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Endangered Species: Seventh Circuit Finds that Forex and Spot Metal Contracts are Not Entitled to Customer Protection in FCM Liquidations

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January 29, 2018 - In its recent decision in *In re Peregrine Financial Group*, the Seventh Circuit became the first circuit to accept a definition of “customer property” which excludes retail foreign exchange contracts, or “forex contracts”, and spot metal contracts.[1] The Court’s ruling highlights the risk parties that transact in foreign exchange transactions and OTC metal transactions may face in the event that a future commodities merchant is forced into liquidation.

Background:

Peregrine was a registered “Future Commission Merchant” (“FCM”) and a registered “Forex Dealer Member” of the National Futures Association. Peregrine, in addition to futures, dealt in retail foreign currency transactions and spot metal transactions. In 2012, it was discovered that over a twenty-year period Peregrine’s CEO, Russel L. Wasendorf, had embezzled nearly \$200 million from Peregrine’s segregated customer future accounts. In July 2012, as a result of this defalcation, Peregrine filed for bankruptcy and a trustee was appointed to administer the Peregrine estate. Subchapter IV of Chapter 7 of the Bankruptcy Code, 11 U.S.C. §§ 761–767, governs the bankruptcy of a futures commissions merchant such as Peregrine, and provides for the distribution of “customer property” in priority to all other claims. “Customer property” is defined as including funds received in connection with a commodity contract, 17 C.F.R. § 190.08(a)(1)(i)(A), which in turn is defined in § 761(4) of the Bankruptcy Code.

The Peregrine Trustee excluded certain former account holders of Peregrine from receiving priority distributions of customer property based on his determination that the forex and spot metal transactions they had conducted

through Peregrine did not constitute “commodity contracts” as defined by the Bankruptcy Code. In response to the Trustee’s determination, certain former account holders (the “Plaintiffs”) commenced an adversary and assert that their forex and spot metal contracts should be treated as commodity contracts, which would entitle them to priority distributions.[2]

Decision: Forex and Spot Metal Contracts are not “similar to” Commodities Contracts

The Seventh Circuit’s ruling turned on the definition of “commodity contract” contained in section 761 of the Bankruptcy Code. The Plaintiffs alleged that their forex and spot metal contracts should be treated as commodity contracts under the “similar to” clause in Chapter 7 of the Bankruptcy Code.[3] The question of whether the forex and spot metal contracts are considered commodity contracts was vital to the Plaintiffs’ potential for recovery as Chapter 7 gives priority distribution to “customer property” which is defined as “property received, acquired, or held to margin, guarantee, secure, purchase, or sell a commodity contract.”[4]

As defined in section 761 of the Bankruptcy Code, a “commodity contract” includes futures contracts,[5] or a contract “similar to” a futures contract.[6] In Peregrine, the Plaintiffs pointed to both the language of the statute and congressional intent that they suggested supported the finding that their retail forex contracts and spot metal contracts were “similar to” futures contracts and therefore fell within the definition of commodity contract contained in the Bankruptcy Code. Based largely on its previous ruling in *In re Zelener*, 373 F.3d 861 (7th Cir. 2004), the Seventh Circuit disagreed.

In *Zelener*, the Seventh Circuit considered whether “[forex transactions] are contracts of sale of a commodity for future delivery regulated by the Commodity Futures Trading Commission.”[7] The Seventh Circuit held that retail forex transactions were distinguishable from futures contracts because the “customer buys foreign currency immediately rather than as of a defined future date, and because the deals lack standard terms. [The defendant] buys and sells as a principal; transactions differ in size, price, and settlement date. The contracts are not fungible and thus could not be traded on an exchange.”[8] The Court expanded on this reasoning to find that the retail forex transactions and spot metal transactions were also not “similar to” futures contracts because “*Zelener* illustrated these two types of transactions were not alike in substance or essentials.”[9] As the Court explained, “[f]utures contracts are fungible instruments that allow parties to trade in the contract with a clearinghouse accepting the risk of any counterparty default. Retail forex, in contrast, involves private transactions that bear no fungible features.”[10] The Court also rejected the Plaintiff’s argument that the legislative history of section 761 indicates that Congress intended for retail forex transactions to be treated as commodities contractions, noting “Congress has had opportunities to include OTC metal and retail forex transactions in the definition of ‘commodity contract’ but has declined to do so. For example, in 2010, as part of Dodd-Frank, Congress amended section 761(4) to include ‘cleared swap’ transactions, 11 U.S.C. § 761(4)(F)(ii), yet declined to include retail forex or OTC metals.”[11] The Court noted that this reasoning was further strengthened by the overall goals of the commodity broker provisions of chapter 7, which are to promote market stability during events of insolvency; a concern that is not implicated with retail forex or OTC metals because they are uncleared transactions where the customer assumes the risk of default.

The decision provides an important warning to lesson to forex and spot metal traders. Namely, that forex and spot metal transactions are not protected under Chapter 7 of the Bankruptcy Code, and will not receive priority distribution in a liquidation.

* Olivia Bensinger assisted with the preparation of this post.

Footnotes

[1] *In re Peregrine Fin. Grp, Inc.*, 866 F.3d 775 (7th Cir. 2017), adopting the opinion of *Secure Leverage Grp., Inc. v. Bodenstein*, 558 B.R. 226, 241 (N.D. Ill. 2016).

[2] 11 U.S.C. § 761(4)(F)(i) (2012).

[3] *Id.*

[4] *Id.* at § 761(10)(A)(i).

[5] *Id.* at § 761(4)(A).

[6] *Id.* at § 761(4)(F)(i).

[7] *In re Zelener*, 373 F.3d 861, 862 (7th Cir. 2004).

[8] *Id.* at 864.

[9] *Secure Leverage Grp.*, 558 B.R. at 241.

[10] *Id.*

[11] *Id.* at 242.

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