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Volatile Commodity Markets: Are Customers Protected?

During the first half of 2008, news of the growing commodities “bubble” and concern over the effects of speculation on the price of commodities dominated the financial headlines.

The prices for oil, wheat and gold rose to record levels.¹ The price of rice had doubled in the past year, corn had advanced 68 percent, wheat 92 percent, soybeans 50 percent and copper prices 26 percent.² Investments in commodities rose by more than a fifth in the first quarter of 2008 to \$400 billion.³ Indexes linked to commodities took in an unprecedented \$235 billion.⁴ By the end of the first half of 2008, it was clear that commodities finished their best first half in 34 years.⁵

In response to the rising commodities prices, legislators were scrambling to introduce new legislation targeting low margin lending requirements, which are often as low as 5 percent to 8 percent.⁶ One such proposal, Senate Bill 3183, from Senator Byron Dorgan, D.-N.D., sought to curb speculation by raising margins to 25 percent for energy traders that were not commercial producers or purchasers. The bill was referred to the Committee on Agriculture, Nutrition and Forestry on June 24, 2008, where it awaits further action. On Sept. 18, 2008, the House of Representatives voted to approve the Commodity Market Transparency and Accountability Act. The bill increases oversight of the commodity markets and sets limits on energy contracts. This legislation was moved to the Senate for its approval on Sept. 22, but no action has taken place yet.⁷ However, the bill’s future is unclear as the White House has already



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suggested President George W. Bush will veto the bill if it is passed by Congress.⁸

A more volatile picture of the commodity markets has emerged in the second half of 2008. After a high of \$143.67 a barrel just months earlier in July, pricing on crude oil futures contracts were down to \$91.51 a barrel on the New York Mercantile Exchange on Sept. 16, just to rise again to \$104.55 by the end of that week.⁹ The S&P 500’s exchange-traded fund for the basic materials sector declined by more than 10 percent from June to July.¹⁰ Trading in corn, soybeans and wheat have also seen dramatic decreases.¹¹ While the current declines may not mean the end for the commodity bull cycle,¹² the commodity markets are less predictable than during the first six months of the year.

Whether price increases in commodities have been the result of speculation or economic and geopolitical forces remains open for debate. However, not debatable is that the volume of trading on the commodity markets has increased dramatically over the past decade, as seen by the 27 percent increase during 2007 over the prior year.¹³ The commodity markets have grown more in the previous five years than at any point in history, in part due to an increase among institutional investors, including hedge funds, buying into these markets as an alternative to the equity markets.¹⁴ Institutional investors now make up a larger share of outstanding commodities futures contracts than any other market participant.¹⁵

Given the increased investing in the commodity markets, a paramount issue is whether adequate safeguards exist to protect these investors should their commodity brokers fail. Importantly, the provisions relating to the liquidation of a commodity broker, as set forth in the Bankruptcy Code (the Code) and the Commodities Exchange Act (the act), are focused toward protecting customers rather than general creditors. Should a commodity broker have to file for bankruptcy, the broker’s customers are provided certain priorities in bankruptcy that protect their respective accounts.

CFTC Regulates Brokers

In order to trade on an exchange, a commodity broker must register with the Commodity Futures Trading Commission (the CFTC) and meet certain financial requirements. Each market is required to set standards that are the same as, or more stringent than, what the CFTC requires. The CFTC must approve these financial requirements, which generally include strict reporting requirements so that the exchanges and CFTC can monitor the commodity broker’s financial situation.¹⁶ If a commodity broker falls below the required minimum capital standards, the broker’s right to trade is put on hold, and its membership can be suspended.¹⁷ Further, the commodity broker’s accounts may be moved and the business halted.

Chapter 7 Is Available

Commodity brokers cannot reorganize under chapter 11 of the Code.¹⁸ The only type of relief available to commodity brokers under the Code is liquidation under subchapter IV of chapter 7.¹⁹ This subchapter of chapter 7 is supplemented by regulations established by the CFTC, created pursuant to §24 of the act.²⁰ The act gave the CFTC authority to promulgate rules on the liquidation of commodity brokers.²¹

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The CFTC has utilized this authority and created rule 190 (CFTC Rule 190), which, in conjunction with the Code, provides a set of rules for operating and liquidating commodity brokers in bankruptcy.²²

The Code and CFTC Rule 190 protect customers of commodity brokers that file for bankruptcy by (i) granting them claims against "customer property" in priority over general unsecured claims; (ii) providing for a pro rata distribution of all customer property among customers; (iii) requiring that best efforts be used by the debtor broker to transfer all customer accounts to another commodity broker in a bulk transfer; and (iv) allowing customers to decide whether to have their accounts transferred or liquidated. These provisions also seek to prevent disruption in the commodity markets that may result from the imposition of the automatic stay and certain avoidance powers granted to a trustee in bankruptcy.²³

Qualifying as a Broker

A commodity broker under the Code includes a futures commission merchant (FCM), which is defined by the act to mean "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."²⁴ To be an FCM, two conditions must be met: (i) the individual, association, partnership, corporation or trust must deal in orders for the purchase or sale of a commodity for future delivery; and (ii) the commodity must be on or subject to the rules of a contract market.²⁵ Whether or not a board of trade is a "contract market" is a determination made by the CFTC.

Treating Customer Accounts

Section 761 of the Code defines "customer property" to include cash, securities and property and proceeds thereof, held by or for the account of the debtor from or for the account of a customer, including, but not limited to, (i) property held to margin, guarantee, secure, purchase or sell a commodity contract; (ii) profits or contractual rights accruing to a customer as a result of a commodity contract; and (iii) an open commodity contract.²⁶ Commodity customers include parties for whom an FCM deals and who hold claims against an FCM on account of a commodity contract.²⁷

A commodity broker must treat each customer account separately.²⁸ Although

one customer's various accounts may be aggregated together, accounts of various customers may not. Such separate treatment will allow for proper pro rata distribution of customer property upon liquidation.²⁹ However, to facilitate a pro rata distribution, the bankruptcy trustee may pool customer property to ensure customers receive their fair share.

Customers have authority in the debtor's bankruptcy to direct the trustee how to distribute their identifiable commodity contracts. This helps ensure that these contracts remain the customers' property and do not become part of the debtor's estate.³⁰ Such separate treatment and customer control reflect the belief that a customer's investment should depend only on the fluctuations of the commodity markets, and not on the commodity broker's skill or behavior.³¹ Further, these provisions in the Code ensure that usual bankruptcy practices and goals will not operate in a commodity

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broker liquidation in such a way to affect confidence in the commodity markets on a greater scale.

Certain provisions of the Code allow exceptions to the automatic stay and protect particular transfers from avoidance. In a commodity broker liquidation, the automatic stay does not interfere with a commodity broker's right to set off any termination value, payment amount or transfer obligation arising under a commodity contract.³² A trustee may not avoid transfers made by the commodity broker that are (i) transfers or liquidations of commodity contracts entered into or carried by the debtor on behalf of a customer and done within five days of filing for chapter 7; (ii) transfers that represent margin payments or settlement payments by or to commodity brokers; or (iii) transfers of commodity contracts or futures contracts by or to commodity brokers made before commencement of the chapter 7 case.³³ Again, these provisions are meant to allay

concerns that the bankruptcy of one broker "in the clearance and settlement chain could produce a ripple effect that threatens other parties in the chain."³⁴

Distribution of Net Equity

Customer property "shall be ratably distributed to customers on the basis of the 'net equity' in their accounts...after the preservation and return of all 'specifically identifiable property' held for specific customers."³⁵ Distributions on a customer's net equity can be in the form of (i) cash; (ii) the return or transfer of specifically identifiable customer securities, property, or commodities contracts; and (iii) payment of margin calls.³⁶ Net equity, which is the basis for distributions, is calculated as the sum of (i) the value of customer property remaining in a customer's account immediately after all commodity contracts have been transferred, liquidated, or identified for delivery and all obligations of the customer have been offset (such as margin payments and brokerage commissions), plus (ii) the value of specifically identifiable customer property returned to the customer prior to the time of the calculation required in (i), plus, (iii) if applicable, the value of any such contract, margin or security to which the customer is entitled, but the trustee has transferred to another party.³⁷

However, in certain circumstances, this scheme may be altered. Notably, a bankruptcy court in the Southern District of Florida decided to forgo a distribution scheme based on customer's net equity claims due to the broker's inability to keep accurate records. Instead, a distribution scheme based on principles of restitution was established.³⁸

Shortfalls in customer property must be treated as general unsecured claims.³⁹ *In re Griffin Trading Co.* involved a challenge by the bankruptcy trustee to the distribution scheme in the Code. The Griffin Trading Co. was a Chicago FCM, and a member firm at the Chicago Board of Trade since 1976, that, at the beginning of 1999, was unable to meet its trading obligations as a result of approximately \$10 million in losses by a London trader, who used the Griffin Trading Co. to clear his transactions.⁴⁰ In the bankruptcy, there was insufficient customer property to satisfy customer accounts, and the trustee sought authority to use all of the estate assets to satisfy customer claims. The court denied the trustee's motion on the grounds that CFTC Rule 190.08 overreached and contravened §766(j)(2) of the Code,

which states that “if a customer is not paid the full amount of such customer’s net equity claim from customer property, the unpaid portion of such claim is a claim entitled to distribution under section 726 of this title.”⁴¹ Section 726 of the Code governs distribution of estate assets to unsecured creditors.

Conclusion

Customers of a commodity broker have protections under the Code should their broker need to file for chapter 7. A broker filing for bankruptcy does not affect customers’ control over transferring their accounts to other brokers to the extent the customers are entitled to distributions and the transfers are done within a specific time frame; nor are customers’ distributions diluted in a bankruptcy proceeding by claims from unsecured creditors of the commodity broker. Such protection is important in light of the fact that commodities trading has grown substantially, approximately six-fold, in the past decade.⁴²

Nonetheless, a chapter 7 filing is not free of inconvenience. Except for offsetting open commodity contracts, trading is frozen once a filing occurs. Further, once a broker files for bankruptcy, the trustee can, for purposes of distributing customer property on a pro rata basis, treat the property of all customers as a single pool of funds.



1. See Saijel Kishan & John Rega, “Soros Says Commodity ‘Bubble’ Still in ‘Growth Phase,’” BLOOMBERG, April 17, 2008, <http://www.bloomberg.com/apps/news?pid=20670001&refer=&sid=aLSge4iZvG3g>.

2. See id.

3. See id.

4. See Millie Munshi & Claudia Carpenter, “Commodities Signal Bubble Bursting as First-Half Ends,” BLOOMBERG, June 30, 2008, <http://www.bloomberg.com/apps/news?pid=20670001&refer=&sid=YZDR265XCpw>.

5. See id.

6. See Carolyn Cui, “Higher Margins Considered to Curb Commodity Speculation,” WALL ST. J., July 10, 2008, at C3.

7. The House of Representatives also approved the Energy Markets Emergency Act of 2008 in early July 2008, but the Senate has yet to act on it.

8. See Jesse A. Hamilton, “House Votes to Tighten Control on Oil Speculation,” THE COURANT, Sept. 18, 2008, <http://www.courant.com/news/politics/hcu-houseoilvotes-0918,0,493547.story>.

9. See Margot Hibiby, “Oil Climbs More Than \$6 in Biggest Three-Day Rally Since 1998,” BLOOMBERG, Sept. 19, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arSkz2hDwmc>.

10. See David Gaffen, “Raw Materials Feeling

the Heat,” WALL ST. J., July 18, 2008, at C5.

11. See Jae Hur, “Corn, Soybeans Drop as Credit Turmoil May Hurt Economy, Demand,” BLOOMBERG, Sept. 16, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHpO3ERCuKJw>.

12. See Jad Mouawad and Clifford Krauss, “Crude Oil Prices Rise Amid Dwindling Inventories,” N.Y. TIMES, Sept. 18, 2008, at C8.

13. See Hearing on the Commodity Futures Trading Commission and Securities and Exchange Commission Budgets Before the S. Subcomm. on Fin. Services and Gen. Gov’t Comm. on Appropriations, 110th Cong. 7 (2008) (statement of Walter L. Lukken, Acting Chairman, Commodity Futures Trading Commission) (hereinafter Lukken Testimony).

14. See Hearing on Financial Speculation in Commodity Markets Before the S. Comm. on Homeland Security and Gov’t Aff., 110th Cong. 1 (2008) (statement of Michael W. Masters, Managing Member/Portfolio Manager, Masters Capital Management, LLC) (hereinafter Masters Testimony); Caroline Braun, “Pension Funds ‘Diversify’ Into Commodities Bubble,” BLOOMBERG, May 14, 2008, <http://www.bloomberg.com/apps/news?pid=20670001&refer=&sid=aZBYblEmb.v0>.

15. See Masters Testimony, supra, note 14 at 1.

16. See 17 C.F.R. §1.52.

17. See, e.g., Chicago Board of Trade Rule 513.00. CFTC Reg. §8.25 (17 C.F.R. §8.25) allows the contract markets to take action to protect the best interests of customers and the marketplace. See Philip McBride Johnson & Thomas Lee Hazen, DERIVATIVES REGULATION 486 n.193 (2004).

18. See 11 U.S.C. §109(d) (“Only...a person that may be a debtor under chapter 7 of this title (except a stockbroker or a commodity broker)... may be a debtor under chapter 11 of this title.”). As an alternative, a commodity broker may be subject to a federal equity receivership at the request of the CFTC.

19. See 11 U.S.C. §§761-67.

20. See 7 U.S.C. §24.

21. See 7 U.S.C. §§2(a)(2), 24(a).

22. See 17 C.F.R. §190.01 et seq. Notably, commodity brokers do not qualify for liquidation under the Securities Investor Protection Act (SIPA), which is the Securities and Exchange Commission alternative to Chapter 7 liquidation for stockbrokers. SIPA provides insurance of up to \$500,000 for each customer account to the extent the estate has insufficient funds to pay customer claims. CFTC Rule 190 provides no such insurance policy for commodity broker customers.

23. See *In re Grafton Partners, L.P.*, 321 B.R. 527, 532-533 (B.A.P. 9th Cir. 2005).

24. 7 U.S.C. §2; 11 U.S.C. §761. Foreign futures commission merchants, clearing organizations, leverage transaction merchants, and commodity options dealers are also commodity brokers under the Code.

25. See *In re Co Petro Marketing Group Inc.*, 680 F.2d 566, 569 (9th Cir. 1982). In this case, the court held that the debtor, which sold contracts for the future delivery of petroleum products, was not a commodity broker because there was no designated market for the commodities it sold.

26. See 11 U.S.C. §761(10); see also *In re Griffin Trading Co.*, 245 B.R. 291, 303 (N.D. Ill. 2000) (court found provision of CFTC Rule 190 expanding definition of customer property exceeded

the CFTC’s rule-making authority and contradicted the Code). Note that *In re Griffin Trading Co.* was vacated pursuant to a subsequent settlement between the parties. However, commentators concur that it is likely that other attacks on this section of CFTC Rule 190 could occur.

27. See 11 U.S.C. §761(9).

28. See 11 U.S.C. §763.

29. See Collier on Bankruptcy ¶763.02 (Alan N. Rosenberg & Henry J. Sommer, Eds., 15th ed. rev.).

30. See 11 U.S.C. §765.

31. See *In re Co Petro Marketing Group Inc.*, 680 F.2d at 571.

32. See 11 U.S.C. §362(b)(6).

33. See 11 U.S.C. §§764(b), 546(e).

34. *In re Grafton Partners, L.P.*, 321 B.R. at 536.

35. *In re Trending Cycles for Commodities Inc.*, 27 B.R. 709, 710 (Bankr. S.D. Fla. 1983). Section 766 of the Code mandates that the trustee must “return promptly to a customer any specifically identifiable security, property, or commodity contract to which such customer is entitled, or shall transfer, on such customer’s behalf, such security, property, or commodity contract to a commodity broker that is not a debtor under this title.” 11 U.S.C. §766(c).

36. See 11 U.S.C. §766(h).

37. See 11 U.S.C. §761(17); S. REP. No. 95-989 (1978); 17 C.F.R. §190.07(b).

38. See *In re Trending Cycles for Commodities*, 27 B.R. at 710-711.

39. See 11 U.S.C. §766.

40. See “Futures Trading Firm Files for Bankruptcy,” N.Y. TIMES, Jan. 1, 1999, at C16.

41. 11 U.S.C. §766(j)(2); see also *In re Griffin Trading Co.*, 245 B.R. at 317.

42. Lukken Testimony, supra, note 13, at 3.