

**IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

COMMODITY FUTURES TRADING	:	CIVIL ACTION
COMMISSION,	:	
	:	
Plaintiff,	:	
	:	
v.	:	
	:	
PAUL M. EUSTACE AND PHILADELPHIA	:	No. 05-CV-2973
ALTERNATIVE ASSET MANAGEMENT	:	
COMPANY, LLC,	:	
	:	
Defendants.	:	

**MEMORANDUM OF LAW OF THE FUTURES INDUSTRY ASSOCIATION, INC.
AS *AMICUS CURIAE* IN SUPPORT OF
MAN FINANCIAL, INC.'S MOTION FOR A PROTECTIVE ORDER**

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INTRODUCTION

The Receiver's motion to have Man Financial, Inc. held in contempt in this case depends on an unprecedented legal position that – if accepted – would upset long-established customs, practices, and expectations in the futures industry.

Under regulations issued by the Commodity Futures Trading Commission ("CFTC") and the requirements of the various futures exchanges, commodity brokers like Man Financial (also known as futures commission merchants or "FCMs") are subject to stringent federal regulation, including regulatory capital requirements, and are obligated to ensure that a customer's positions are always adequately margined. Pursuant to such regulatory capital and margin requirements, FCMs have always been able, and must always be allowed, to net the equity and debit balances of all accounts owned by the same customer acting in the same capacity.

FCMs have long operated under established industry practices and regulations that recognize that multiple sub-accounts held by an identical beneficial owner in the same capacity are presumed to be part of a single, combined account, unless the parties contract otherwise. A customer may, as in this case, for its own administrative convenience, ask its FCM to divide its trading activity among several different bookkeeping entries – more appropriately called sub-accounts. But the establishment of multiple sub-accounts does not change the fact that the sub-accounts constitute a single account and the real value of the assets held by the FCM is the combined value of all of the sub-accounts – a point well understood by all professionals in the industry.

However, even if such sub-accounts were to be viewed as separate accounts and the “netting” that took place in this case between the sub-accounts were to be construed as a transfer or offset – as opposed to simply a matter of accounting within a combined account – to comply with regulatory requirements such netting will of necessity have occurred throughout the life of the sub-accounts, prior to entry of the restraining order and prior to the liquidation of the positions held in the sub-accounts. An FCM like Man Financial cannot be held in contempt for the necessary and legitimate practice of treating all accounts owned by a single customer as a single account for margin purposes or for determining the customer’s equity or debit.

By concluding that a commodity broker does *not* have the power to combine or “net” the sub-accounts when a customer is in receivership, the Receiver insists on disaggregating what the industry regards as an integrated whole – based on both practice and applicable law. In this case, the Receiver would have the Court ignore these long-established practices and the law in favor of cherrypicking only the gains and foisting the customer’s losses back on the commodities broker.

Given the significant implications of this issue for the futures industry, *Amicus* urges this Court to grant Man Financial’s motion for a protective order.

STATEMENT OF INTEREST OF *AMICUS CURIAE*

The Futures Industry Association, Inc. (“FIA”) was founded in 1955 and serves as a principal advocate for the commodity futures and options industry. With more than 180 corporate members, FIA reaches thousands of people involved in this industry.

FIA's regular membership is comprised of thirty eight of the nation's largest commodity brokers, including the top twenty firms in terms of customer equity. These FCMs buy and sell futures and options contracts on organized commodity exchanges as agents on behalf of their customers. FIA estimates that its members are responsible for more than 90% of the customer business on U.S. futures exchanges.

Among FIA's associate members are representatives from virtually all other segments of the futures industry, both national and international. They include international exchanges, banks, legal and accounting firms, commodity trading advisors, and information and equipment providers headquartered here and abroad.

Given the breadth of its membership and its history of scholarship and advocacy for the futures industry, FIA is uniquely well positioned to assist the Court in its consideration of this important issue.

STATEMENT OF FACTS

FIA understands the basic facts of this dispute to be as follows: The Philadelphia Alternative Asset Fund, Ltd. ("PAAF") – a fund engaged in futures trading – opened an account with Man Financial. Although its relationship with Man Financial was governed by a single account agreement, PAAF's assets and trading activities were divided among two sub-accounts, each with a different account number.¹ With respect to the two sub-accounts at issue here, PAAF deposited funds into only one of them; the

¹ Whether these were called "sub-accounts" or "accounts" makes no difference; it is the substance, not the nomenclature, of the parties' dealings that matters.

trading activities in the second sub-account were supported solely by the positive equity (or “margin”) in the first.

PAAF suffered massive trading losses, and the market value of its commodities holdings dropped significantly over time. At the close of business on June 23, 2005, PAAF had a total of \$37 million lodged with Man Financial, with \$212 million recorded in one sub-account account and *negative* \$175 million in the other.

On June 23, 2005, CFTC filed its complaint against Defendants. This Court appointed a receiver and entered a restraining order that froze the assets under the control of Defendants. Then, at the request of the Receiver, Man Financial liquidated the open positions it held for PAAF and paid the balance – \$31.5 million – to the Receiver. The Receiver has now filed a motion to hold Man Financial in contempt on the theory that Man executed a self-help remedy by offsetting the positive balance in one sub-account with the negative balance in the other after the restraining order was effective.

ARGUMENT

The position the Receiver has threatened in this case must be rejected. Many customers maintain multiple sub-accounts with their FCM for bookkeeping purposes. Longstanding customs, practices, and expectations in the futures industry recognize that when a customer has multiple accounts with the same commodity broker, those accounts cannot be viewed independently of one another but instead are merely sub-accounts making up a single combined account. Indeed, to allow the Receiver to disaggregate the accounts at this stage would shift the risk of the customer’s trading

losses onto the FCM and potentially the other customers of the FCM—a result that industry regulations and practice is designed to prevent. Moreover, to the extent that “cross-margining” among accounts of the same customer requires any transfer of funds, those transfers are necessarily made to meet margin requirements on an ongoing basis at the end of each day’s trading activity, rather than occurring only when the accounts are liquidated at the request of the Receiver. Viewed from this perspective, what appears to the Receiver as Man Financial’s “netting” of the two “accounts” after liquidation of the positions was merely a bookkeeping entry that memorialized legitimate netting of equity that took place since the commencement of trading in the second sub-account, well before entry of the restraining order. For all these reasons, Man Financial’s pending motion should be granted.

I. The Receiver’s position ignores longstanding industry custom, practice and regulation, which provides that multiple accounts owned by the same customer in the same capacity are treated as a single account (unless the parties contract otherwise).

Customers that engage in futures trading very often ask their FCMs to subdivide their trading activity by creating several “sub-accounts” for the administrative convenience of the customer. Depending on the bookkeeping system used by the FCM, such sub-accounts may be assigned different account numbers or may be established as sub-accounts under a master account number. Nonetheless, multiple sub-accounts owned by the same customer acting in the same capacity still constitute a single account. An account is subdivided largely for the administrative convenience of the

customer and – unless the parties specifically agree otherwise – the sub-accounts are not treated separately for purposes of margin requirements or otherwise.

There are various reasons why a customer may wish to establish sub-accounts. For example, customers may establish speculative and hedge positions. A customer may establish a speculative position to attempt to achieve profits through the successful anticipation of price movements. JOINT AUDIT COMMITTEE, MARGIN HANDBOOK, at 1-6 (2nd ed. 1999) (JAC HANDBOOK) (attached hereto as Tab 1) (Handbook prepared by the a committee of representatives of US futures exchanges and the National Futures Association which participate in a joint audit and financial surveillance program of the future industry that has been approved and is overseen by the CFTC). A hedge position is established for the purpose of minimizing price risks attendant to a customer's business. *Id.* at 1-3. Hedge positions are generally entitled to lower margin rates than speculative positions. *Id.* at 2-1. To obtain the lower hedge margins, hedge and speculative positions of the same customer must be held in separate accounts unless the FCM is able to identify within a single account hedge positions separately from speculative positions. *Id.* at 2-3. Due to the limitations of most bookkeeping systems utilized by FCMs, almost all FCMs require their customers holding both speculative and hedge positions to maintain those positions in separate sub-accounts.

It is also customary for a customer to establish sub-accounts for bookkeeping purposes to track and analyze the trading performance of different traders, trading strategies, or products employed by the customer. If all of the positions generated by various traders or trading strategies are held in a single account, or if multiple products

are held in a single account, it may be difficult for the customer to break out how much each trader, trading strategy, or product is making or losing. Thus, it is very common for a customer to ask its commodity broker to establish multiple sub-accounts to track the performance of individual traders, to account for different types of trading strategies (such as short term vs. long term trading strategies), or to account for the trading of different products (such as dollar-denominated products vs. Euro-denominated products). In addition, in all of these situations, the margin funds supporting all of a customer's trading activity may be held in one sub-account, supporting the trading positions that are held in one or more other sub-accounts for the same customer.

Unless a customer's agreement with its FCM provides otherwise, accounts under identical ownership may be combined for margin purposes and are treated as a single account. *See* Chicago Mercantile Exchange ("CME") Rule 930.H (Tab 2) ("Clearing members may aggregate accounts under identical ownership within the same classifications . . . for [margin] purposes . . ."); *see also* JAC HANDBOOK at 9-1 ("Identically owned accounts within the same classification of customer segregated [account] . . . *should be combined* for margin purposes. That is, positions across such identically owned accounts may be combined to recognize spreads and to net concurrently long and short positions. Such accounts may be combined even if denominated in different currencies.") (emphasis added).

This presumption acknowledges the economic reality of the customer's trading activity and makes it possible for FCMs to establish sub-accounts as customers request

them for their recordkeeping convenience without requiring that the customers separately fund each sub-account and without being forced to physically transfer funds each day between sub-accounts. Thus, for example, an FCM is not required to issue a margin call simply because one sub-account is under-margined, as long as the customer's sub-accounts taken as a whole have adequate assets to meet the margin requirements for all of the sub-accounts collectively.

The rules and instructions established by the CFTC – the agency that instituted this lawsuit and caused the appointment of the Receiver – specifically support this well-established practice. The CFTC Instructions to its Form 1-FR-FCM Segregation Statement (Pages 10-2 and 10-3) (Tab 3) provide as follows: “If a customer has one or more regulated commodity accounts, an FCM *must combine all such accounts* in determining whether a customer has a net deficit on the FCM's books.” (Emphasis added.) Similarly, the CFTC has expressly acknowledged that if a commodity broker itself enters bankruptcy, the trustee must net credits and debits in futures accounts carried for the same customer. 17 C.F.R. § 190.07(b) (2005) (Tab 4). In determining the “net equity” of a particular customer for purposes of the FCM's bankruptcy, the trustee must “[a]ggregate the credit and debit equity balances of all accounts of the same class held by a customer in the same capacity.” *Id.* § 190.07(b)(2) .

Moreover, relevant CFTC regulations governing an FCM's handling of customer funds speak in terms of the FCM's obligations to a customer (implying all accounts of a customer), and not in terms of the customer's individual accounts. For example, CFTC regulations require that “[e]ach FCM shall treat and deal with the customer funds of a

commodity customer or of an option customer as belonging to such commodity or option customer.” 17 C.F.R. § 1.20(c) (Tab 5); *see also* 17 C.F.R. § 1.22 (Tab 5).

The Receiver’s effort to deconstruct the customer’s consolidated account flies in the face of industry practice and regulatory policy and would expose FCMs to substantial financial risk, and as set forth below, regulatory non-compliance.

Accordingly, his argument should be rejected.

II. Any “netting” that took place between the accounts here necessarily happened on an ongoing basis and at least once during each day of trading, not after the restraining order was entered.

The Receiver’s objection to Man Financial’s handling of PAAMCO’s sub-accounts stems from a second misunderstanding as well; namely, that assets are somehow physically transferred between sub-accounts for netting purposes. This is not the case in practice. In reality, an FCM simply looks to the bookkeeping entries of all sub-accounts under common beneficial ownership when determining the economic value of the aggregate account. As set forth below, the economic value of the aggregate account was required to be calculated and realized by Man Financial on an ongoing basis – no less frequently than daily – well before the restraining order was entered in this case.

The regulations are clear: FCMs, such as Man Financial, must call customers for margin within one day after the event that makes such margin necessary (JAC HANDBOOK at 4-1 (Tab 1); CME Rule 930.E (Tab 2)), must take a charge against its regulatory capital if such margin call is outstanding for three or more business days (17 C.F.R. § 1.17(c)(5)(viii),(ix) (Tab 6)), and may not allow an under margined customer to

establish new positions (JAC HANDBOOK at 6-2, Chicago Board of Trade (“CBOT”) Rule 431.02 (Tab 8)). Thus, the only way that Man Financial could permit an under-margined sub-account with a debit balance to establish and maintain positions would be for Man Financial, on an ongoing basis, to look to the economic value as a whole, in the manner contemplated by the exchange rules, the JAC HANDBOOK, and CFTC Instructions noted above in Section I.

From this perspective, Man Financial’s “netting” of the two sub-accounts upon the eventual liquidation of the positions was effectively an accounting entry that recognized transfers of value that took place daily, commencing with the establishment of the sub-accounts prior to entry of the restraining order.

III. A rule precluding FCMs from netting between sub-accounts would have highly problematic consequences for the futures industry.

The result proposed by the Receiver in this case would upset settled practices and expectations in the futures industry and may cause significant disruption in two very specific respects.

First, and most important, the Receiver’s position would turn the FCM in this case, and potentially all FCMs, into the guarantor of its customer’s trades – a result not permitted by the regulations that govern this industry.² PAAF chose to deposit cash

² CFTC Rule 1.56 prohibits a broker from guaranteeing a customer against loss or from forgoing the exchanges’ requirements that customer accounts be adequately margined. 17 C.F.R. § 1.56 (Tab 7). Similarly, the rules that govern the CME, the New York Mercantile Exchange, and the CBOT all prohibit brokers from making unsecured loans to customers for the purpose of financing their margin requirements. *See, e.g.*, CBOT Rule 431.02 (Tab 8); CME Rule 930.G (Tab 2).

into only one of the two sub-accounts – thus relying on the practice of combining the equity of both sub-accounts for purposes of margining its open positions in the other sub-account. PAAF should not be able to foist its losses from those positions onto the FCM by now disaggregating two sub-accounts that were always intended to be considered together.

Second, if this Court were to accept the Receiver’s position, the practice of allowing customers to use sub-accounts as an administrative tool for tracking particular aspects of a customer’s trading would effectively be eliminated. Any FCM providing sub-accounts would have to treat each sub-account as a separate credit risk, and customers would likely be required to fully margin and settle up each sub-account on a daily basis. Having to pay additional margin on a single sub-account – even though another sub-account contains sufficient assets to margin both accounts – would result in a customer paying more margin than would otherwise be the case. Moreover, at the end of each trading day FCMs would be required to physically transfer excess funds from sub-accounts with a credit balance to sub-accounts with a debit balance. In sum, the inability to utilize sub-accounts in accordance with long standing industry custom and practice would impose significant operational and economic costs on market participants and their FCMs.

CONCLUSION

For the reasons discussed above, *Amicus* FIA urges this Court to grant Man Financial’s motion for a protective order and to reject any argument by the Receiver that

an FCM's "netting" of sub-accounts held by identical ownership violates an order freezing assets in a receivership proceeding.

Respectfully submitted:

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JOINT AUDIT COMMITTEE, MARGIN HANDBOOK (2nd ed. 1999) (selected chapters) Tab 1

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