Katten
Katten Muchin Rosenman LLP

Client Advisory

Treatment of Customers and Financial Counterparties in Stockbroker Liquidations Under SIPA and the Bankruptcy Code

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Introduction

With the possibility of a major stock brokerage liquidation appearing more likely than it has been in recent periods, the effect of a liquidation on customers and financial counterparties has become of great interest to many of our clients and others. This article summarizes some of the key issues that may arise in a stockbroker liquidation and, in particular, the impact upon customers with securities accounts and counterparties to securities contracts, swaps, repurchase agreements and other common financial instruments under either (i) the Securities Investor Protection Act of 1970 ("SIPA"),[1] or (ii) chapter 7 of the United States Bankruptcy Code (the "Bankruptcy Code").[2]

Liquidation Under SIPA and the Bankruptcy Code in General

Neither SIPA nor the Bankruptcy Code allow a broker-dealer to reorganize. Both SIPA and subchapter III of chapter 7 require the liquidation of a failed stockbroker. Both liquidation schemes, however, prioritize to a significant extent the repayment of "customer" claims over those of general unsecured creditors, which may include those who "lend" their excess cash to the broker, foreign exchange creditors and more routine creditors such as landlords and vendors.

SIPA

Among the most important aspects of SIPA is the liquidation process that is overseen by the SIPA-created Securities Investor Protection Corporation ("SIPC"). Also important is the SIPA fund (the "SIPA Fund"), which is essentially an insurance program funded by SIPC members to protect customers from loss if a SIPC member fails.

A SIPA liquidation proceeding may only be commenced by SIPC in federal district court, and then only if SIPC determines that a member has failed, or is in danger of failing, to meet its obligations to its customers and one of the following has occurred:

(i) the SIPC member is insolvent;

(ii) there is already a pending proceeding against the member and a receiver, trustee or liquidator has been appointed;

(iii) the member is in violation of certain financial responsibility or hypothecation rules promulgated by the SEC or a self-regulatory organization; or

(iv) the member cannot compute whether it is in compliance with the financial responsibility or hypothecation rules promulgated by the SEC or a self-regulatory organization.

If failure has occurred or is likely and one of these tests is satisfied, the federal district court will issue a protective order at SIPC's request that will serve to protect customer accounts and customer property and limit the failing SIPC member's activities in certain ways described below. Although the district court enters the protective order, the SIPA proceeding is then referred to the bankruptcy court for the district which actually oversees the liquidation. Except to the extent SIPA

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1 SIPA is codified at 15 U.S.C. § 78aaa et seq.

2 The Bankruptcy Code is located at 11 U.S.C. § 101 et seq.

mandates different treatment, a SIPA trustee operates as and has the powers of a bankruptcy trustee under chapter 7 of the Bankruptcy Code. The protective order, much like the automatic stay in bankruptcy, freezes customer activity and unless there is a sale of the customer accounts to a more stable brokerage firm (which is common but might be more problematic where a large broker is in liquidation), the customer may find himself without access to his securities or cash in his securities account for months.

After a SIPA liquidation is commenced, SIPC will designate a trustee[3] who will then set about the tasks of notifying customers of the impending liquidation, transferring customer accounts to a more financially stable brokerage firm if possible, having customers and other creditors file claims, and paying customers and other creditors in accordance with the statutorily mandated priorities.

The Bankruptcy Code

Through subchapter III of chapter 7 of the Bankruptcy Code, Congress has provided an alternative method for stockbroker liquidation in the relatively rare instances when the stockbroker is not a SIPC member.

As with SIPA, under the Bankruptcy Code, stockbrokers are only entitled to liquidate assets for the benefit of customers and creditors and may not reorganize. Many of the steps taken in a bankruptcy case parallel those taken in a SIPA liquidation. Specifically, a bankruptcy trustee is chosen to secure and marshal the debtor's assets, return "customer name" (as opposed to street name) securities to their owners, invite all creditors to file claims, and pay those creditors in accordance with statutory priorities. As discussed in more detail below, the fact that all securities are liquidated and customer claims are paid in cash (except for securities registered in the customer's name which are returned to the customer) is a key distinction between a bankruptcy liquidation and one under SIPA, where SIPC and the SIPA trustee will attempt to return securities to customers in satisfaction of their customer claims.

Priority of Customer Claims

Both SIPA and the Bankruptcy Code seek to return the customers to the economic position they were in immediately prior to the commencement of the liquidation case. SIPA does so by attempting to transfer customer accounts to a more financially stable SIPC member, and, where possible, by returning securities to customers in satisfaction of their claims based on the holdings in their securities account on the day the liquidation commences. Both schemes prioritize the satisfaction of customer claims from customer property above the claims of general unsecured creditors.

Securities Registered in the Customer's Name

Both SIPA and the Bankruptcy Code require the trustee to return to the customer all securities registered in that customer's name that have not been pledged or hypothecated to secure a debt the customer owes to the liquidating brokerage firm. Specifically, under SIPA, the trustee must return, as soon as possible, all "customer name securities" – i.e., non-negotiable securities registered in the name of the customer, or in the process of being registered in the customer's name, and held for the account of the customer on the date the SIPA proceeding is commenced. Similarly, under the Bankruptcy Code, the chapter 7 trustee must return any "customer name security" – a definition that tracks that used by SIPA.

Customer Property – Securities Held in Street Name

The vast majority of securities held by a broker are not registered in a customer's name, but are held by the broker in street name. Moreover, because customer securities may be pledged by the customer to secure a debt owed to the broker (i.e., margined), in turn enabling the broker to pledge or use those securities to raise cash, or because the customer may have authorized the brokerage house to use his holdings (e.g., in exchange for interest payments or under other securities lending arrangements), there is often a shortfall in the total pool of "customer property" (cash and other securities held for the benefit of customers). This shortfall most commonly arises because of the closeout of transactions by counterparties to outstanding transactions with the broker where the broker was authorized to pledge a customer's securities. Fraud or other misappropriation or misuse of customer property may also cause a shortfall. So, for example, if a snapshot is taken of all customer accounts and all securities held by the broker on the date the liquidation commences, the total number of shares of X Corp stock actually held by the broker will frequently be less than the total number of shares of X Corp stock reported to the broker's customers on their account statements. Outside of a liquidation scenario, if a customer sought the return or sale of securities in his account that the broker had pledged and no longer has immediate access to, the broker might

3 If the SIPC member has less than 500 customers and its obligations to general unsecured creditors and subordinated lenders are less than $750,000, SIPC may designate itself or one of its employees as trustee.

simply go to the market and purchase the securities to meet its obligation to the customer. Once a SIPA or bankruptcy liquidation is commenced, the results may be different. Because the SIPA protocol is to try to return securities to customers "to the maximum extent practicable," SIPA authorizes the trustee to use assets of the broker to buy securities. Moreover, to the extent that SIPC is liable under SIPC's insurance obligations to make up shortfalls, SIPC may authorize the trustee to purchase securities with SIPC funds to satisfy customer claims. A bankruptcy liquidation differs in that a bankruptcy trustee is mandated under chapter 7 to liquidate customer property and pay customer claims in cash, so the shortfall in securities is, for the most part, purely an economic issue.

Under both regimes, each customer will have a "net equity" claim against the total pool of "customer property." Customer property is comprised of the cash and securities in all of the customer accounts, as well as any cash and securities traceable as customer property that were transferred prior to liquidation and are recovered by the trustee.[4] To repay the customer's net equity claim, the SIPA trustee will, to the extent possible, provide the customer with the identical securities owned by that customer as of the day the liquidation case was commenced and irrespective of when the broker obtained those securities. If the aggregate pool of customer property is insufficient to repay the full net equity claims of customers, the customers will then share from the pool of non-customer property of the broker on a *pro rata* basis (based on the amount of the customer's deficiency) with holders of general unsecured claims. If there is still a deficiency after the customer has received its share of customer and non-customer property, the SIPA Fund will provide up to $500,000 per customer to satisfy the deficiency.[5] Some SIPC members have purchased so-called "excess SIPC coverage" from third-party insurers such as the Customer Asset Protection Company ("CAPCO") that would cover claims exceeding the SIPC limits. Any net equity claims not satisfied by the SIPC trustee, the SIPA Fund or additional CAPCO-like insurance become general unsecured claims that share *pro rata* with unsecured claims in non-customer property of the broker.

A similar process is used in a bankruptcy liquidation where the bankruptcy trustee must solicit claims from creditors and customers and return to the broker's customers all "customer property" which is defined to include cash, security and property (and the proceeds thereof) "received, acquired, or held by or for the account of the debtor, from or for the securities account of a customer." In other words, "customer property" is – as with SIPA – the aggregate pool of securities and other assets held by the prime broker for the benefit of its customers and not registered in a particular customer's name. Unlike a SIPA trustee who will try to return customer property "in kind," the chapter 7 trustee will, in accordance with "good market practice," reduce all customer property to cash and then pay cash to the customers to satisfy their net equity claims. If the aggregate pool of customer property is insufficient to return each customer to his or her pre-bankruptcy position, the customers' deficiency claims will share *pro rata* from the pool of non-customer property with general unsecured creditors.

In the overwhelming majority of cases, SIPC is successful in transferring customer accounts to another broker, thus enabling customers to regain access to their accounts reasonably quickly (measured in days or weeks) and SIPC will advance funds to make up any shortfalls for the vast majority of accounts under $500,000. Note that SIPC will not make advances with respect to net equity claims of any customer who is a dealer, broker or bank (except if the claim arose out of transactions for customers of the dealer, broker or bank).

If SIPC is unsuccessful in transferring accounts, or if customers' accounts are in excess of the SIPC limits and there is a shortfall, customers may have to wait months or even years before they recover their full net equity claims, although SIPC will try to make partial distributions of customer property within one to three months of the liquidation having been commenced, at least if the broker's records were well maintained and accurate.

In the rare non-SIPC liquidation, the trustee must liquidate securities, solicit and review claims and marshal other assets through liquidation or otherwise. Delays in customers receiving payment are much more likely to be measured in months and final recoveries could take a year or more.

4 "Net equity" is the amount that would have been owed to the customer if the broker had liquidated the customer's account on the day the liquidation case was commenced minus any amount the customer owes to the broker.

5 The SIPA Fund covers only securities, and customers with more than one account in the same legal capacity will have their accounts aggregated for purposes of the $500,000 limit. Commodity futures contracts and currency (i.e., FX positions), investment contracts (e.g., limited partnership interests) and fixed annuity contracts not registered with the SEC under the Securities Act of 1933 are among claims not covered by SIPC insurance. Note that cash in a customer account is only covered by SIPA up to $100,000, but the cash must be customer property (i.e., deposited for the purpose of buying securities, including margin, or proceeds from the sale of securities). The cash may be treated differently if the broker is paying interest to the customer for the use of that cash – a debtor-creditor lending relationship, instead of customer-broker relationship, may exist.

The Treatment of Financial Contracts

SIPA

The court overseeing the SIPA liquidation may stay, for a fixed period of time, the ability to enforce liens against the debtor's property and to exercise setoff rights without receiving the consent of the SIPA trustee. With a limited exception, neither this stay nor a SIPA liquidation case, generally, affects the contractual rights of a creditor to liquidate, terminate or accelerate a securities contract, commodity contract, forward contract, swap agreement, repurchase agreement or master netting agreement, to exercise setoff rights under such agreements, or to foreclose on cash collateral pledged by the insolvent SIPC member. The limited exception is that the court may stay, for a fixed period of time, the ability to foreclose on, or dispose of, securities collateral pledged by the debtor, securities sold by the debtor under a repurchase agreement, and securities loaned under a securities lending agreement without the written consent of the SIPA trustee. Stays of these types are routinely sought by SIPC and, for example, were recently ordered by the United States District Court for the Eastern District of Louisiana for 21 days when SIPC obtained a protective order in conjunction with its liquidation of Hanover Investment Securities, Inc.

According to a June 25, 2002 letter to the Bond Market Association, SIPC indicated that it will consent (and urge an appointed SIPA trustee to consent) to the closeout of a repurchase agreement or a securities lending transaction upon receipt of an affidavit from the counterparty or one of its officers that they have no knowledge of any fraud involved in the transaction and that, by the terms of the transaction, the counterparty has either acquired the rights of an owner of assets received in the transaction or a perfected security interest in those assets. While in the liquidation of a small broker, short judicial stays may be sufficient to enable SIPC and a SIPA trustee to evaluate its need for the securities and the entitlement of the counterparty to otherwise liquidate those securities, a stay of significantly longer duration may be required in the liquidation of a large broker because of the volume of transactions requiring analysis.

The Bankruptcy Code

The Bankruptcy Code provides special treatment for most securities contracts, commodities and forward contracts, swap agreements, repurchase agreements and master netting agreements. Most counterparties (stockbrokers, financial institutions, clearing agencies and others that satisfy certain trading thresholds and qualify as "financial participants") are not bound by the Bankruptcy Code's "automatic stay" and are free to liquidate, terminate or accelerate these contracts in accordance with the terms of the contract. These actions may be taken without obtaining the prior approval of the Bankruptcy Court as would normally be required when the Bankruptcy Code's automatic stay is implicated. There is an important proviso, however: Such remedies cannot be exercised for securities contracts or repurchase agreements if SIPC has obtained a protective order with the stay discussed above. In such a case, the trustee and SIPC must give their consent before these remedies are exercised. The definitions of these contracts and agreements in the Bankruptcy Code and the counterparties not affected by the stay are specific and a counterparty should consult with legal counsel to determine whether the automatic stay applies to any particular transaction.

For Additional Information

Attorney	Direct Dial	Email
Henry Bregstein	212.940.6615	henry.bregstein@kattenlaw.com
Jeff J. Friedman	212.940.7035	jeff.friedman@kattenlaw.com
Marilyn Selby Okoshi	212.940.8512	marilyn.okoshi@kattenlaw.com
Merritt A. Pardini	212.940.6742	merritt.pardini@kattenlaw.com
Ross Pazzol	312.902.5554	ross.pazzol@kattenlaw.com
Fred M. Santo	212.940.8720	fred.santo@kattenlaw.com
Meryl E. Wiener	212.940.8542	meryl.wiener@kattenlaw.com

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Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

401 S. Tryon Street
Suite 2600
Charlotte, NC 28202-1935
704.444.2000 tel
704.444.2050 fax

525 W. Monroe Street
Chicago, IL 60661-3693
312.902.5200 tel
312.902.1061 fax

5215 N. O'Connor Boulevard
Suite 200
Irving, TX 75039-3732
972.868.9058 tel
972.868.9068 fax

1-3 Frederick's Place
Old Jewry
London EC2R 8AE
+44.20.7776.7620 tel
+44.20.7776.7621 fax

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel
310.788.4471 fax

575 Madison Avenue
New York, NY 10022-2585
212.940.8800 tel
212.940.8776 fax

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
650.330.3652 tel
650.321.4746 fax

1025 Thomas Jefferson Street, NW
East Lobby, Suite 700
Washington, DC 20007-5201
202.625.3500 tel
202.298.7570 fax

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