

Client Alert

A report
for clients
and friends
of the Firm **March 2008**

FAQs Regarding Customer Asset Protection in a Broker-Dealer Bankruptcy

This client alert addresses some of the most frequently asked questions regarding the safeguards the financial industry has in place to protect investors from the economic failure of broker-dealers.

What protections are available for customer funds and securities held by a registered broker-dealer?

Broker-dealers are regulated by the Securities and Exchange Commission (SEC). The primary mechanism the SEC uses to assess a brokerage firm's financial integrity is the net capital rule (17 CFR Section 15c3-1), which requires broker-dealers to maintain enough liquid assets, net of liabilities, to satisfy promptly the claims of customers in the event they must liquidate. Brokerage firms must remain in compliance continuously with their net capital requirements, file regular periodic reports of their financial and operational condition and file special early warning reports if their liquid capital falls below specified levels.

Additionally, under the customer protection rule (17 CFR Section 15c3-3), broker-dealers are required to segregate customer funds and maintain possession and control of customer fully paid and excess margin securities (securities carried as margin collateral with a value in excess of 140% of a customer's debit balance). Margin securities may be used for a broker's permitted purposes, such as lending to other market participants.

In addition to safeguards provided under the net capital and customer protection rules, virtually all broker-dealers are members of the Securities Investor Protection Corporation (SIPC).

Many broker-dealers also obtain private insurance policies to provide customers with protection beyond SIPC limits.

What is SIPC?

SIPC is a non-profit corporation created pursuant to the Securities Investor Protection Act of 1970 (SIPA) to (1) establish and administer procedures for the liquidation of failed broker-dealers that are SIPC members and (2) provide limited financial protection to customers of failed broker-dealers out of SIPC funds.

How does SIPC protection work?

When a SIPC member firm fails, it ordinarily is liquidated under SIPA, not the Bankruptcy Code. SIPC generally steps in immediately and asks a federal court to appoint a trustee to liquidate the firm and protect its customers. Normally, the trustee will first try to have some or all customer accounts transferred from the failed broker-dealer to another SIPC member broker-dealer. Customers whose accounts are transferred are notified promptly and permitted to deal with the new firm or subsequently transfer their accounts to firms of their own choosing. If the trustee is unable to transfer customer accounts, the trustee satisfies claims on an individual basis after the customer files his or her claim with the trustee. There are a number of factors that may affect the timing of the liquidation process, including how quickly and completely claims are filed and the quality of the failed firm's books and records.

SIPA substantially alters the rights of unsecured creditors, giving customers with unsecured claims priority over other unsecured creditors in distributions of customer property.¹ (SIPA generally does not alter

¹ "Customer property" is "cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." (15 USC Section 78lll(4).)

the rights of secured creditors who have rights under the Bankruptcy Code.) While customers have a preferential claim to customer property, they rank *pari passu* with general creditors as to the distribution of other assets of the failed firm.

Customers of a failed brokerage firm will get back all securities that are registered in their name or are in the process of being registered (customer name securities).²

Other customer property is distributed ratably to customers based on their net equity claims.³ If sufficient funds are not available in the firm's customer accounts, SIPC will protect each customer up to \$500,000 for claims for cash and securities, except that claims for cash are limited to \$100,000 (the same amount of coverage offered by the FDIC for bank accounts).

Who is a “customer” and how are a customer’s separate accounts treated?

A customer is a person who has securities or cash on deposit with a SIPC member for the purpose of, or as a result of, securities transactions. Insiders of the firm, such as its owners, officers, directors, partners or control persons, are not customers for purposes of SIPC coverage.⁴ A broker-dealer or bank acting for itself rather than for its own customer also is not a “customer.”

It should be emphasized that customers who have more than one account at the same broker-dealer will have their accounts aggregated for purposes of the \$500,000 SIPC coverage limit. However, accounts held by a customer in separate capacities will be deemed accounts of separate customers. (See 15 USC Section 78lll(11).) For example, someone with an individual account, a joint account with a spouse, an individual retirement account and a trust account will be protected up to \$500,000 on each account (but a joint account with a spouse will not receive protection in excess of \$500,000). (See 17 CFR Section 300.100 – 105.)

What assets are not covered by SIPC?

SIPC protects most types of securities, such as notes, stocks, bonds, mutual funds and other investment company shares, and other registered securities. SIPC does not cover instruments such as unregistered investment contracts, unregistered limited partnership interests, fixed annuity contracts, currency, and interests in gold, silver, or other commodity futures contracts or commodity options.

From what date is the value of a customer’s account fixed?

The value of a customer’s net equity claim is fixed as of the SIPC filing date. The value can increase after this date if (1) the customer pays back a margin loan or other indebtedness to the broker-dealer or (2) there is a post-filing transaction.

What if the value of my securities change while the broker-dealer is being liquidated?

Customers remain at the risk of the market during the liquidation process, since SIPC will return securities and not cash to the extent that the customer had securities at the broker-dealer. SIPC does **not** protect investors against losses caused by a decline in the market value of their securities during the liquidation process. Of course customers will also receive the benefit of any increase in the market value of their securities during this period.

What if my broker-dealer clears through another broker-dealer?

For SIPC purposes, a customer is considered a customer of the clearing firm, not the introducing firm, except in cases where the introducing firm ordered unauthorized trades.

What if I invested in the broker-dealer’s own securities or proprietary investment products, such as its hedge funds?

As discussed above, SIPC does not cover market losses. Therefore, an investor who owns the securities of the failed

² “Customer name securities” are securities registered in the name of the customer and are not transferable in the hands of the failed broker-dealer. They do not include securities registered in the name of the customer which, by endorsement or otherwise, were in negotiable form. The stock transfer certificate must be completely unavailable to the broker-dealer so that it would be impossible for the broker-dealer to transfer the security to a new name.

³ A customer’s “net equity claim” equals the dollar amount of all cash in the customer’s account at the broker-dealer for the purpose of purchasing securities *plus* the value of securities held in the customer’s account *minus* any amount owed by the customer to the broker-dealer. A net equity claim represented by securities owned by a customer will to the extent possible be paid in kind by a distribution of securities of the same class. If the broker-dealer does not own enough securities to cover the claim, SIPC will attempt to purchase the needed securities in the marketplace. (See 15 USC Section 78fff-2(d).)

⁴ Owners include beneficial owners of five percent or more of any class of equity security of the firm (other than certain nonconvertible preferred stocks) or limited partners with a participation of five percent or more in the net assets or net profits of the firm.

broker-dealer will bear any loss of value of those securities. Investments in a failed firm's proprietary products remain subject to market risk like any other security and will be distributed in the same manner as other customer name securities or customer property, as described above.

What is the procedure for insolvent banks?

The procedure for FDIC administered receivership or conservatorship of an insolvent bank or thrift is governed by Title 12 of the U.S. Code. Banks are excluded from filing bankruptcy under Title 11. If securities are deposited in a custodial account at a bank, the bank must properly and clearly label the securities for the benefit of the customer. Under normal circumstances (absent fraud or operational error, just as with broker-dealers), securities properly identified in a custodial account at the bank should be returned to depositors as customer property. The potential risk lies in the treatment of the securities at the bank. If the securities are commingled with the bank's or other customers' assets, the customer might not be able to reclaim them and the securities could be treated as general assets of the bank subject to the claims of its creditors, or be subject to the security interests of secured creditors.

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