

Securities Investor Protection Act

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Overview

Typically, when a brokerage firm fails, the SIPC will arrange to have the failed brokerage's accounts transferred to a different securities brokerage firm. If the SIPC is unable to arrange the accounts' transfer, the failed firm is liquidated. In that case, the SIPC will send investors either certificates for the stock that was lost or a check for the market value of the shares.

Although the Bankruptcy Code provides for a stockbroker liquidation proceeding, 11 U.S.C. § 741 *et seq.*, it is far more likely that a failing brokerage will find itself involved in a SIPA proceeding rather than a Bankruptcy Code liquidation case. Brokerage firms may be liquidated under the Bankruptcy Code, however, if SIPC does not file an application for a protective decree with the district court or if the district court finds that customers of the brokerage firm are not in need of protection under SIPA. 15 U.S.C. §§ 78eee.

History

Prior to 1938, little protection existed for customers of a bankrupt stockbroker unless they could trace cash and securities held by failed stockbrokers. In 1938 Congress enacted section 60e of the Bankruptcy Act and created a single and separate fund concept which was intended to minimize losses to customers by giving them priority over claims of general creditors. *1898 Bankruptcy Act § 60(e)(2) (repealed)*. Because the fund was normally inadequate, however, customer losses continued.

Following a period of great expansion in the securities industry during the 1960's, a serious business contraction hit the industry in 1969-1970. This situation led to voluntary liquidations, mergers, receiverships, and bankruptcies of a substantial number of brokerage houses. *Annotation, Validity, Construction,*

and Application of Securities Investor Protection Act of 1970 (15 U.S.C.S. §§ 78aaa et seq.), 23 A.L.R. Fed. 157, 179 (1975). Customers of these firms found the cash and securities which they had on deposit dissipated or tied up in lengthy bankruptcy proceedings. Along with the concern over mounting customer losses and the subsequent erosion of investor confidence, the Congress was also concerned with a possible "domino effect" involving otherwise solvent brokers that had substantial open transactions with firms that failed. In reaction to this growing concern, the Congress enacted the Securities Investor Protection Act of 1970 (hereinafter referred to as SIPA). The goal was to arrest this process, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers. *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 414 (1975). SIPA was designed to apportion responsibility for carrying out the various goals of the legislation to several groups. Among them are the Securities and Exchange Commission (hereinafter referred to as SEC), various securities industry self-regulatory organizations, and the Securities Investor Protection Corporation (hereinafter referred to as SIPC). SIPA was designed to create a new form of liquidation proceeding. It is applicable only to member firms and was designed to accomplish the completion of open transactions and the speedy return of most customer property. *Id.*

SIPA

SIPA is codified as Title 15, United States Code, Sections 78aaa - 111. SIPA created SIPC, a nonprofit, private

membership corporation to which most registered brokers and dealers are required to belong. 15 U.S.C. § 78ccc. The SIPC fund, which constitutes an insurance program, is authorized under 15 U.S.C. § 78ddd(a) and assessments against members are authorized by 15 U.S.C. §§ 78ddd(c) and (d). The fund is designed to protect the customers of brokers or dealers subject to SIPA from loss in case of financial failure of the member. The fund is supported by assessments upon its members. If the fund should become inadequate, SIPA authorizes borrowing against the U.S. Treasury. An analogy could be made to the role of the Federal Deposit Insurance Corporation in the banking industry.

Bankruptcy Liquidation Versus SIPA Liquidation In Bankruptcy Court

The essential difference between a liquidation under the Bankruptcy Code (11 U.S.C. §§ 741 - 752) and one under SIPA is that under the Code the trustee is charged with converting securities to cash as quickly as possible and, with the exception of the delivery of customer name securities, making cash distributions to customers of the debtor 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 debtor.

There is a fundamental difference in orientation between the two proceedings. There is a statutory grant of authority to a SIPC trustee to purchase securities to satisfy customer net equity claims to specified securities. 15 U.S.C. §78fff-2(d). The trustee is required to return customer name securities to customers of the debtor (15 U.S.C. § 78fff-2)(c)(2)), distribute the fund of "customer property" ratably to customers (15 U.S.C. § 78fff-2(b)), and pay, with money from the SIPC fund, remaining customer net equity claims, to the extent provided by the Act (15 U.S.C. §§ 78fff-2(b) and 3(a)). A trustee operating under the Code lacks similar resources. The Code seeks to protect the filing date value of a customer's securities account by liquidating all non-customer name securities. SIPA seeks to preserve an investor's portfolio as it stood on the filing date. Under SIPA, the customer will receive securities whenever possible.

Role Of The District Court

15 U.S.C. § 78eee(a)(3)(A) provides that SIPC may file an application for a protective decree with the United States district court if SIPC determines that any member has failed or is in danger of failing to meet obligations to customers and meets one of the four conditions specified in 15 U.S.C. § 78eee(b)(1). This application will be filed as a civil case in which SIPC or the SEC or both are named as plaintiff, and the member securities firm is named as the debtor-defendant. In the event that the SIPC refuses to act under the SIPA, the SEC may apply to the United States District Court for the District of Columbia to require the SIPC to discharge its obligations under SIPA. 15 U.S.C. § 78ggg(b). By contrast, customers of failing broker-dealers do not have an implied right of action under SIPA to compel the SIPC to exercise its statutory authority for their benefit. *Barbour* at 425. Upon the filing of an application, the district court has exclusive jurisdiction of the debtor-defendant and its property.

The institution of a case under SIPA brings a pending bankruptcy liquidation to a halt. Irrespective of the automatic stay, SIPC may file an application for a protective decree under SIPA. 11 U.S.C. § 742; 15 U.S.C. § 78aaa *et seq.* The filing stays all proceedings in the bankruptcy case until the SIPC action is completed. *Id.* Pending issuance of a protective decree, the district court:

[i.] *shall* stay any pending *bankruptcy*, mortgage foreclosure, equity receivership, or other proceeding to reorganize, conserve, or liquidate the debtor or its property and any other suit against any receiver, conservator, or trustee of the debtor or its property, and shall continue such stay upon appointment of a trustee . . .

[ii.] *may* stay any proceeding to enforce a lien against property of the debtor or any other suit against the debtor, including a suit by stockholders of the debtor which interferes with prosecution by the trustee of claims against former directors, officers, or employees of the debtor, and may continue such stay upon appointment of a trustee ...

[iii.] *may* stay enforcement of, and upon appointment of a trustee ... [if a protective decree is issued] ... may continue the stay for such period of time as may be appropriate, but shall not abrogate,[sic] any right of setoff, except to the extent such right may be affected under section 553 of Title 11 of the United States Code ... and shall not abrogate the right to enforce a valid, nonpreferential lien or

pledge against the property of the debtor; and

[iv.] *may* appoint a temporary receiver.

15 U.S.C. § 78eee(b)(2)(B)(I - iv) (emphasis added).

In addition, upon the filing of a SIPC application, 11 U.S.C. § 362 comes into effect.

SIPA provides that the district court shall issue a protective decree if the debtor consents, the debtor fails to contest the application for a protective decree, or the district court finds that one of the conditions specified in 15 U.S.C. § 78eee(b)(1) exist. If the court issues a protective decree, then the court will appoint a trustee and an attorney for the trustee whom SIPC, in its sole discretion, specifies. 15 U.S.C. § 78eee(b)(3). Upon the issuance of a protective decree and appointment of a trustee, or a trustee and counsel, the district court shall order the removal of the entire liquidation proceeding to the bankruptcy court in the same judicial district. 15 U.S.C. § 78eee(b)(4).

Removal To Bankruptcy Court

The case is removed to the bankruptcy court as an adversary proceeding for liquidation. No filing or removal fee is charged. The reason for using an adversary proceeding number is historical. While these SIPA proceedings are not bankruptcy cases, by law certain procedures prescribed in chapters 1, 3, and 5, and subchapters I and II of chapter 7 of Title 11 of the United States Code are applicable in SIPA proceedings. In addition, there is no related bankruptcy case number. Statistical reports to the Administrative Office should repeat the adversary number so that the Statistics Division will know it is a SIPA matter. Forms B111A (Adversary Proceeding Opening Report) and B111B (Adversary Proceeding Closing Report) should be used since this is an adversary proceeding. For adversary proceedings within the adversary SIPA proceeding, the clerk's office should use the original adversary proceeding number for the related case number.

SIPA requires that the bankruptcy court hold a hearing with 10 days notice to customers, creditors, and stockholders on the disinterestedness of the trustee or attorney for the trustee. 15 U.S.C. § 78eee(b)(6)(B). At the hearing, the court will entertain grounds for objection to the retention of the trustee or attorney for the trustee including, among other things, insider considerations. 15 U.S.C. § 78eee(b)(6)(A). If SIPC appoints itself as trustee, it should be deemed disinterested, and where a SIPC employee has been specified, the employee shall not be disqualified solely because of his employment. *Id.* Neither the Bankruptcy Code, Bankruptcy Rules, nor SIPA provide for United States trustee or Bankruptcy Administrator involvement.

SIPA provides for noticing of both customers and creditors. The noticing requirements provided for in 15 U.S.C. § 78fff-2(a)(1) are performed by the trustee, not the clerk of the bankruptcy court. While SIPA does not require a formal proof of claim for customers (other than certain insiders and their relatives), it does require a written statement of claim. The trustee will normally provide customers with claim forms and instructions. The claim form must be filed with the trustee rather than the clerk of the bankruptcy court. 15 U.S.C. § 78fff2(a)(2). With limited, specified exceptions, no claim of a customer or other creditor can be allowed unless it is received by the trustee within six months after the initial publication of notice. 15 U.S.C. § 78fff-2(a)(3).

Liquidation Proceedings

The purposes of a SIPA liquidation are: (1) to deliver customer name securities to or on behalf of customers; (2) to distribute customer property and otherwise satisfy net equity claims of customers; (3) to sell or transfer offices and other productive units of the debtor's business; (4) to enforce the rights of subrogation; and (5) to liquidate the business as promptly as possible. 15 U.S.C. § 78fff(a). To the extent possible, consistent with SIPA, the liquidation is conducted in accordance with chapters 1, 3, 5 and subchapters I and II of chapter 7 of Title 11. 15 U.S.C. § 78fff(b). A section 341 meeting of creditors is conducted by the trustee. Noncustomer claims are handled as in an asset case. Costs and expenses, and priorities of distribution from the estate, are allowed as provided in section 726 of Title 11. Funds advanced by SIPC to the trustee for costs and expenses are recouped from the estate, to the extent there is any estate, pursuant to section 507 of Title 11.

Powers Of The Trustee

The powers of the trustee in a SIPC case are essentially the same as those vested in a chapter 7 trustee appointed under Title 11. "In addition, a trustee may, with the approval of SIPC but without any need for court approval:

1. hire and fix the compensation of all personnel (including officers and employees of the debtor and of its examining authority) and other persons (including accountants) that are deemed by the trustee necessary for all or any purposes of the liquidation proceeding;
2. utilize SIPC employees for all or any purposes of a liquidation proceeding; and
3. margin and maintain customer accounts of the debtor . . ."

15 U.S.C. § 78fff-1(a).

A SIPC trustee may reduce to money customer securities constituting customer property or in the general estate of the debtor. 15 U.S.C. § 78fff-1(b). The trustee shall, however, deliver securities to customers to the maximum extent practicable. 15 U.S.C. § 78fff-1(b)(1). Subject to prior approval of SIPC, but again without any need for court approval, the trustee may also pay or guarantee any part of the debtor's indebtedness to a bank, person, or other lender when certain conditions exist. 15 U.S.C. § 78fff-1(b)(2).

The trustee is responsible for investigating the acts, conduct, and condition of the debtor and reporting thereon to the court. 15 U.S.C. § 78fff-1(d)(1). The trustee must also provide a statement on the investigation to SIPC and to other persons as the court might direct. 15 U.S.C. § 78fff-1(d)(4). Moreover, the trustee must make periodic reports to the court and to SIPC on the progress of distribution of cash and securities to customers. 15 U.S.C. § 78fff-1(c).

Claims

Upon receipt of a written statement of claim, the trustee promptly discharges obligations of the debtor relating to cash and securities by delivering securities or making payments to or on behalf of the customer insofar as such obligations are ascertainable from books and records of the debtor, or are otherwise established to the satisfaction of the trustee. The value of securities delivered in this regard are calculated as of the close of business on the filing date. 15 U.S.C. § 78fff-2(b).

The court must authorize the trustee to satisfy claims out of monies advanced by SIPC for this purpose, notwithstanding that the estate may not have sufficient funds for such payment. 15 U.S.C. § 78fff-2(b)(1). The court is generally not involved in the process except to the extent that a dispute arises between the trustee and customers regarding specific claims. Simple objections stay with the initial adversary proceeding. Occasionally, however, significant litigation arises in this area which generates related actions in the form of additional adversary proceedings.

Distribution

Customer related property of the debtor is allocated as follows:

- A. First, to SIPC in repayment of advances made to the extent they were used to recover securities apportioned to customer property;
- B. Second, to customers of the debtor on the basis of their net equities;
- C. Third, to SIPC as subrogee for the claims of customers; and
- D. Fourth, to SIPC in repayment of advances made by SIPC to transfer or sell customer accounts to another SIPC member firm.

15 U.S.C. § 78fff-2(c)(1).

The trustee must deliver customer name securities to the customer if such customer is not indebted to the debtor. If indebted, then the customer may, with the approval of the trustee, reclaim securities in his name upon payment to the trustee of all such indebtedness. 15 U.S.C. § 78fff-2(c)(2).

The trustee may, with the approval of SIPC, sell or otherwise transfer to another member of SIPC, without consent of any customer, all or any part of the account of a customer. 15 U.S.C. § 78fff-2(f). The trustee may also enter into any agreement, and SIPC will advance funds as necessary, to indemnify the member firm against shortages of cash or securities in customer accounts sold or transferred. 15 U.S.C. § 78fff-2(f)(2). In addition, the trustee may purchase securities in a fair and orderly market in order to deliver securities to customers in satisfaction of their claims. 15 U.S.C. § 78fff-2(d).

To the extent customer property and SIPC advances are not sufficient to pay or satisfy in full the net equity claims of customers, then customers are entitled to participate in the estate as unsecured creditors. 15 U.S.C. § 78fff-2(c)(1).

Advances

The law requires that SIPC make advances to the trustee in order to satisfy claims and otherwise liquidate the business. These advances are made to satisfy customer claims in cash, to purchase securities to satisfy net equity claims in lieu of cash, and to pay all necessary costs and expenses of administration and liquidation of the estate to the extent the estate of the debtor is insufficient to pay said costs and expenses. Any amount advanced in satisfaction of customer claims may not exceed \$500,000 per customer. 15 U.S.C. § 78fff-3(a). If part of the claim is for cash, the total amount advanced for cash payment must not exceed \$100,000. 15 U.S.C. § 78fff-3(a)(1). The difference between cash payments and the maximum amount allowed can be satisfied by the delivery of securities, or cash in lieu of securities.

Direct Payment Under SIPA Outside The Bankruptcy Court

In certain situations, SIPC may elect to utilize a direct payment procedure to the customers of a debtor, thereby avoiding a trustee and the courts. Certain preconditions must exist. The claims of all customers must aggregate less than \$250,000, the debtor must be financially distressed as defined in the law, and the cost to SIPC for direct payment process must be less than for liquidation through the courts. 15 U.S.C. § 78fff-4(a).

If direct payment is utilized, the entire proceeding remains outside the court. The process remains essentially a transaction between SIPC and the debtor's customers.

Although SIPA provides for a direct payment procedure in lieu of instituting a liquidation proceeding, the bankruptcy court may still become involved in disputes regarding the direct payment procedure. A person aggrieved by a SIPC determination with respect to a claim in a direct payment procedure may, within six months following mailing of a SIPC determination, seek a final adjudication of such claim by the court. 15 U.S.C. § 78fff-4(e). The courts having jurisdiction over cases under Title 11 have original and exclusive jurisdiction of any civil action for the adjudication of such claims. The action is to be brought in the judicial district where the head office of the debtor is located. It would be brought as an adversary proceeding in the bankruptcy court even though there is no main case.

Role Of Securities And Exchange Commission

The SEC is responsible for regulating and supervising the activities of the SIPC. The SEC promulgates operating rules which establish the role of self-regulatory organizations and examining authorities, and their reporting responsibilities to SIPC of inspections and reviews of its member firms. SIPC's member firms are also required to provide information and documentation as necessary to assist in accomplishing these inspections. The penalties for fraud, deceit, or withholding of information throughout the processes covered by this law are severe. 15 U.S.C. § 78jjj(c).

Compensation In A SIPA Action

SIPA specifies that the bankruptcy court must grant reasonable compensation for the services and expenses of the trustee and the attorney for the trustee. Interim allowances are also permitted. 15 U.S.C. § 78eee(b)(5)(A). Any person seeking allowances must file an application which complies in form and content with provisions in Title 11, and must also serve a copy on the debtor, SIPC, creditors and other persons the court may designate. The court is required to fix a time for a hearing on the application. Notice need not be given to customers whose claims have been or will be paid in full or creditors who cannot reasonably be expected to receive any distribution. 15 U.S.C. § 78eee(b)(5)(B).

SIPC will review the application and file its recommendation with respect to such allowances prior to the hearing on the application. In any case where the allowances are to be paid by SIPC without reasonable expectation of recoupment and there is no difference between the amount applied for and the amount recommended by SIPC, the bankruptcy court must award that amount. 15 U.S.C. § 78eee(b)(5)(C). If there is a difference, the court must, among other considerations, place considerable reliance on the recommendation of SIPC. If the estate is insufficient to cover these awards as costs of administration, 15 U.S.C. § 78eee(b)(5)(E) provides that SIPC will advance the necessary funds to cover the costs.