US CORNER

Cross-Border Broker Dealer Insolvencies

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I. Introduction

Over the past ten years, there has been increased international activity in the global securities markets. Coupled with this is the increased number of brokerage firms that now have international offices or subsidiaries in a variety of countries.[2] Given the globalization of the market, the Securities Investor Protection Corporation ('SIPC'), located in the United States, and the Financial Compensation Scheme Limited ('FSCS'), located in the United Kingdom, have agreed to enter into a Memorandum of Understanding in order to better serve the needs of securities investors in the event of member broker dealer liquidations.

SIPC is a non-profit membership corporation composed of most securities brokerage firms registered with the United States Securities and Exchange Commission. Membership in SIPC is not voluntary; it is mandated by law. SIPC was created under the Securities Investor Protection Act of 1970, codified at Title 15, United States Code, Sections78aaa-*lll*. The purpose of SIPC is to afford certain protections against losses to customers resulting from a member broker dealer's failure. SIPC is designed to promote investor confidence in the US securities markets. FSCS is an independent company set up in the United Kingdom under the Financial Services and Markets Act 2000. Similar to SIPC, FSCS is designed to compensate investors in cases where persons who are or have been authorized persons are unable, or likely to be unable, to satisfy claims in respect to a civil liability owed by them in connection with their investment business.

SIPC and FSCS recognize the potential for cross-border insolvencies and the prospect of cross-border claims from investors arising from failed member broker dealer firms and their affiliates. Consequently, SIPC and FSCS held a conference and entered into discussions on the treatment of investor claims arising from cross-border broker dealer member firms. As a result of these discussions, SIPC and FSCS mutually agreed to enter into a Memorandum of Understanding (the 'MoU'). This article discusses the protocol in arriving at the memorandum of understanding, the background of the investor protection programs, the terms of the MoU, and its implications for cross-border broker dealer insolvencies.

II. The roles of SIPC and FSCS within their own jurisdictions

A. Securities Investor Protection Corporation

The Securities Investor Protection Act ('SIPA'), 15U.S.C. Sect. 78aaa et seq., was enacted in 1970 in response to a rash of broker dealer firms that either went out of business or were merged or acquired during the paperwork crunch of 1968–1970.[3] SIPA incorporates the U.S. Bankruptcy Code (chapters 1, 3, and 5 and subchapters I and II of Chapter 7 of Title 11) to the extent it is consistent with the provisions of SIPA.

SIPC's members are generally all persons registered as broker or dealers under Section 15(b) of the Securities Exchange Act of 1934. SIPC excludes membership to persons whose principal business in

Notes

1 Ms. Caplan is Associate General Counsel, Securities Investor Protection Corporation. Mr. Kuczynski is Head of Legal Services for Financial Services Compensation Scheme. The Securities Investor Protection Corporation and the Financial Services Compensation Scheme, as a matter of policy, disclaim responsibility for any private publication by any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Securities Investor Protection Corporation or the Financial Services Compensation Scheme.

2 For example, as reported by the Central Registration Depository of the National Association of Securities Dealers (NASD), there are currently 580 SIPC member firms with 6,733 foreign affiliates, and 103 SIPC member firms with 236 foreign branches. These numbers represent a significant increase in international branches and affiliates since 1993.

3 In the late 1960s, after a rapid expansion in trading volume, the securities industry was not prepared for the concomitant paperwork explosion. The paperwork crunch impacted the financial position of many firms, leading to insufficient operating capital. Many firms were required to liquidate or merge. SIPA was drafted in response to this crisis. See Michael E. Don and Josephine Wang, 'Stockbroker Liquidations Under The Securities Investor Protection Act and Their Impact on Securities Transfers' (1990) 12 *Cardozo Law Review*.

the determination of SIPC, taking into account business of affiliated entities, is conducted outside the US.[4] There are seven directors who determine the policies and govern SIPC's operations.[5] The source of the SIPC Fund is assessments collected from SIPC broker dealer members and interest on investments in US government securities.[6] There is constant reassessment of the SIPC Fund by SIPC's Board of Directors in light of historical experience and potential future risk.

There are essentially three classes of SIPA liquidation proceedings. The first is the 'Direct Payment Procedure' where small cases are handled without supervision from the courts and no relief is afforded to general creditors.[7] This procedure is used where the claims of customers aggregate less than US$250,000. In moderately sized cases, SIPC serves as trustee in a liquidation proceeding. In these cases, the US Bankruptcy Court supervises the proceeding and SIPC designates outside counsel to assist in the liquidation. This type of SIPA case is usually used where there appear to be less than 500 customers and where non-customer creditors appear to be owed less than US$750,000.[8] In such a case, SIPC's personnel perform the review of claims filed with the trustee. As trustee, SIPC attempts to amass a general estate to satisfy creditors as in any other US Bankruptcy case. In the third type of proceeding, larger cases are handled by an independent trustee and outside counsel designated by SIPC.[9] SIPC remains an active party but provides more of a support role. The outside trustee processes claims with some oversight by SIPC. The trustee acts as a fiduciary to customers and other creditors, and attempts to maximize the return to all creditors.

The limits of SIPC protection are US$500,000 per customer, except that claims for cash are limited to US$10,000 per customer.[10] In addition, customers may receive a pro rata share of 'customer property'.[11]

SIPC only covers claims that arise from the entrustment of securities or cash with the Debtor. Pursuant to the statutory definition:

> The term 'customer' of a debtor means any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer. The term 'customer' includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities, but does not include –
>
> (A) any person to the extent that the claim of such person arises out of transactions with a foreign subsidiary of a member of SIPC …

SIPA Sect. 78*lll*(2)

Notably, the definition of 'customer' does not include the claim of a person that arises out of transactions with a foreign subsidiary of a member of SIPC. This provision appears to be somewhat inconsistent with the fact that SIPA provides customer coverage where a person conducts transactions with either a foreign branch office of a SIPC member or foreign division/affiliate (rather than a subsidiary) of a SIPC member firm.[12]

In terms of the scope of coverage, claims based on fraud, market loss, unsuitability, or lack of sophistication of the purchaser or seller in making a transaction do not form the basis of a 'customer' claim. In addition, claims for breach of contract, for example the failure to carry out a customer's order to sell securities, are not considered 'customer' claims and are therefore not eligible for SIPC coverage. Such claims may be perfectly valid claims against the defunct brokerage firm, but may only be satisfied out of the general estate assets of the Debtor, rather than: (i) through customer property held by the Debtor or (ii) funds advanced by SIPC. Clearly claims based upon unprotected investments such as commodities futures or foreign currency are not given SIPC coverage. Likewise, brokers, banks, directors of the brokerage firm, officers of the firm, partners of the firm and others are ineligible for advances from SIPC.[13] As described below, there are

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4 See SIPA Sect. 78ccc(a)(2)(A)(i). In the past, nine members were granted this foreign exclusion.

5 SIPA Sect. 78ccc(c).

6 SIPA Sect 78ddd.

7 SIPA Sect. 78fff-4.

8 SIPA Sect. 78eee.

9 Id.

10 SIPA Sect. 78fff-3.

11 SIPA Sects. 78*lll*(4); 78fff-2(c).

12 See SIPC Rule 200; SIPA Sect. 78fff-3(a)(5).

13 SIPA Sect. 78fff-3.

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significant differences in the coverage provided by SIPC as compared to FSCS.

B. The Financial Compensation Scheme Limited

FSCS, as a protection scheme, was established by rules made by the Financial Services Authority (FSA) for the purpose of compensating persons where authorized firms are unable, or likely to be unable, to satisfy claims against them.

The Financial Services and Markets Act 2000 provides for a single regulator, the FSA, and a single compensation scheme, FSCS. FSCS contributes to the consumer protection objective of the 2000 Act. FSCS is a 'one stop shop' for claims for compensation in respect of investments, deposits, and insurance. FSCS assumed the responsibilities carried out by predecessor schemes including the Investors Compensation Scheme (ICS), the Deposit Protection Board and the Policyholders Protection Board. ICS operated from 28 August 1988 to 30 November 2001.

FSCS is a company limited by guarantee, established by the FSA, and whose directors are appointed by the FSA. The Chairman's appointment (and removal) is subject to the approval of HM Treasury. It is funded by a 'pay as you go' levy on authorized firms, usually calculated by reference to the expected cost of compensation for the next 12 months and allocated to firms by reference to their levels of the protected business giving rise to claims.

FSCS is triggered by an inability of an authorized firm to meet investors' claims against it. Firms may, but need not, be subject to formal insolvency process. If not, FSCS will make an assessment of the firm's ability to meet investors' claims. Unlike SIPC, FSCS does not fulfill any formal 'trustee' role in insolvency proceedings such as liquidation. FSCS's involvement tends to be limited to coordinating the handling of investor creditor claims, and making a claim in the liquidation when standing in the shoes of compensated investors.

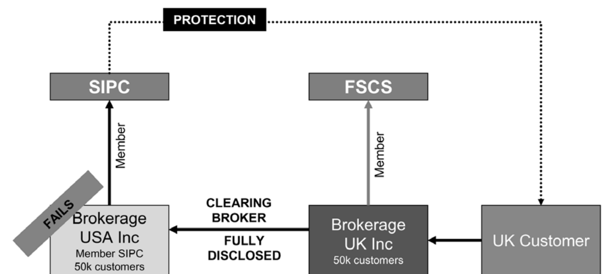
FSCS is directed towards individuals and small businesses. Investors based overseas but dealing with the UK offices of authorized firms are usually eligible for protection. Connected parties such as directors, managers and partners of a failed firm, and their close relatives, are excluded. Compensation is available in respect of any civil liability owed by an investment firm to an investor in respect of the investment business.

In contrast to SIPC coverage, FSCS would consider a claim for fraud or theft, and for breach of contract, such as the failure to carry out an order. The majority of compensation claims against investment firms received by FSCS are in respect of bad advice. The maximum compensation payable in respect of an investment claim is GBP48,000 comprising 100% of the first GBP30,000 and 90% of the next GBP20,000 of the investor's loss (as quantified by FSCS).

III. Customer protection in member broker dealer cross-border insolvencies

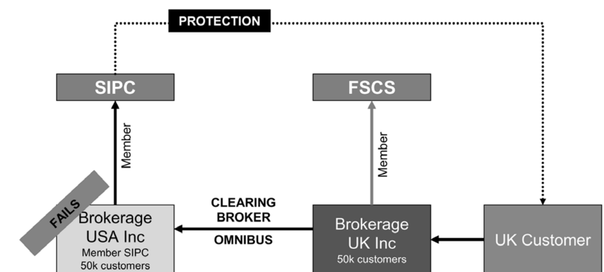
There are several scenarios that may involve cross-border insolvencies of member broker dealers. The question arises, which investment protection program provides the coverage and what happens if a customer reaches the limits of that protection? FSCS and SIPC analyzed these fact patterns prior to developing the MoU. The following provides hypothetical examples of such questions.

A. Case 1: USA Clearing Broker Fails/Fully Disclosed



In this hypothetical, there is a UK customer of a UK brokerage firm (a member of FSCS) that clears its trades and orders on a fully disclosed[14] basis with a US, SIPC member firm. If the US clearing broker becomes insolvent and is placed in a SIPA liquidation, then the UK customer will be afforded protection by SIPC, so long as there is a fully disclosed clearing agreement.

B. Case 2: USA Clearing Broker Fails/Omnibus Clearing Arrangements



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14 A fully disclosed clearing agreement is one in which the brokerage firm can identify the names of all the investors and/or their accounts. In other words, the clearing broker is informed as to who is the account holder.

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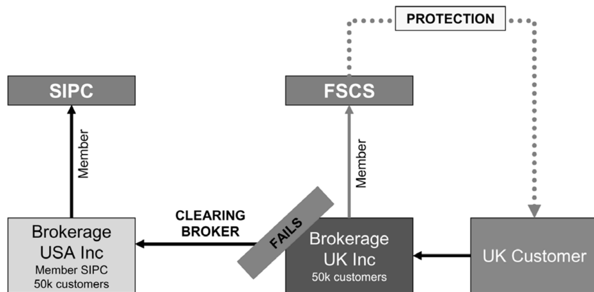
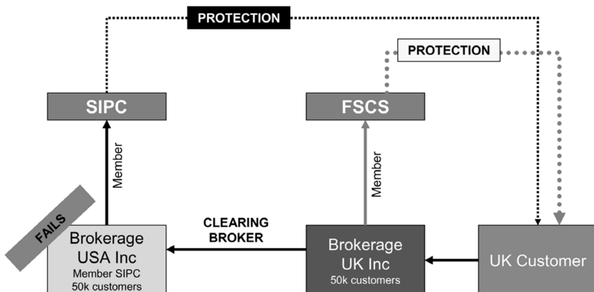
In this hypothetical, the US clearing broker is placed in a SIPA liquidation. The UK broker firm clears through the US clearing broker. In such a scenario, the UK customer will be protected by the 'pass through' provisions under SIPA Sect. 78fff-3(a)(5) if there is an omnibus clearing agreement between the UK brokerage firm and the US clearing broker.

C. Case 3: UK Brokerage Firm Fails



In this scenario, the UK broker clears through a US clearing broker. The UK member brokerage firm becomes insolvent. In such a case, FSCS would be likely to compensate the UK customers for their losses.

D. Case 4: UK Customer Protection



In this final hypothetical, the interaction of both authorities comes into play. Here, a UK customer has an account at a UK brokerage firm. The UK brokerage firm clears through a US member clearing broker that has failed. Clearly, SIPC would cover losses to the UK customer up to the extent that customer was eligible for SIPC coverage. The question becomes one of supplemental coverage. At this point, there would be required some interaction between SIPC and FSCS Here, FSCS may provide the UK customer for losses not covered under SIPA. Clearly, FSCS offers a broader protection for customers in such an insolvency and may in fact, choose to provide such extended protections to the UK customer if its member firm is unable to meet all claims.

E. Chart Summarizing Hypothetical Insolvencies

The chart below illustrates potential areas of interaction for the authorities in the event of a cross-border liquidation. Likewise, the chart delineates areas for which there could be potential coverage from both investor protection programs and cross-border claims from investors.

In these examples FSCS would not protect in the first two, as the UK firm is not insolvent, but may do so in the third scenario.

IV. The Memorandum of Understanding

As illustrated above, given the number of international branch and affiliate broker dealer offices, there is the prospect that the UK and US may be required to work together in a member insolvency. In light of this fact, FSCS and SIPC agreed that a MoU would be useful for future insolvencies of member brokerage firms.[15] The following is a discussion of the terms and conditions of the MoU.[16]

Broker failure	*Clearing agreements with USA broker*	*SIPC protection*	*FSCS protection*
Case 1. USA broker failure	Fully disclosed	SIPC protection	Would FSCS protect non-entrustment losses?
Case 2. USA broker failure	Omnibus	Protected by pass through provisions under SIPA	Would FSCS protect non-entrustment losses?
Case 3. UK broker failure	All	None necessary, securities	Would FSCS protect

Notes

15 Pursuant to the terms of the MoU, the US member broker dealer insolvencies refer to those proceedings conducted under SIPA. In the US, there are alternatives to a SIPA liquidation proceeding for stockbrokers. See Stephen P. Harbeck, 'Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court Under the Securities Investor Protection Act' (1982) 56 *The American Bankruptcy Journal*. Moreover, a firm may become 'insolvent' in the US and not file a proceeding.

16 The International Organization of Securities Commissions ('IOSCO') have entered into a memorandum of understanding among various international securities commissions, including the United States Securities and Exchange Commission and the Financial Services Authority. The nature of this MoU differs from that of the MoU discussed above because its purpose is in enforcing security compliance with the laws of the signatories.

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The objective of the MoU is to facilitate and encourage good relations between FSCS and SIPC by requiring performance on the part of each investor compensation program. To reach this goal, the MoU provides by its terms for the regular exchange of information between the authorities, and the cooperation when dealing with claims that involve cross-border issues. The MoU is not legally binding on the parties. As a corollary to this, the MoU does not override or challenge any laws or regulations of the jurisdictions under which each investor compensation program is governed.

In an effort to facilitate communication between the organizations, the MoU requires that the authorities notify each other as soon as possible if a member firm has joined the other's program, for example, where an overseas foreign branch of a member firm in one country joins the other country's investor compensation program. The MoU also requires that the authorities communicate to one another with respect to any insolvency where the member brokerage firm or clearing firm has connections with the host country, for example, where there is a large customer base. It provides that the home country keep the other investor protection program up to date on the developments of a liquidation proceeding.

The terms of the MoU also provide for information to be exchanged when there are changes in the legal aspects of the authorities, or any material changes that may affect overseas investors and the treatment of their claims. Moreover, it is agreed that at least every twelve months, the authorities will send each other a report of activities, such as an annual report.

A key element of the MoU is cooperation. To facilitate cooperation, the terms provide that an investor compensation program, upon becoming aware of an insolvent member firm which has connections to the host country, will notify the host country of the firm's identity and relevant facts as soon as possible. To assist in processing claims, the two countries will cooperate with one another, as far as legally and practicably possible. Such cooperation includes exchanging information on the brokerage firm, directing investors/claimants to the appropriate authorities, and providing contact information to investors. In addition, in the processing of claims, each investor compensation program, if requested by the other, will provide general insolvency advice and assistance, or information on compensation.

The MoU also provides for the treatment of member broker dealer insolvencies where the failure triggers claims against both countrys' investor protection programs. It is agreed that the firm's home country will lead the handling of investor claims for compensation and will determine the claims first, including the compensation, before the host country investor compensation program reviews any claims[17]. Pursuant to the MoU, when the home country has concluded its procedure with respect to an investor, who also has a claim against a branch of the member firm in the host country, the program in the home country shall send a copy of any determination and the details of any distribution along with the supporting documents to the investor compensation program in the host country. This procedure will apply only when the home country investor compensation program or the investor believes that the host country may be obliged to pay supplementary compensation. Supplementary compensation is a distinct possibility given the differing breadth of the SIPC program and FSCS. The host country will seek to inform the home country of the outcome of the claim procedure, along with a copy of the decision and any supporting documentation.

During the analysis of the claims of investors of the defunct brokerage, each investor compensation program will apply its own rules and laws when notifying investors of the insolvency of a member firm, when reviewing and dealing with claims, and when conducting the liquidation. In doing so, the home country will not prejudice the right of the host country to impose its objective and apply its rules with respect to participating member firms.

Finally, as to insolvency issues, it is agreed upon between the investor compensation programs that if requested by one investor compensation program, the other will reasonably attempt to deal with third parties in its own jurisdiction as to requesting and sorting files from an insolvent member, compiling and submitting any reports required in that jurisdiction, and attending meeting with investors, creditors and insolvencies practioners.

V. Summary

The terms of the MoU, based upon the facts of prior liquidations, will prove beneficial. For example, in the SIPA liquidations of A.R. Baron & Co., Inc., and Blinder, Robinson & Co., Inc., SIPC had significant

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17 It should be noted that, in a SIPA liquidation, the process of compensating customers includes a prompt distribution of 'customer property' and funds from SIPC. However, customers with large claims that are not fully satisfied with the initial distribution may receive additional distributions as a trustee recovers additional customer property often by means of lawsuits. Thus, a customer's full payment of a large claim may be gradual and may take years as the trustee of the liquidation recovers assets for distribution to creditors and makes multiple distributions.

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mailings to foreign claimants, and in particular to claimants in the UK. The cooperation delineated in the MoU could assist in reaching foreign investors or providing information to investors regarding the member firm insolvency, and the nature and limits of protection of the particular customer protection program.

The MoU also provides terms of cooperation, which may prove useful when either investor protection program is attempting to repatriate assets for distribution to creditors. For example, in the SIPA liquidation of Bevill, Bressler & Schulman, Inc., the trustee filed a complaint to void a US$19 million transfer of securities to Spencer Savings & Loan Association. The securities were held by Bevill, Bressler & Schulman ('BBS') for the benefit of Spencer, a BBS customer, in an account located in the London. The trustee was faced with the extraterritorial application of SIPA and succeeded in recovering the securities. Under the MoU, SIPC could request assistance, advice and cooperation from FSCS.

Historically, SIPC has also had some, albeit limited, experience in the liquidation of foreign branch offices or subsidiaries of a SIPC member firm. In the liquidation of Weis Securities, Inc., the Weis firm held operations in London, Paris, and Tel Aviv. British customers serviced by the London branch office did not commence separate liquidation proceedings in the UK, but instead simply filed their claims with the Weis trustee in the US. These claims were treated in the same manner as those of domestic creditors. Pursuant to the terms of the MoU, SIPC would notify FSCS of such a liquidation, rely on FSCS for cooperation in the liquidation, and, if appropriate, FSCS may extend supplemental coverage to claimants.

In short, the MoU is important for the UK and US in a situation when there is an international broker dealer insolvency where such broker dealer is a member of either country's investor protection program. As discussed, an insolvency of such a broker dealer could raise supplemental coverage issues for a customer. To this end, the purpose of both SIPC and FSCS would be furthered in protection of investor customers. Thus, in light of: (1) the investor protection programs experience in dealing with international claimants; (2) the liquidation of member firms with international subsidiaries or branch offices; and (3) the increased globalization of securities market, this MoU will forge a continuing relationship between the international investor protection programs to make the programs efficient and effective in a cross-border insolvency of a member firms.

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