of its assets would be governed by specific CFTC regulations and the Bankruptcy Code. As discussed above, the regulations and Code accord differing priorities to the various forms in which customer funds may be held. To the extent that property segregated on behalf of customers is insufficient to satisfy all claims of customers, the CFTC's regulations affirmatively require a bankrupt FCM to apply its own property. Thus, FCM XYZ would exhaust its \$10 million excess capital reserve to restore half of the balance deposited by foreign futures account customers. The remainder would be restored by invading the FCM's core capital.

No specific provision of the Act or the CFTC's regulations directly mandates this conclusion where the FCM remains in business following the default of a depository institution. CFTC Rule § 1.22 has been cited to require an FCM to cover shortfalls in customer accounts out of the FCM's own reserves.¹⁶⁴ Rule § 1.22, however, only prohibits an FCM from using the funds of one customer to purchase, margin, or settle the trades of any other customer.¹⁶⁵ This rule is principally intended to make certain that funds belonging to solvent customers are not used to margin the trades of debtor customers. To argue that Rule § 1.22 requires an FCM to cover shortfalls in customer accounts out of the FCM's own reserves under circumstances not involving a debtor customer, but instead involving the default of a depository institution, assumes that the FCM may effectively become an absolute guarantor of its customers' funds.

Neither Rule § 1.22 nor any other regulatory provision directly addresses the obligations of an FCM upon the default of a third party depository institution, nor do the regulations address the status of the customer's segregated funds in such a circumstance. In the absence of clear regulatory guidance as to the existence and scope of a solvent FCM's obligations to its customers following such a default, customers would argue in favor of imposing an affirmative obligation on such FCMs based upon the sources previously discussed. Specifically, customers would maintain that the FCM is liable based on the common law's treatment of brokers as fiduciaries, the intimations in the legislative history of the Act's segregation provisions, and subsequent dicta

164. See Corcoran & Ervin, *supra* note 75, at 873, 877.

165. See 17 C.F.R. § 1.22.

in legal opinions and administrative pronouncements confirming the creation of such a relationship. Regulators could argue on public policy grounds that a solvent FCM's capital ought to be used to pay its customers for losses caused by the default of third parties selected by such FCM to hold customer funds. The purpose of the minimum financial requirements is to avoid customer losses in the event of an FCM's default. Under this view, the ability to use the "safety cushion" provided by the net capital rules is implicit in the regulations requiring FCMs to maintain such a cushion.

FCMs could respond by citing the apparent exclusion of the term "as trust funds" in the legislative history as a rejection of the creation of a traditional common law fiduciary relationship. Moreover, even if such a relationship were deemed to exist, an FCM could argue that it exercised the requisite level of care in selecting the depository institution. The FCM could do so by demonstrating its compliance with, for example, the FIA's recommended guidelines.

The presence of exculpatory clauses in an FCM's customer agreement may further complicate the resolution of this issue. As discussed, though the enforceability of such clauses depends upon the unique facts and circumstances of each individual case, the case law nevertheless generally enforces such clauses absent a contrary statutory or regulatory provision. An enforceable exculpatory clause relieving an FCM from liability to its customers for losses caused by the default of a depository institution arguably may lead to the FCM not having to reimburse its customer and not being deemed to be undercapitalized.

Although an enforceable exculpatory clause will not restore the assets lost through the default of a depository institution, it may eliminate the FCM's liability to customers in the FCM's computation of its minimum financial requirements, thus potentially permitting an FCM to continue its business. Under circumstances where the FCM remains a going concern following the failure of a foreign depository institution, one could reasonably expect the CFTC to object to this position. Nevertheless, the FCM's response that its customer freely and knowingly entered into an agreement containing a valid exculpatory clause, might be sustained in a final adjudication.

An enforceable exculpatory clause also may lead to a different outcome where the FCM is itself forced into bankruptcy following the default of a depository institution. In such a situation, absent an exculpatory clause as a possible basis for argument, Rule § 190.08 af-

firmatively obligates an FCM to draw on its own capital by treating the FCM's capital as "customer property" to the extent funds segregated by the FCM on behalf of its customers are insufficient to meet the losses incurred. An enforceable exculpatory clause may allow an FCM to argue that Rule § 190.08 does not apply to the extent that the customer has taken responsibility for the losses occasioned by the failure of the depository institution.

CONCLUSION

The United States regulatory system has been singularly successful in protecting customer funds invested in United States futures markets with exchange member firms from systemic risk. Over the years, the system has successfully weathered market crashes as well as several high-profile defaults like Volume Investors and Stotler & Co. The ability of the system to limit the impact of the default of Barings plc in February 1995 may be interpreted as yet further proof of its ability to insulate against such risk. However, at least one area of risk raised by the Barings crisis — the responsibility of FCMs for losses of customer funds caused by the default of a depository institution — was never addressed.

Absent the participation of an institution willing to assume the margin obligations of the failed depository institution, the ensuing struggle among FCMs, customers and regulators regarding the responsibility for customer losses, particularly where the FCM remains a going concern, is almost certain to involve issues regarding the FCM's care in selecting the depository and the enforceability of an exculpatory clause, if any, in the FCM's customer agreement. As discussed in this article, the FIA's "Financial Integrity Recommendations" provide FCMs with guidance as to some of the more salient factors to consider in selecting depository institutions, including correspondent brokers. FCMs that have adopted the FIA's recommendations will be better positioned to disclaim responsibility for customer losses following the default of a depository institution than those FCMs that have not. In addition, an FCM that has drafted into its customer agreement an enforceable exculpatory clause will have a colorable position that it is not responsible for customer losses following the default of a depository institution. Absent definitive regulatory or judicial guidance, however, customers, FCMs, and their respective correspondents will have to deal with the uncertainty surrounding this important link in the financial integrity chain.