The CFTC's New Rule for Banks: Protect Your Customers' Customers

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A lawsuit filed early this month by the Commodity Futures Trading Commission could significantly increase banks? liability exposure and require banks to increase oversight of their commodity firm clients. Since the CFTC came under fire for very large, very public failures to oversee protection of customer money in cases such as the fall of MF Global Holdings Ltd., which unveiled a $1.6 billion shortfall in customer funds, it has increased its efforts to pursue potential violators of the Commodity Exchange Act (the ?Act?). The most recent suit filed by the CFTC arises out of the Peregrine Financial scandal. Years ago, the principal of Peregrine Financial, Russell Wasendorf, Sr., began defrauding Peregrine?s clients. The scheme unraveled, and Wasendorf was indicted. He then pled guilty and was sentenced to 50 years in prison in January of this year.

The CFTC is now suing Peregrine?s deposit and lending bank, US Bank, contending that US Bank violated the Act and its implementing regulations. A copy of the complaint can be found *here*. The gist of the CFTC?s suit is that Section 4d(b) of the Act, 7 U.S.C. § 6d(b), prohibits any person from treating funds belonging to customers of a commodities firm as anything but customer funds. Peregrine had maintained a customer-segregated account at US Bank, and this account was used as collateral for loans made by US Bank to parties affiliated with Peregrine, including Wasendorf himself. Also, US Bank honored transactions against the customer-segregated account that the CFTC contends were not for customer purposes. Both acts?using this account as collateral and honoring transactions that were not for customer purposes?are allegedly violations of the Act. The CFTC is seeking full restitution from US Bank for Peregrine customers? losses, disgorgement of any benefit US Bank received from any conduct that the CFTC contends violated the Act, and civil money penalties of $130,000 to $140,000 for each separate violation of the Act. Although it is not possible to calculate the total exposure based upon the allegations in the CFTC?s complaint, the circumstances and the CFTC?s allegations appear to push US Bank?s potential exposure to upwards of half a billion dollars.

The CFTC?s core theory in the case is that a bank violates the Act by accepting a customer-segregated account as collateral for loans to affiliated parties and by honoring transactions on that account that were not for customer purposes. This theory is relatively untested, but, if it prevails, banks face serious compliance issues and overwhelming regulatory liability. For example, the CFTC in its complaint contends that the bank violated the Act each time it ?held and/or used Peregrine?s customer funds to secure, extend, or calculate the terms and/or risk of the loans? made by the bank to the Peregrine-affiliated parties, and, as a result, US Bank allegedly must repay Peregrine?s customers, disgorge all benefits from the transaction, and pay civil money penalties of $130,000 to $140,000 for each violation. If this theory were correct, this in essence creates strict liability for a bank that accepts as collateral a customer-segregated account for a loan to any party other than the commodity firm itself. And, as a practical matter, this theory prohibits a bank from accepting such an account as collateral. It should also be noted that the allegations of the CFTC?s complaint regarding the meaning of Section 4(b) of the Act are extremely broad, and a reasonable conclusion could be drawn that the CFTC contends that a customer-segregated account could not be used as collateral for a loan to the commodity firm itself. Thus, if a bank has secured any loan with a commodity firm?s customer-segregated account, it should immediately consider whether holding such collateral is worth the potential liability. Moreover, according to the CFTC, a bank is subject to liability for every transaction that the bank honors on a customer-segregated account that can be shown to be for non-customer purposes. In its complaint, the CFTC alleges that US Bank violated the Act by ?knowingly allowing Wasendorf to transfer customer funds from the [customer-segregated account] to his various entities that US Bank?knew were not for the benefit of Peregrine?s customers.? The CFTC further alleges, in very vague terms, that the bank violated the Act by holding funds in the customer-segregated account, which the bank treated ?as if it were Peregrine?s and/or Wasendorf?s checking account.?

Perhaps the facts of the Peregrine-US Bank relationship are unique and somewhat egregious. The CFTC contends that US Bank had actual knowledge of the nature of the Peregrine transaction, and this knowledge is a large part of the basis for the CFTC?s theory of liability. However, the CFTC?s complaint itself alleges that Wasendorf defrauded US Bank by, among other things, intercepting mail intended for the bank. Moreover, according to the CFTC?s allegations, US Bank?s knowledge extended only to the nature of the transactions on the customer-segregated account, not knowledge of the fraud that Wasendorf perpetrated. Therefore, the CFTC is proceeding on the theory that a deposit bank is exposed to huge liability based solely upon knowingly honoring transactions on a customer-segregated account that are not for customer purposes.

The compliance issues stemming from this theory are nightmarish. When one studies how US Bank could have avoided liability in its dealings with Peregrine, it becomes clear that the means of such avoidance is to monitor a commodity firm?s customer-segregated account and refuse to honor transactions from that account unless it has confirmed that the transactions are for the benefit of the commodity firm?s customers. Indeed, nothing in the CFTC?s complaint leads to the conclusion that actual knowledge is required to show a violation of the Act, and deposit banks very well could face liability for constructive knowledge of misuse of customer funds. In other words, there is no assurance that the CFTC will not, in a future lawsuit, contend that a deposit bank ?should have known? that transactions were not for the benefit of a commodity firm?s customers.

While the facts of Peregrine may be unique, banks should expect to see the CFTC bring more enforcement actions and suits based on similar theories. In 2012, the CFTC filed 102 enforcement actions, the highest number ever filed in one year, and opened more than 350 new investigations.

While not all of these investigations or enforcement actions involve safeguarding customer funds, 2012 saw some significant developments on that front. For example, the CFTC settled with JPMorgan Chase Bank for $20 million after charges were brought against JPMorgan for alleged unlawful handling of Lehman Brothers Inc.?s customer funds. The $20 million settlement, the largest ever CFTC sanction for a segregated fund violation, was solely civil penalties, and there were actually no customer losses in that matter. Charges were also brought against Goldman Sachs Execution & Clearing, L.P. for failure to investigate signs of questionable conduct by one of its clients (Goldman Sachs settled for $7 million) and against Rosenthal Collins Group, LLC for failing to supervise an account that a client was using to perpetrate a multi-million dollar commodity futures Ponzi scheme (Rosenthal Collins Group settled for $2.5 million). The reality of CFTC suits is not limited to the big players, or even to financial institutions. On June 17, 2013 the CFTC filed suit in the Western District of North Carolina against an individual in Southern Pines, North Carolina who operated a relatively small fund pool for trading commodity options, alleging commingling and misappropriation of customer funds. While currently there are no allegations against a bank in that matter, the individual?s bank was publicly identified by name in the associated criminal charges.

Banks certainly have their fair share of regulatory oversight, and now it is apparent that CFTC regulation, enforced through litigation, is an additional concern. Any bank that has a commodity firm as a customer should look more closely at its relationship with that firm, read the CFTC?s complaint in detail, and determine whether any corrective action is necessary.

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