WHAT HAPPENS WHEN A BROKER-DEALER FAILS? A SUMMARY OF CERTAIN KEY BANKRUPTCY CODE AND SIPA-RELATED ISSUES

As widely reported, on March 16, 2008, J.P. Morgan Chase & Co. agreed to acquire The Bear Stearns Companies, Inc. ("Bear Stearns") for approximately $2 per share, halting a downward spiral that transpired over less than one week. In all likelihood, prior to agreeing to the sale, Bear Stearns and its legal advisors evaluated other strategic alternatives, including the possibility of seeking relief under title 11 of the United States Code (the "Bankruptcy Code"). As explained below, however, an entity that is classified as a "stockbroker" or "commodity broker" under the Bankruptcy Code is not entitled to seek chapter 11 protection to reorganize its business.[1] Instead, the only chapter of the Bankruptcy Code available to a stockbroker or commodity broker is chapter 7, which is the liquidation chapter of the Bankruptcy Code. Moreover, notwithstanding the automatic stay provisions of the Bankruptcy Code, the Securities Investor Protection Corporation ("SIPC")[2] may file an application for a protective decree under the Securities Investor Protection Act of 1970 ("SIPA") to stay all proceedings in a chapter 7 stockholder liquidation to allow SIPC to complete the liquidation of a stockbroker debtor that is a member of SIPC.

This memorandum highlights certain provisions of United States law relevant to a customer of a registered broker-dealer (like Bear Stearns) in the event of its insolvency.

1. The Customer Protection Rule.

All major brokerage houses (such as Bear Stearns) are registered as broker-dealers with the Securities and Exchange Commission, and all registered broker-dealers must comply with Rule 15c3-3 (the "Customer Protection Rule") under the Securities Exchange Act of 1934. Generally, the Customer Protection Rule requires a broker-dealer to: (i) take "physical possession or control of all fully-paid securities and excess margin securities carried" for customer accounts (that is, segregate customer fully-paid and excess margin securities on its books and records); and (ii) maintain with a bank a special reserve bank account (separate from the broker-dealer's other bank accounts) for the exclusive benefit of the customers of the broker-dealer containing the net amount of funds it owes its customers (calculated in accordance with a prescribed formula). The Customer Protection Rule further prohibits a broker-dealer from pledging

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1 It has been reported that most of the Bear Stearns enterprise, including its valuable prime brokerage business, would not be eligible for chapter 11 protection. *See, e.g.*, "For Bear Stearns, Chapter 11 was never an option," *The Daily Deal*, March 18, 2008, pp. 4-5. There seems to be no dispute that a registered broker-dealer is not entitled to chapter 11 protection.

2 SIPC is a nonprofit corporation comprised of all registered brokers, dealers and members of national securities exchanges.

customers' fully-paid securities or otherwise using them in its proprietary business and limits the amount of customers' securities a broker-dealer can pledge to third-party lenders to support customers' debit balances (e.g., margin loans) owed to the broker-dealer.

In the event of a broker-dealer failure, and assuming that the broker-dealer has complied with the Customer Protection Rule, a customer's cash and securities positions should be able to be identified and transferred on its behalf to another registered broker-dealer pursuant to a liquidation under chapter 7 of the Bankruptcy Code, as further set forth below. Given the delays and confusion that often accompany bankruptcies, however, it may take a considerable amount of time to obtain such a transfer (during which time the customer may be unable to hedge its market exposure).

2. Liquidations of Stockbrokers Under the Bankruptcy Code.

Liquidations of stockbrokers[3] are subject to a distinct set of provisions under the Bankruptcy Code (sections 741 through 753 of the Bankruptcy Code).

Customers of a stockbroker, including persons that have advanced money to a stockbroker for the purchase of securities, are granted preferred status in receiving distributions from a stockbroker's estate. The distribution scheme and priority of claims of customers against a stockbroker's estate is based upon the distinction between the types of property that comprise the estate: (1) customer name securities; (2) customer property; and (3) other property of the estate.

Customer Name Securities

The Bankruptcy Code defines "customer name securities" as securities "(A) held for the account of a customer on the date of the filing of the petition by or on behalf of the debtor; (B) registered in such customer's name on such date or in the process of being so registered under instructions from the debtor; and (C) not in a form transferable by delivery on such date." 11 U.S.C. § 741(3).

A customer is entitled to reclaim a customer name security (and the trustee is obligated to deliver such security), unless the customer has a "negative net equity." Under the Bankruptcy Code, a customer's net equity is calculated by:

- Determining the dollar balance of each account that would remain after the liquidation (by either sale or purchase) of all securities positions in all such accounts as of the petition date, but not including any customer name securities (the "Remaining Balance");

3 The Bankruptcy Code defines a "stockbroker" as a person: (A) with respect to which there is a customer, as defined in section 741 of the Bankruptcy Code; and (B) that is engaged in the business of effecting transactions in securities (i) for the account of others or (ii) with members of the general public, from or for such person's own account. 11 U.S.C. § 101(53)(A).

- Aggregating the Remaining Balances of all accounts of a customer that such customer has in the same capacity;
- Subtracting any amount the customer (in such capacity) would have owed the debtor immediately after the liquidation of securities; and
- Adding any timely payment by such customer to the trustee by payment to the trustee of any business-related claim of the debtor against such customer in such capacity.

Customer name securities will not be released until negative net equity obligations are satisfied by payment to the trustee.

Customer Property

Property of the stockbroker that was received by or acquired from the securities account of a customer, and that is being held by or for the account of the debtor, is "customer property." Customer property includes shares that are segregated in "bulk" and customer cash balances. Customer property is treated as fungible property under the Bankruptcy Code and all customers may share ratably in such pool according to their net equity claims. Customers' claims against customer property enjoy priority over all other claims against the debtor, except claims related to the costs of administering the customer property.

Section 748 of the Bankruptcy Code requires that securities that are customer property be liquidated promptly in order to effect distributions. If the customer property fund is insufficient to cover the customers' claims, then such customers will receive distributions from other property of the estate on a *pari passu* basis with general creditors. *See* 11 U.S.C. § 752(b)(2).

3. Securities Investor Protection Act of 1970 ("SIPA") and the Securities Investor Protection Corporation ("SIPC").

SIPA provides an alternative to a liquidation under the Bankruptcy Code for registered broker-dealers with the Securities and Exchange Commission (each a "firm").[4] SIPA requires every firm to be a SIPC member. SIPC is a nonprofit corporation which administers a reserve fund to protect securities investors (firms pay flat fees to SIPC to support the fund). Under SIPA, the Securities and Exchange Commission or some other regulatory agency may notify SIPC that a firm is approaching financial difficulty. SIPC may then, upon notice to the firm, file an application for a protective decree with a court of competent jurisdiction if SIPC has determined that the firm: (i) has failed or is in danger of failing to meet its obligations to customers; and (ii)

[4] The most meaningful difference between a chapter 7 stockbroker liquidation and one under SIPA is that a chapter 7 trustee is required to liquidate for cash as quickly as possible the securities held by the failed broker and, with the exception of the delivery of customer name securities, make cash distributions to the debtor's customers in satisfaction of their claims. A SIPC trustee, on the other hand, is required to distribute securities to customers to the greatest extent practicable in satisfaction of their claims against the failed broker.

is either (A) insolvent, (B) the subject of a bankruptcy proceeding or (C) is not in compliance with any applicable regulations. Upon the issuance of a protective decree and appointment of a trustee, or a trustee and counsel, the court will order the removal of the entire liquidation proceeding to the bankruptcy court in the same judicial district.

For purposes of a liquidation under SIPA, a firm's assets are divided into three categories: (i) securities (including stocks and bonds) registered in the name of customers, which are either returned to the applicable customer or transferred on behalf of such customer to another firm;[5] (ii) cash and other securities held for customers (including stocks and bonds that are, for example, held in "street name"), which are divided pro rata among the customers; and (iii) general assets, which are used to pay any remaining unsecured claims of customers (after payments out of the SIPC reserve fund as discussed below) and expenses of the liquidation.

To the extent amounts in categories (i) and (ii) in the above paragraph are insufficient to cover customers' claims, SIPC will cover the remaining shortfall owed to customers in an amount up to $500,000 (including a maximum of $100,000 which a customer may have at the time held in cash with the firm) from the SIPC reserve fund. Customers are unsecured creditors of the firm for any shortfalls which are not paid out of the reserve fund.

In sum, in the event of a broker-dealer's failure and subsequent liquidation under SIPA, securities that are registered in the name of a customer would be transferred to another firm. With respect to cash and securities not registered in the name of the customer, but held by the broker-dealer for the customer's benefit, the customer would receive a pro rata portion of the aggregate amount of the cash and securities actually held by the broker-dealer. If there is a remaining shortfall, SIPC would cover a maximum of $500,000, only $100,000 of which may be a recovery for cash held at the broker-dealer.

4. Commodity Exchange Act ("CEA").

Customers' deposits of cash or other assets at a futures commission merchant (an "FCM") that represent margin or premiums on futures contracts or options on futures contracts traded on U.S. exchanges (the "deposits") are subject to the CEA and regulations thereunder. Some futures commission merchants are dually registered as broker-dealers under the Exchange Act.

In accordance with the CEA, an FCM generally must hold all deposits in the name of its customers as segregated "customer funds." An FCM dually registered as a broker-dealer should not commingle these "customer funds" with its broker-dealer assets.

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5 A "security" for SIPC purposes includes, among other things, notes, stock, debentures, puts, calls, straddles, options or privileges on any security. A "security" does not include any currency, or any commodity or related contract or futures contract, or any warrant or right to subscribe, purchase or sell any of the foregoing. *See* 15 U.S.C. § 78,111(14). These latter types of currency and instruments are discussed in Section 4 below.

In the event of the failure of an FCM dually registered as a broker-dealer, customers' claims to deposits would be subject to the Bankruptcy Code, as further set forth in Section 2 above.

5. *Insurance.*

Some firms purchase excess insurance to cover some or all of their customers' accounts in the event of a firm's failure. This coverage would compensate a customer for losses above the statutory limits under SIPA. Such excess coverage typically covers customers in the event of a firm's failure under the same circumstances that SIPA provides coverage. Sixteen broker-dealers[6] have formed a captive insurer, Customer Asset Protection Company ("CAPCO"), to provide excess coverage (although the coverage limits of the CAPCO policy are unclear). Only those 16 firms have coverage from CAPCO. In addition, the websites for Merrill Lynch and Schwab contain information that these firms have purchased excess coverage from Lloyd's of London.

6. *Some Practical Considerations.*

Although securities held by a broker-dealer in a customer's name ("customer-name securities") are largely without risk, most securities are held by broker-dealers in street name and would be available to satisfy other customers' claims in the event of a broker-dealer's insolvency. As a practical matter, it likely is not practical to hold any significant percentage of a sophisticated customer's securities in the customer's name. Thus, a customer should closely monitor the financial condition of its broker-dealers.

Moreover, inasmuch as securities that are registered in the name of a customer would be transferred to another firm in the event of a broker-dealer's failure, customers should consider establishing accounts with several different broker-dealers (assuming they have not already). This will facilitate the expeditious transfer of customer-name securities in the event of the failure of a broker-dealer, and will have the important ancillary benefit of mitigating the risk of loss that would exist if all accounts were held at one broker-dealer that failed.

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[6] The 16 broker-dealers are: A.G. Edwards & Sons, Inc.; Bear Stearns Securities Corp.; Credit Suisse Securities (USA) LLC; Edward D. Jones & Co. L.P.; National Financial Services LLC; Goldman Sachs & Co.; Goldman Sachs Execution & Clearing, L.P.; Lehman Brothers Inc.; Neuberger Berman LLC; Morgan Stanley & Co., Inc.; Morgan Stanley DW Inc.; Raymond James and Associates; Ridge Clearing & Outsourcing Solutions, Inc.; Robert W. Baird & Co.; Pershing LLC; and First Clearing, LLC.

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