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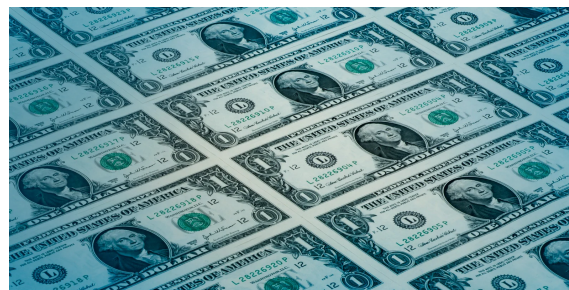
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FDIC, SEC ADOPT RULE ON ORDERLY LIQUIDATION OF LARGE BROKER-DEALER
TITLE II OF DODD-FRANK

FDIC, SEC Adopt Rule on Orderly Liquidation of Large Broker-Dealers Under Title II of Dodd-Frank

AUGUST 2020 | COMMENTARY

In Short

The Situation: Title II of the Dodd-Frank Act created an insolvency framework for the orderly liquidation of large financial companies, including SEC-registered broker-dealers, if certain financial distress and systemic risk determinations are made. The Joint Rule integrates the requirements of Title II of the Dodd-Frank Act and the customer and other protections of the Securities Investor Protection Act of 1970 ("SIPA") into the orderly liquidation processes for systemically important broker-dealers when the FDIC is appointed receiver for those firms and the Securities Investor Protection Corporation ("SIPC") acts as trustee.

The Result: The FDIC and SEC, in consultation with SIPC, adopted the Joint Rule on July 24, 2020, to harmonize and clarify the integration of SIPA liquidation principles into the orderly liquidation of covered broker-dealers under Title II of the Dodd-Frank Act.

Looking Ahead: The Joint Rule adds definition to the liquidation process for the orderly resolution of a large broker-dealer, providing greater certainty and transparency to customers, creditors, and counterparties of covered broker-dealers regarding the processes for initiating an orderly liquidation, for transferring accounts to a bridge broker-dealer, and for making customer and creditor claims.

On July 24, 2020, the FDIC and SEC (collectively, "Agencies") adopted a rule ("Joint Rule"), required by Section 205(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Joint Rule clarifies and implements the orderly liquidation processes for systemically important brokers and dealers that are registered with the SEC ("Covered Broker-Dealers") in the event the FDIC is appointed receiver under Title II of the Dodd-Frank Act.

The orderly liquidation of Covered Broker-Dealers under Title II of the Dodd-Frank Act is intended to avoid or diminish serious adverse impacts on U.S. financial stability while providing customer protections comparable to those provided under SIPA. Under Title II of the Dodd-Frank Act, the orderly

liquidation of a systemically important broker-dealer must be accomplished in a manner that ensures broker-dealer customers receive payments or property at least as beneficial to them as would have been the case if the broker-dealer were liquidated by SIPC under SIPA.

Section 205(a) of the Dodd-Frank Act requires that when the FDIC is appointed receiver over a Covered Broker-Dealer, it is to appoint SIPC as trustee for the liquidation under SIPA. Because a Covered Broker-Dealer registered broker-dealer, it will already be a member of SIPC.

Pursuant to Section 205(d) of the Dodd-Frank Act, the FDIC, as receiver of a Covered Broker-Dealer, may not take action that would: (i) adversely affect the rights of a customer to customer property or customer name securities; (ii) diminish the amount or timely payment of net equity claims of customers; or (iii) otherwise impair the recoveries provided to a customer under SIPA. Likewise, under Section 205(f) of the Act, the orderly liquidation of a Covered Broker-Dealer must be accomplished in a manner that ensures customers receive payments or property at least as beneficial to them as would have been the case had the Covered Broker-Dealer been liquidated under SIPA.

Because of SIPC's involvement in a liquidation of a Covered Broker-Dealer, Section 205(h) of the Dodd-Frank Act required the Agencies to develop and implement rules in consultation with SIPC. SIPC was created by SIPA to oversee the liquidation of SIPC member brokerage firms. In the normal course, SIPC initiates the liquidation process when it receives a referral from a securities regulator such as the SEC or FINRA when a firm fails and cash and/or securities are missing from customer accounts. SIPC protection is limited to \$500,000, which includes a \$250,000 limit for cash.

Because SIPC covers only the custody of customer cash and securities in the failing broker-dealer, and does not protect the value of any security (e.g., it replaces missing stocks when possible but does not insure against losses in value), SIPC protection does not provide the same protection that an FDIC-insured bank provides for customer cash in a bank account.

The Joint Rule clarifies the process for the orderly liquidation of Covered Broker-Dealers. It makes clear, for example, that while SIPC is to be appointed as trustee for the Covered Broker-Dealer, it is not in conjunction with a proceeding under SIPA because a liquidation under Title II is an

alternative to a SIPA liquidation. The Joint Rule also describes the statutory roles of SIPC as trustee and FDIC as receiver.

Although SIPA proceedings are conducted with bankruptcy court oversight, a liquidation under Title II of the Dodd-Frank Act is conducted outside of bankruptcy court process with FDIC as receiver. In a Title II liquidation, therefore, SIPC is required to promptly file an application for a protective decree with a federal district court to give notice to interested parties that an orderly liquidation proceeding has been initiated.

The Joint Rule provides detail on the requirements of the notice and application for a protective decree, including the court in which an application may be filed and a nonexclusive list of matters that may be included in the notice and application for a protective decree. The Joint Rule also includes deadlines for the filing of customer and creditor claims and for responding to such claims, priorities for unsecured claims against a Covered Broker-Dealer, administrative expenses recoverable by SIPC, and the treatment of qualified financial contracts in a liquidation proceeding.

As receiver, the FDIC has the power to form bridge financial companies which transfer customer accounts, securities, and property from a Covered Broker-Dealer. The use of a bridge broker-dealer is intended to give customers access to their accounts as quickly as practicable, while ensuring that customers receive assets in the same form and amount that they would receive in a SIPA liquidation. The Joint Rule, therefore, makes clear that, where a bridge financial company is used in connection with a Title II liquidation, "customer" status remains the same as in a SIPA proceeding. The Joint Rule further sets forth the process by which all customer claims relating to, or net equity claims based upon, customer property or customer name securities are satisfied in a manner and in an amount at least as beneficial to customers as would have been the case if the broker-dealer were liquidated under SIPA.

Three Key Takeaways

1. Adoption of the Joint Rule improves clarity regarding the orderly liquidation of a large broker-dealer by interpreting how Title II of the Dodd-Frank Act and SIPA will apply.

2. The Joint Rule helps ensure that the protections afforded customers of Covered Broker-Dealers in a Section 205 liquidation will be similar to, and no worse than, those afforded in SIPA liquidations.
3. The Joint Rule provides greater certainty and transparency to customers, creditors, and counterparties of Covered Broker-Dealers regarding the processes for initiating an orderly liquidation, for transferring accounts to a bridge broker-dealer, and for making customer and creditor claims.

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LAURA S. PRUITT

Partner

[Washington](#) | +

1.202.879.3625

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