

Managing the Risks of Broker-Dealer Insolvency | Insights | Ropes & G...

The current tumult in the credit markets has sharpened investors' concerns about the safety of their securities accounts and has brought into focus the importance of counterparty risks in derivative and brokerage transactions. With the near-failure of Bear Stearns in recent days, investors have squarely faced the possibility of a major broker-dealer bankruptcy. In such times, it is important to have a basic understanding of the rights of account holders and trading counterparties in a U.S. broker-dealer insolvency.

Broker-Dealer Insolvencies

A broker-dealer is not eligible to reorganize under chapter 11 of the Bankruptcy Code. A broker-dealer insolvency will instead lead either to a distressed sale, as in the case of Bear Stearns, or to a liquidation proceeding. A liquidation proceeding can be carried out either under chapter 7 of the Bankruptcy Code, which has special provisions that apply to stockbroker liquidations, or under the provisions of the Securities Investor Protection Act ("SIPA"). The commencement of a SIPA liquidation by the Securities Investor Protection Corporation ("SIPC") essentially supersedes a stockbroker liquidation commenced under the Bankruptcy Code. Because almost all broker-dealers registered with the SEC are members of SIPC, many broker-dealer liquidations are conducted pursuant to SIPA rather than the Bankruptcy Code.

In both a bankruptcy liquidation and a SIPA liquidation, a court-appointed trustee marshals and distributes the assets of the broker to customers and to general creditors. Ordinarily, a trustee will also seek to transfer customer accounts to a financially sound broker-dealer.

In each type of liquidation proceeding, customer claims have priority over general unsecured creditors with respect to securities allocable to customer accounts. However, in a chapter 7 liquidation, customers are entitled only to the cash value of their securities, whereas the goal of a SIPA liquidation is to return or replace customer securities.

Treatment of Customer Securities in a SIPA Liquidation

Customer Name Securities. A "customer name security" is a security registered in the customer's name and ordinarily takes the form of a physical certificate. In a SIPA liquidation, physical securities registered in the customer's name are returned to the customer and are not pooled with the other assets to satisfy the claims of general creditors or other customers. The same holds true in a chapter 7 liquidation.

Street Name Securities. Most widely held securities are registered in "street name" (i.e., held indirectly through a clearing corporation). Each customer has a "net equity claim" against the broker for its street name securities, which is the dollar amount in the account(s) of the customer, calculated as if the entire portfolio of the customer's securities had been liquidated on the filing date, net of any claims of the broker against the customer (for example, on account of margin loans). Net equity claims are satisfied first by a pro rata distribution of "customer property," which consists principally of the pool of "street name" securities and cash held by the broker for all customers. Aside from cases of fraud or malfeasance, shortfalls in the pool of customer property might occur, for example, from a broker's use of securities pledged by customers to secure margin loans. Because customer property is distributed pro rata in a liquidation, all customers share in any shortfall, even if it is generated by activities relating to the accounts of others.

However, SIPC insures losses up to \$500,000 per customer (with a sub-limit of \$100,000 for any cash held with the broker), which is paid in the form of identical replacement securities (or cash, in the case of missing cash). SIPC insurance covers only registered securities; it does not provide

protection for commodities, foreign exchange or other investments. Furthermore, SIPC will neither insure shortfalls in the accounts of customers that are beneficial owners of more than five percent of the broker's outstanding equity securities nor replace the securities of a broker, dealer or bank investing for its own account.

Some brokers carry excess insurance to cover claims over the \$500,000 SIPC limit through CAPCO, a private self-insurer comprised of 15 broker-dealers. Some insurance companies also provide third party excess SIPC insurance.

To the extent insurance does not cover the shortfall between a customer's net equity claim and its pro rata share of customer property, that customer will have a general unsecured claim against the broker that will be entitled to distributions, if any, only after all advances by SIPC have been repaid.

Similarly, in a chapter 7 liquidation, if the pro rata distribution of customer property is not sufficient to satisfy a customer's net equity claim, the difference is treated as a general unsecured claim against the broker.

Managing the Risks of Broker-Dealer Insolvency

Customers should assess the financial condition of their brokers. Broker-dealers are required to file annual audited reports with the SEC on Form X-17A-5. These reports are available on the Commission's Web site. In addition, customers may wish to review the quarterly and annual financial reports of publicly traded banks and brokerages, which are generally available on the Internet, including on the Commission's Web site.

Customers should also inquire with their brokers about any excess SIPC insurance that is in place or may be available to protect customer accounts. Depending on the size of their accounts and the level of excess insurance coverage available at their existing brokers, customers may wish to move accounts to a broker that is a CAPCO participant or otherwise carries the desired excess insurance. Furthermore, customers should be alert to the limits on insurance coverage for cash and establish account protocols for investments in liquid, short-term securities such as Treasury obligations.

Customers that currently hold all their accounts with a single broker may wish to establish additional brokerage accounts at other firms, which would diversify their risk and also expedite the transfer of assets out of a troubled brokerage. Alternatively, to the extent cash or securities are not otherwise needed in brokerage accounts (for example, to satisfy margin requirements), customers may want to consider moving these assets to bank custodial accounts. Under certain circumstances, broker-dealers may pledge securities in customer accounts, whereas banks may not pledge securities in a custodial account.

Closing Out Derivative Contracts with an Insolvent Broker-Dealer

Securities contracts, forward and commodities contracts, repurchase agreements, swaps and master netting agreements are exempt from the automatic stay and avoidance provisions in the Bankruptcy Code, which generally apply to contracts and transactions between debtors and their counterparties. Specifically, qualified non-debtor counterparties (generally, stockbrokers, financial institutions, clearing agencies and other entities that satisfy certain trading thresholds) may enforce default and termination provisions triggered by a counterparty's insolvency or bankruptcy filing and may liquidate, terminate, accelerate and exercise rights of setoff under these types of derivative contracts, without the need for relief from the automatic stay. Furthermore, a bankruptcy trustee generally may not recover pre-petition margin payments and settlement payments to non-debtor counterparties under these classes of contracts as preferences or fraudulent transfers, except in the case of actual fraud.

SIPA also expressly prohibits any stay of a counterparty's contractual rights to liquidate, terminate or accelerate derivative contracts. However, SIPC has the right in a SIPA liquidation to seek a stay of foreclosures on or other dispositions of securities collateral, securities sold by a debtor under a

repurchase agreement or securities loaned under a securities lending agreement.

While the classes of protected derivative contracts are broadly defined, investors concerned about the financial capacity of their counterparties should review their derivative portfolios for contracts that may fall outside the protections and the Bankruptcy Code. Conventional, high-volume derivatives should not raise concerns. However, complex, transaction-specific contracts may not be covered by the safe harbors in the statute. Numerous factual questions may be raised to challenge a counterparty's eligibility for these protections, such as: Is the counterparty qualified under the terms of the Bankruptcy Code or SIPA? Is the contract sought to be terminated a protected contract, or is it instead a secured loan masquerading as a derivative instrument?

The Bankruptcy Code and SIPA offer significant protections to customers and financial contract counterparties in the event of a broker-dealer insolvency. However, recent events in the market should focus investors' attention on analyzing broker-dealer risks and taking affirmative steps to maximize the benefits of these protections.