FDIC and SEC Propose Rules to Implement the Provisions for Covered Broker-Dealers under Title II of Dodd-Frank

March 2, 2016

Overview

On February 17, 2016, the Federal Deposit Insurance Corporation ("**FDIC**") and the Securities and Exchange Commission ("**SEC**") jointly issued a **proposed rule** (the "**Proposed Rule**") to implement the provisions applicable to covered broker-dealers under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Title II**").[1] The Proposed Rule is intended to provide clarity on those provisions, including the roles of the FDIC as receiver and the Securities Investor Protection Corporation ("**SIPC**") as trustee as well as the administration of claims of customers and creditors.

The Proposed Rule attempts to assure rapid and orderly transfer of assets to a viable entity (which could include a new bridge broker-dealer) that would continue the business without systemic disruptions while still assuring that the basic protections afforded under a proceeding under the Securities Investor Protection Act of 1970 ("**SIPA**") are made available. While the Proposed Rule indeed provides welcomed clarity to the roles of the FDIC and SIPC and the interplay between the orderly liquidation provisions of Title II and the liquidation provisions of SIPA, we anticipate that an actual liquidation of a broker-dealer under Title II will be quite rare.

Comments on the Proposed Rule are due within 60 days after publication of the Proposed Rule in the Federal Register.

Background

Broker-Dealer Resolution under SIPA

An SEC-registered broker-dealer that encounters financial difficulty and whose customers are in need of protection has traditionally been resolved through liquidation under SIPA, which is a judicial process supervised by a bankruptcy court and conducted under the oversight of a trustee appointed by SIPC.

A key goal under SIPA is the protection of customers, who have a preferred claim to recovery from the pool of "customer property" (generally all customer-related property held by the broker-dealer). In addition, customers are entitled to recover any "customer name securities" held by the broker-dealer.[2] Upon commencement of a SIPA proceeding the broker-dealer will cease to conduct business, subject to very limited exceptions. In order to mitigate disruption to customers, the trustee in a SIPA proceeding will generally seek to sell or transfer the broker-dealer's customer accounts and associated customer property to another SIPC member as promptly as practicable, thereby allowing customers to regain early access to their accounts and resume trading.

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[1] FDIC and SEC, Covered Broker-Dealer Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Feb. 17, 2016).

[2] SIPA defines "customer name securities" as securities "which on the filing date were registered in the name of the customer, or were in the process of being so registered…but does not include securities registered in the name of the customer which, by endorsement or otherwise, were in negotiable form." Customer name securities are relatively rare in practice in the modern securities industry.

To the extent an account transfer is not effected, customers recover through a claims process in which the SIPA trustee determines (i) each customer's "net equity"—generally the dollar value of the customer's account on the filing date less indebtedness of the customer to the broker-dealer on such date—and (ii) the total amount of customer property available for distribution to all customers, with customers entitled to share pro rata in the pool of customer property in accordance with their net equity. Any shortfall in the amount of customer property available for distribution to a customer in respect of the customer's net equity claim will, to the extent possible, be satisfied through advances from SIPC up to a maximum of $500,000 per customer (of which up to $250,000 may be in respect of claims for cash). To the extent any deficiency claims remain after the distribution of customer property and such SIPC advances, customers would share pari passu with general unsecured creditors of the broker-dealer in recoveries coming from the broker-dealer's "general estate" (i.e., the pool of non-customer property).

Resolution of Broker-Dealers under Title II

Title II created a new orderly liquidation authority for resolving most nonbank financial companies,[3] including broker-dealers, if certain financial distress and systemic risk determinations are made.[4] The provisions of Title II are modeled largely on the bank resolution provisions in the Federal Deposit Insurance Act, subject to several important differences designed to harmonize the provisions defining creditor rights in Title II more closely with their counterparts in the Bankruptcy Code.

Subject to certain exceptions, a broker-dealer can be designated as a "covered financial company" under Section 203(b) of Title II, and the FDIC will be appointed as its receiver, if the Treasury Secretary, upon recommendation by 2/3 of the Federal Reserve Board and 2/3 of the SEC, and in consultation with the FDIC and the President, determines, among other things, that:

- such broker-dealer is "in default or in danger of default";
- the failure of the broker-dealer and the use of normal insolvency laws to resolve the entity would have serious adverse effects on financial stability in the United States;
- the use of Title II would avoid or mitigate such adverse effects; and
- the effect of using Title II on the claims or interests of creditors, counterparties and shareholders and other market participants would be appropriate given the beneficial impact on U.S. financial stability of using such authority.

The FDIC also has the authority under Section 210(a)(1)(E) (without any involvement from the Treasury Secretary, the SEC or the President) to appoint itself as a receiver under Title II of a broker-dealer subsidiary of a bank holding company or other financial company that has been designated by the Treasury Secretary as a covered financial company under Section 203(b), if the FDIC determines that:

- such broker-dealer subsidiary is "in default or in danger of default";

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[3] A "financial company" is defined in Section 201(a)(11) of the Dodd-Frank Act as any company that is incorporated or organized under U.S. Federal or State law that is (i) a bank holding company, as defined by the Bank Holding Company Act; (ii) a nonbank financial company, including an insurance company or a securities broker-dealer, that has been determined by the Financial Stability Oversight Council to be systemically important and therefore subject to supervision by the Federal Reserve; (iii) any company that is predominantly engaged in activities that are financial in nature or incidental thereto under Section 4(k) of the Bank Holding Company Act, including an insurance company or securities broker-dealer; or (iv) any subsidiary of any of the foregoing that is predominantly engaged in activities that are financial in nature or incidental to a financial activity under Section 4(k) of the Bank Holding Company Act, other than a subsidiary that is an insured depository institution or an insurance company. The following companies are excluded from the term financial company for purposes of Title II: Fannie Mae, Freddie Mac, any Federal Home Loan Bank, any Farm Credit System institution and any governmental entity. 12 U.S.C. § 5381(a)(11).

[4] 12 U.S.C. §§ 5383(b) and 5390(a)(1)(E).

- such action would avoid or mitigate serious adverse effects on the financial stability or economic conditions of the United States; and
- such action would facilitate the orderly liquidation of the covered financial company parent.[5]

Section 205 of Title II contains special provisions applicable to a broker-dealer that has been designated or would be treated as a covered financial company under either Sections 203(b) or 210(a)(1)(E) and that is an SEC-registered broker-dealer and a member of SIPC (a "**covered broker-dealer**"). Section 205 incorporates certain substantive provisions of SIPA and provides for SIPC to serve as trustee for the covered broker-dealer. Importantly, Section 205 provides that customers of a covered broker-dealer under Title II must 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. Section 205(h) of Title II requires the FDIC and the SEC, in consultation with SIPC, jointly to issue rules to implement Section 205.

The Proposed Rule is intended to provide further detail on how the relevant provisions of SIPA would interact with Title II and delineates the respective roles and authority of SIPC and the FDIC.

Limited Applicability of Section 205

While the Proposed Rule responds to the statutory mandate to issue rules implementing Section 205 of Title II, the circumstances under which Section 205 of Title II would be called into play are likely to be very limited. First, as noted above, resolution under Title II is an extraordinary remedy that would be invoked only if use of ordinary insolvency laws would have serious adverse effects on the financial stability of the United States and the use of Title II would avoid or mitigate those effects. In addition, the FDIC has developed what is known as a Single Point of Entry ("**SPOE**") strategy to implement its authority under Title II for the resolution of U.S. global systemically important banking groups ("**U.S. G-SIBs**").[6] Under the SPOE strategy, only the top-tier bank holding company parent of a U.S. G-SIB would be placed into orderly liquidation proceedings under Title II, while its subsidiaries would continue to operate outside of resolution proceedings. In this case, there would be no separate SIPA or Title II proceeding for a broker-dealer subsidiary of the ultimate parent of a U.S. G-SIB.

Key Elements of Proposed Rule

Nature of Proceeding

The statutory text of Section 205 seems to contemplate that the liquidation of a covered broker-dealer would be conducted *under SIPA* even if Title II is invoked with respect to the covered broker-dealer and all or some of its assets, customer accounts and customer property are transferred to a bridge broker-dealer by the FDIC as receiver. For example, upon the appointment of the FDIC as receiver for the covered broker-dealer under Title II, Section 205 provides that the FDIC "shall appoint, without the need for court approval, the Securities Investor Protection Corporation to act as trustee for the *liquidation under the Securities Investor Protection Act of 1970 (15 U.S.C. §§ 78aaa et seq.)* of the covered broker-

[5] 12 U.S.C. § 5390(a)(1)(E). Although the FDIC's authority in Section 210(a)(1)(E) is limited to any "covered subsidiary" and the term "covered subsidiary" is defined in Section 201(a)(9) in a manner that excludes any "covered broker or dealer," we believe that the authority in Section 201(a)(1)(E) applies to any broker or dealer subsidiary that has not itself been designated as a covered financial company under Section 203(b) or as to which the FDIC has not yet been appointed as receiver under Section 201(a)(1)(E) because in such case the broker or dealer subsidiary would not be deemed to be a covered financial company and therefore would not be a covered broker or dealer as defined in Section 201(a)(7).

[6] *See* FDIC, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

dealer."[7] Section 205 also provides that upon such appointment SIPC shall file, in federal district court, an application for a "protective decree *under [SIPA]*."[8] The Proposed Rule deviates from the statutory language to eliminate reference to the liquidation being conducted and the protective decree being issued "under SIPA**.**" The Supplemental Information accompanying the Proposed Rule (the "**Preamble**") states that this is intended to clarify that a Title II receivership of a covered broker-dealer is not a liquidation under SIPA, which is a judicial process conducted under bankruptcy court supervision, but rather is an orderly liquidation of the broker-dealer through an administrative process under Title II that incorporates the customer protection provisions of SIPA under which SIPC, as trustee, would operate.[9]

Establishment of Bridge Broker-Dealer

Under Title II and the Proposed Rule, the FDIC, as receiver, may establish one or more bridge broker-dealers.[10] The FDIC is granted authority to transfer customer accounts, associated customer property and other assets and liabilities of a covered broker-dealer to the bridge broker-dealer(s) without any consent or authorization from any person or entity. The Proposed Rule clarifies and elaborates upon the procedures for transferring customer accounts and customer property to the bridge broker-dealer and the role played by SIPC in that process, including determining what constitutes customer property and the making of advances from the SIPC fund to customer accounts at the bridge broker-dealer within the limits prescribed by SIPA.

Transfer of Customer Accounts and Customer Property

- If the FDIC establishes a bridge broker-dealer, the Proposed Rule mirrors language in Title II that requires the FDIC to transfer all customer accounts and all associated customer property and customer name securities to an established bridge broker-dealer unless it determines, in consultation with the SEC and SIPC, that (i) transfer of the customer accounts and customer property to one or more other qualified broker-dealers[11] is likely to occur promptly or (ii) the transfer of such customer accounts to a bridge broker-dealer would materially interfere with the FDIC's ability to avoid or mitigate serious adverse effects on financial stability or economic conditions in the United States.[12]
- According to the Preamble, this requirement is intended to clarify that the transfer of such customer accounts and property to a bridge broker-dealer will take place unless a transfer to a qualified broker-dealer is imminent.[13] The Preamble notes that the use of the word "promptly" is intended to emphasize the urgency of transferring customer accounts, customer name securities,

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[7] 12 U.S.C. § 5385(a)(1) (emphasis added).

[8] 12 U.S.C. § 5385(a)(2)(A) (emphasis added). Other provisions of Section 205 similarly refer to the determination of claims and liquidation of assets retained in the receivership as being conducted under SIPA. *See*, *e.g.*, 12 U.S.C. § 5385(a)(2).

[9] Preamble, at 6-7.

[10] The Proposed Rule defines a "bridge broker-dealer" as "a new financial company organized by the [FDIC] in accordance with 12 U.S.C. § 5390(h) for the purpose of resolving a covered broker or dealer." Proposed Rule § 380.60.

[11] The Proposed Rule defines a "qualified broker-dealer" as "a broker or dealer that (A) is registered with the [SEC] under Section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)); and (B) is a member of SIPC." Proposed Rule § 380.60.

[12] Proposed Rule § 380.63(b); *see* 12 U.S.C. § 5390(a)(1)(O).

[13] Preamble, at 17-18.

and customer property either to a qualified broker-dealer or to a bridge broker-dealer as soon as practicable to allow customers the earliest possible access to their accounts.[14]

- The Proposed Rule clarifies that in the event of such a transfer, customer property, together with advances from SIPC, will be allocated to customer accounts at the bridge broker-dealer.[15] SIPC, as trustee for the covered broker-dealer, will determine customer status, claims for net equity, claims for customer name securities and whether property of the covered broker-dealer qualifies as customer property in a manner consistent with SIPC's customary practices under SIPA.[16]
- The Proposed Rule provides that the allocation of customer property to customer accounts that have been transferred to the bridge broker-dealer may initially be based on estimates derived from the books and records of the covered broker-dealer or other information deemed relevant in the discretion of the FDIC, in consultation with SIPC, which estimates can subsequently be revised in a manner consistent with SIPA and SIPC's normal practices.[17] The Preamble explains that this flexibility is needed because rapid action to set up a bridge broker-dealer and transfer assets, including customer accounts and customer property, may be critical to preserving financial stability and giving customers the promptest possible access to their accounts.[18]
- The overarching requirement under the Proposed Rule, consistent with Section 205 of Title II, is that the allocation of customer property, advances from SIPC and delivery of customer name securities to each customer or to its customer account at a bridge broker-dealer must be in a manner, including form and timing, and in an amount at least as beneficial to such customer as would have been the case had the covered broker-dealer been liquidated under SIPA.[19]

Satisfaction of Claims for Net Equity

- A customer's net equity claim is defined under the Proposed Rule in the same manner as under SIPA, with the date of the FDIC's appointment as receiver deemed to be the "filing date" under SIPA for these purposes.[20]
- Under the Proposed Rule, the customer's net equity claim is stated to "remain with the covered broker-dealer" even if there is a transfer of customer accounts to a bridge broker-dealer, but such claim is deemed satisfied in whole or in part by the value, as of the appointment date, of the customer property and SIPC advances that are transferred to the customer's account at the bridge broker-dealer.[21]

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[14] Preamble, at 17-18. While not specifically addressed in the Proposed Rule, Title II also provides that the FDIC must not operate a bridge broker-dealer in a manner that would adversely affect the ability of customers to promptly access their customer property in accordance with applicable law. 12 U.S.C. § 5390(h)(2)(H)(iv).

[15] Proposed Rule § 380.63(d).

[16] Proposed Rule §§ 380.64(a)(1) and 380.64(a)(4).

[17] Proposed Rule § 380.63(d).

[18] Preamble, at 23-24.

[19] 12 U.S.C. § 5385(d)(1)(C); Proposed Rule § 380.64(a)(4).

[20] 15 U.S.C. § 78lll(11); Proposed Rule § 380.60(h).

[21] Proposed Rule § 380.63(d).

- The Preamble indicates that in most cases a customer's net equity claim would be satisfied in whole or in part by such transfer.[22]
- In the event a customer's account and associated account property are not transferred, the customer's net equity claim would be subject to satisfaction by SIPC as trustee for the covered broker-dealer in same manner and extent as in a SIPA proceeding.[23]

Transfer of Other Assets and Liabilities

- Both the statute and the Proposed Rule make it clear that the FDIC has the authority to transfer such other assets and liabilities of the covered broker-dealer (including non-customer accounts and any associated property) to the bridge broker-dealer as the FDIC may in its discretion determine to be appropriate.[24]
- The Preamble explains that this authority is designed to facilitate the FDIC's ability to continue the day-to-day operations of the broker-dealer and facilitate the maximization of the value of the assets of the receivership by making it possible to avoid a forced or other distressed sale of the assets of the covered broker-dealer and mitigate the impact of the failure of the covered broker-dealer on other market participants and financial market utilities and thereby minimize systemic risk.[25]
- The Proposed Rule expressly provides that the transfer of any account or property to a bridge broker-dealer is not determinative of whether the holder of such an account qualifies as a "customer" or if the property so transferred qualifies as "customer property" under SIPA or the Proposed Rule.[26] Instead, this would depend on whether the claimant would be considered a customer under SIPA.[27] The Preamble cites claims in respect of reverse repurchase agreements as an example of an area where litigation over customer status has arisen under SIPA.[28]

Status and Obligations of the Bridge Broker-Dealer

- The Proposed Rule provides that the bridge broker-dealer undertakes the obligations of a broker-dealer with respect to each person holding an account transferred to the bridge broker-dealer, but only to the extent of the property (including SIPC funds) transferred and held by the bridge broker-dealer with respect to that person's account.[29] The bridge broker-dealer would not have any obligations with respect to any customer property or other property that is not transferred from the covered broker-dealer to the bridge broker-dealer.[30]

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[22] Preamble, at 25. The assumption of liability by the bridge broker-dealer to each customer in connection with property transferred to the bridge broker-dealer does not itself, however, affect the calculation of net equity.

[23] Preamble, at 25 (citing 12 U.S.C. § 5385(f)(2)).

[24] 12 U.S.C. §§ 5385(b)(2)(A)(iii), 5385(c) and 5390(a)(1)(G)(i)(II); Proposed Rule § 380.63(c).

[25] Preamble, at 18-19.

[26] Proposed Rule § 380.63(d).

[27] Proposed Rule § 380.64(a)(1).

[28] Preamble, at 19-20.

[29] Proposed Rule § 380.63(d).

[30] Proposed Rule § 380.63(d).

- The Proposed Rule mirrors provisions in Title II that stipulate that the transfer of assets and liabilities to the bridge broker-dealer, and any succession by the bridge broker-dealer to the rights, powers and privileges of the failed broker-dealer, is effective without the need for any consent, authorization or approval by any person or entity, including any customer, contract party, governmental authority or court.[31]
- In addition, the Proposed Rule provides that the bridge broker-dealer will immediately and by operation of law be deemed to be registered with the SEC and a member of SIPC and will succeed to all memberships of the covered broker-dealer in any self-regulatory organization ("**SRO**"), and will operate in accordance with applicable federal securities laws and SRO requirements, subject to any exemptions that the SEC may determine in its discretion.[32]
- A bridge financial institution under Title II is of a limited duration.[33] The Proposed Rule specifies that, at end of the term of existence of the bridge broker-dealer, any residual value in the bridge broker-dealer after payment of its obligations would be distributed to the receiver.[34] The Preamble explains that this residual value would be for the benefit of the creditors of the covered broker-dealer in satisfaction of their claims.[35]

Claims Process

The Proposed Rule provides further detail with regard to the roles of SIPC and the FDIC in the claims process for customers and creditors of the covered broker-dealer.

FDIC's Role As Receiver

- The Proposed Rule clarifies that the FDIC as receiver would oversee the claims process for all claims against the covered broker or dealer, including customer claims, and would determine all non-customer claims.[36]
- The Proposed Rule provides that the FDIC must consult with SIPC regarding the procedures for creditors to file claims, including the claim form and filing instructions. The claim form must include provision for a claimant to claim status as a customer.[37]
- Under Title II the FDIC must set a claims bar date, which the Proposed Rule establishes at the expiration of a six-month period beginning on the first date notice to creditors is published, which is consistent with the claims bar date in a SIPA proceeding and is also consistent with the requirement under Title II that the bar date be no earlier than 90 days after first publication.[38]

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[31] Proposed Rule § 380.63(e); *see* 12 U.S.C. §§ 5390(a)(1)(O) and 5390(h)(5)(D).

[32] Proposed Rule § 380.63(f).

[33] *See* 12 U.S.C. § 5390(h)(15)(B).

[34] Proposed Rule § 380.63(h).

[35] Preamble, at 28.

[36] *See* Proposed Rule § 380.64(b).

[37] Proposed Rule § 380.64(b)(2).

[38] Proposed Rule § 380.64(b)(3); *see also* 12 U.S.C. § 5390(a)(3)(C)(i); 15 U.S.C. § 78fff-2(a)(3).

- Claims filed after the claims bar date will be disallowed, although the Proposed Rule, consistent with Title II, provides an exception if a claimant did not receive notice and the claim is filed in time to permit payment.[39]
- The Proposed Rule further provides that claims for net equity that are filed 60 days after notice to creditors do not need to be satisfied in whole or in part out of customer property and, if such claims are satisfied by funds advanced by SIPC, they would be satisfied in cash, securities or both, as determined by SIPC to be the most economical to the receivership estate.[40] This is similar to the rule under SIPA.[41]

SIPC's Role as Trustee

- SIPC, as trustee for the covered broker-dealer, would make determinations as to customer status, claims for net equity, claims for customer name securities and whether property of the covered broker-dealer constitutes customer property.[42]
- The Proposed Rule provides that SIPC shall make advances in accordance with, and subject to the limitations of SIPA, including where appropriate by delivering cash or securities to the customer accounts established at the bridge broker-dealer.[43]
- While the FDIC as receiver would send notice of the allowance or disallowance of any claim to the claimant, the Proposed Rule appears to require it to rely on the determinations made by SIPC, as trustee, with respect to any claim for net equity or customer name securities.[44]

Priorities for Unsecured Claims

- Any customer deficiency claims that remain unsatisfied after final allocation of customer property, as well as other general unsecured claims, would be paid in accordance with the general waterfall of priorities under Title II, subject to certain adjustments. These adjustments include provision for SIPC administrative expenses (which the Proposed Rule clarifies may include expenses for the retention of private attorneys and consultants), amounts paid by the FDIC to customers or by SIPC, and amounts advanced by SIPC for the purpose of satisfying customer net equity claims.[45]

Decision and Review

- Under Title II and the Proposed Rule a claimant must be notified within 180 days as to whether its claim has been allowed or disallowed by the FDIC.[46]
- Title II provides for expedited determination of certain categories of claims, including any claimant that alleges a valid security entitlement in respect of assets held by the covered financial company, which must be determined within 90 days.[47]

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[39] Proposed Rule § 380.64(b)(3); *see also* 12 U.S.C. § 5390(a)(3)(C)(ii).

[40] Proposed Rule § 380.64(b)(3).

[41] 15 U.S.C. § 78fff-2(a)(3).

[42] Proposed Rule § 380.64(a)(1).

[43] Proposed Rule § 380.64(a)(2).

[44] Proposed Rule § 380.64(c).

[45] Proposed Rule §§ 380.65 and 380.66(a).

[46] 12 U.S.C. § 5390(a)(3)(A)(i); Proposed Rule § 380.64(c).

- The Proposed Rule stipulates that expedited relief is not available for claims by customers of a covered broker-dealer for customer property or customer name securities.[48] The Preamble explains that this is because of the "pro rata" nature of a customer's claim against the pool of customer property and invites comment on whether allowing customers to seek expedited determinations of their claims would allow them to "jump ahead" of other similarly situated claimants and whether that would be appropriate.[49]
- Consistent with Title II, the Proposed Rule would allow a claimant to seek de novo judicial review of a disallowed claim, in whole or in part, including customer claims that are disallowed based on a determination by SIPC.[50]

Additional Proposed Rules

Notice and Application for a Protective Decree

Under Title II, SIPC is required to promptly file with any federal district court of competent jurisdiction an application for a protective decree under SIPA, and SIPC and the FDIC, in consultation with the SEC, must jointly determine the terms of the protective decree to be filed.[51] As noted above, the Proposed Rule deletes the words **"**under SIPA**"** from the provisions relating to such a protective decree. This is consistent with the position taken in the Preamble that a Title II receivership of a broker-dealer is not a proceeding under SIPA but rather is a proceeding under Title II that incorporates the customer protection provisions of SIPA.

- The Preamble states that since a proceeding under Title II is not a judicial proceeding, the primary purpose of the filing is to give notice to interested parties that an orderly liquidation proceeding for the covered broker-dealer has been initiated, including making parties aware of applicable stays under Title II.[52] It is not clear whether this emphasis on the non-judicial nature of the proceeding is intended to mean that under the Proposed Rule the court would not have the authority to impose other stays or relief that it would otherwise be empowered to impose through a protective decree in a proceeding under SIPA.
- The Proposed Rule narrows the venues where the notice and application for a protective decree can be filed to the federal district court where the covered broker-dealer's principal place of business is located or, if a SIPA proceeding has already been commenced with respect to the broker-dealer, the federal district court where such proceeding is pending.[53] Restricting the venue for filing is designed to make it easier for interested parties to know where the application for a protective decree might be filed.
- The Proposed Rule includes a non-exclusive list of notices drawn from other parts of Title II that may be included in the notice and application for a protective decree.[54] The goal of this list is to highlight the application of certain provisions of Title II, such as the dismissal of existing or

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[47] 12 U.S.C. § 5390(a)(5)(B).

[48] Proposed Rule § 380.64(c).

[49] Preamble, at 31 and 38.

[50] 12 U.S.C. § 5390(a)(4); Proposed Rule § 380.64(d).

[51] 12 U.S.C. §§ 5385(a)(2)(A) and 5385(b)(3).

[52] Preamble, at 13-14.

[53] Proposed Rule § 380.62(a).

[54] Proposed Rule § 380.62(b)(2).

pending bankruptcy or SIPA proceedings, the revesting of assets in the covered broker-dealer and applicable stays under Title II.[55]

- This includes notice that, except as otherwise provided with respect to qualified financial contracts (discussed below), no person may exercise any right or power to terminate, accelerate or declare a default under any contract to which the covered broker-dealer is a party, or to obtain possession of or exercise control over any property of the covered broker-dealer or affect any contractual rights of the covered broker-dealer, without the consent of the FDIC as receiver upon consultation with SIPC during the 90-day period beginning from the appointment date.[56]
- The list is neither mandatory nor all-inclusive and the Preamble notes that some provisions, such as those relating to qualified financial contracts, may require more specificity.[57]

Qualified Financial Contracts

Qualified financial contracts ("**QFCs**") include securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and master agreements for any of the foregoing.

- Section 205 of Title II provides that the Title II provisions with respect to QFCs, which are different from those applicable in a proceeding under SIPA, apply in a liquidation of a covered broker-dealer under Title II.[58]
- Under Title II, a QFC counterparty is subject to a one-business day stay on the exercise of any contractual right to terminate, liquidate or accelerate a QFC with a covered broker-dealer, or associated rights to net and apply collateral, solely as a result of the insolvency or financial condition of the broker-dealer or the appointment of the FDIC as receiver or the transfer to the bridge financial company or third-party financial institution.[59] During the one-business day stay period, the FDIC has the option to transfer all, but not less than all, of the QFCs with a particular counterparty and its affiliates to a bridge broker-dealer or to another single third-party financial institution.[60] This permits the bridge broker-dealer to preserve the QFCs necessary for its continued operation, including financing of customer positions and hedging of exposures, and also avoid the loss of value that could result from a fire sale of collateral. If the QFCs are not transferred by the end of the stay period, the counterparty is free to terminate the QFCs, net or set off its claims thereunder and liquidate collateral.
- By contrast, in a SIPA proceeding counterparties may terminate QFCs and liquidate cash collateral without stay or delay, but may be subject to a stay on liquidating securities collateral (as well as securities purchased from the broker-dealer under repurchase agreements and securities

[55] Preamble, at 14-16.

[56] Proposed Rule § 380.62(b)(2)(iv).

[57] Preamble, at 16.

[58] 12 U.S.C. § 5385(b)(4).

[59] 12 U.S.C. § 5390(c)(10)(B)(i).

[60] 12 U.S.C. § 5390(c)(9)(A)(i).

borrowed from the broker-dealer under securities lending transactions) without the consent of SIPC and the SIPA trustee.[61]

- The Proposed Rule confirms that QFCs of a covered broker-dealer would be governed exclusively by Title II.[62] As a result, to the extent any QFCs are not transferred to the bridge broker-dealer or a third-party financial institution, counterparties would be free to close out and liquidate all collateral, including securities collateral, immediately after the one business day stay.
- In addition, the Preamble notes that Title II and the rules thereunder impose restrictions on the exercise of cross-defaults under subsidiary contracts that are linked to a covered financial company in resolution under Title II,[63] which may also be appropriate to highlight in a protective decree.

Conclusion

The Proposed Rule provides some clarity regarding the orderly liquidation process for covered broker-dealers under Title II, particularly with regard to effecting a rapid transfer of customer accounts, customer property and SIPC advances to a bridge broker-dealer as a means of satisfying customer net equity claims and SIPC's role therein, although it deviates from the statutory language of Title II in certain respects. Given the FDIC's SPOE strategy for the resolution of systemically important financial companies under Title II, however, it is uncertain whether the process outlined in the Proposed Rules is likely to be invoked in practice to liquidate a broker-dealer.

[61] 15 U.S.C. § 78eee(b)(2)(C)(i)-(ii). Typically, this stay is for a period of 21 days, subject to extension, but the extent and duration of the stay may be varied in the SIPA protective decree. SIPC has in the past given its consent to the liquidation of securities collateral under certain types of QFCs within a shorter period of time, subject to submission of an affidavit attesting as to certain matters.

[62] Proposed Rule § 380.67.

[63] Preamble, at 15-16; *see also* 12. U.S.C. § 5890(c)(16).

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