Dechert LLP

SEC and FDIC Propose Dodd-Frank Broker-Dealer Resolution Rules

A legal update from Dechert's Financial Services Group

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Troubled financial institutions, some with substantial broker-dealer operations, played a prominent role in the 2008 financial crisis. In an effort to protect the financial system from serious threats posed by significant nonbank financial companies in financial distress, Congress enacted Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to provide for an orderly liquidation of such entities under the supervision of federal authorities. Federal regulators have proposed rules that would implement the provisions of Title II in regard to the resolution of a large broker-dealer. Most notably, the proposed rules address how a "bridge broker or dealer" could be used in connection with the liquidation of a "covered broker or dealer."

On February 17, 2016, the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC, and together with the FDIC, the Agencies) proposed rules (Proposed Rules) to implement provisions of the Dodd-Frank Act that would permit the FDIC and the Securities Investor Protection Corporation (SIPC) to manage the orderly liquidation of certain large brokers and dealers under Title II.[1] Comments may be submitted until May 2, 2016.

Previous rules adopted by the FDIC under Title II have addressed the orderly liquidation of most types of large nonbank financial companies, particularly bank holding companies and systemically important financial institutions (SIFIs).[2] The Proposed Rules would clarify the manner of operation of the liquidation regime specifically established for certain broker-dealers under Title II (which supplants, in certain respects, the existing provisions of the Securities Investor Protection Act of 1970, or SIPA).

The Dodd-Frank Act and the Orderly Liquidation of Financial Services Companies

The Dodd-Frank Act gave federal regulators significant new authority to resolve systemically important financial companies in a non-judicial receivership process, which is intended to mitigate threats to U.S. financial stability related to a troubled organization. As a general matter, a Title II resolution of a financial company would occur following a recommendation by the Board of Governors of the Federal Reserve System (Board) and the FDIC to the Secretary of the Treasury (Secretary) that the company should be placed in a Title II receivership. The Secretary must then make a series of determinations in regard to the company.[3] If the Secretary makes these determinations and so designates a financial company – and the U.S. District Court for the District of Columbia does not block such

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1 See Covered Broker-Dealer Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 81 Fed. Reg. 10798 (Mar. 2, 2016) (Proposing Release).

2 The FDIC has adopted regulations governing receiverships of covered financial companies. For additional information regarding Title II, please see Thomas P. Vartanian, Robert H. Ledig, David L. Ansell, Title II Overview: Orderly Liquidation Authority, Dechert LLP's Analysis of Financial Regulatory Reform for the American Bankers Association, *available here*.

In addition, the following *Dechert OnPoints* cover the development of the Orderly Liquidation Authority under Title II: U.S. FSOC Proposes Qualified Financial Contract Rules and Creates a New Challenge for Large Financial Companies that are not SIFIs; FDIC Issues Opinion Clarifying Treatment of Securitizations by Financial Companies Subject to Resolution Under Title II of the Dodd-Frank Act; and FDIC Begins Action on Its Super-Resolution Rules for Covered Financial Companies.

3 These determinations include whether: (i) the failure of the company and its resolution under otherwise applicable law would have a serious adverse effect on financial stability in the United States; (ii) no viable private sector alternative is available to prevent the default of the company; and (iii) any action taken would avoid or mitigate adverse effects.

designation within 24 hours of receipt of a petition from the Secretary – the company will then be designated as a "covered financial company."[4] Covered financial companies are generally resolved by the FDIC under a receivership regime borrowed from the FDIC's receivership process for insured depository institutions under the Federal Deposit Insurance Act (FDIA).[5]

Title II also creates a special resolution regime for a covered financial company that is a broker or dealer registered with the SEC under section 15(b) of the Securities Exchange Act of 1934 (Exchange Act) and which is a member of the SIPC. In the case of a broker or dealer (or where the largest U.S. subsidiary of a financial company is a broker or dealer), the SEC and the Board are authorized to make a recommendation to the Secretary that the broker or dealer should be placed in a Title II resolution.[6] If the Secretary makes the required determinations (described above) and the court does not block the Secretary's petition, the broker or dealer will then be referred to as a "covered broker or dealer" and placed in receivership under the FDIC.

The treatment of a covered broker or dealer differs from the treatment of a covered financial company in a number of important respects. The Agencies have issued the Proposed Rules to implement, and clarify the application of, the special provisions of Title II in regard to a covered broker or dealer.

Under Title II, the FDIC acts as receiver for a covered financial company, applying FDIA-type receivership provisions. In contrast, in the case of a covered broker or dealer, while the FDIC is initially appointed as receiver, section 205 of Title II provides that the FDIC shall appoint SIPC to act as trustee for the liquidation of the covered broker or dealer under SIPA. Although SIPA generally governs the liquidation of a covered broker or dealer, section 205 of Title II provides that in some respects the general receivership regime provision of Title II will apply to a covered broker or dealer. In addition, Title II provides that, in the case of a covered broker or dealer, the FDIC may establish a new entity, called a "bridge broker or dealer," to which assets and liabilities of the covered broker or dealer may be transferred subject to certain conditions.

As a practical matter, it appears likely that the top-tier holding company in a financial company organization will be the entity that will be the subject of a Title II designation by the Secretary. In September 2013, the FDIC published a notice of its "Single Point of Entry" strategy for a covered financial company in a Title II receivership, which was aimed at: (i) promoting market discipline by imposing losses on shareholders and creditors of the top-tier holding company; and (ii) preserving financial stability by maintaining the critical services, operations, and funding mechanism through the company's operating subsidiaries.[7] Under this strategy, once a receiver has been appointed for the top-tier holding company, the company's subsidiaries (including any brokers or dealers) would remain open and continue their operations – this is intended to minimize disruptions to the financial system and spillover effects.

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4 The following types of entities can qualify as a covered financial company: (i) any bank holding company; (ii) any financial company that has been designated as systemically significant financial institution by the Financial Stability Oversight Council; (iii) any other company that is predominantly engaged in financial activities; and (iv) certain subsidiaries of the foregoing entities.

5 In a manner similar to the resolution regime under the FDIA, whereby the directors of a troubled bank may consent to the appointment of the FDIC as a receiver, under Title II, directors of a covered financial company will not be liable to shareholders or creditors for consenting in good faith to the appointment of the FDIC as receiver.

6 In the case of a broker or dealer, it is the SEC rather than the FDIC that makes a recommendation. However, the SEC and the Board are required to consult with the FDIC on any such recommendation.

7 Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

The ownership of such operating subsidiaries would likely be transferred to a bridge financial company that would be established by the FDIC.

Separately, under Title II, once the FDIC has been appointed as receiver for a covered financial company, the FDIC may appoint itself as the receiver of any "covered subsidiary"[8] of the covered financial company if the FDIC and the Secretary jointly determine that: (i) the covered subsidiary is in default or in danger of default, (ii) such action would avoid or mitigate serious adverse effects on financial stability; and (iii) the appointment would facilitate the orderly resolution of the covered financial company. Any such "covered subsidiary" may be a broker or dealer.

It is unlikely that a top-tier holding company would be an operating broker or dealer. Thus, as a practical matter there may only be limited circumstances under which a broker or dealer would be designated as a covered broker or dealer.

Orderly Liquidation and Receivership of Broker-Dealers

Existing Liquidation Authority

Existing authority under SIPA permits SIPC to liquidate troubled broker-dealers under the oversight of a bankruptcy court, in a procedure that is largely modeled on a Chapter 7 bankruptcy but with provisions designed to protect customers' funds and securities. In a SIPA liquidation, SIPC initiates the liquidation of a troubled broker or dealer, and then petitions a federal district court for a "protective order" over the troubled broker-dealer.[9] Once such order has been granted, the federal district court transfers the case to a bankruptcy court that oversees the remainder of the proceedings.[10] With the grant of the protective order, SIPC is also appointed the receiver of the broker-dealer and, in turn, appoints a trustee to manage the liquidation.[11]

SIPA does not permit SIPC to give any financial assistance to, or to take any steps to rehabilitate, a broker-dealer, and most brokerage failures are resolved in liquidation. However, SIPA does provide favorable treatment of customers' claims for the securities and cash in their accounts, up to a limit of $500,000 (including a limit of $250,000 for cash). When a broker-dealer enters SIPC receivership, customer accounts may be: (i) transferred, involuntarily, to another SIPC member; or (ii) handled through the "customer claims process," whereby the trustee first identifies and distributes all customer property held in a given customer's name to that customer, then aggregates all customer property held in "street name" by the failing financial institution, and distributes the such street name property to each customer on a *pro-rata* basis. Any assets remaining at the broker-dealer following the *pro-rata* distribution are first used to repay the administrative expenses of SIPC and other agencies, and then are distributed to creditors in accordance with normal bankruptcy proceedings.

8 A "covered subsidiary" is a subsidiary of a covered financial company other than an insured depository institution, an insurance company, or a broker or dealer that has been designated as a covered broker or dealer.

9 15 U.S.C. § 78eee(a)(3).

10 15 U.S.C. § 78eee(b).

11 15 U.S.C. § 78eee(b)(3).

Liquidation and Receivership under the Proposed Rules

Title II and the Proposed Rules do not represent a large departure from the existing SIPA protocols – by and large, the methods and procedures are comparable.[12] The Agencies pose a series of broad questions for comment, including regarding the adequacy and clarity of the Proposed Rules and the impact of the Proposed Rules on financial stability.

Like SIPA, Title II has an explicitly liquidation-focused mandate, providing "[a]ll financial companies put into receivership under [Title II] *shall be liquidated*."[13] At the same time, Congress, through the enactment of Title II, also sought to ensure that customers have access their accounts as quickly as practicable if the broker-dealer holding their accounts is at risk of failure – even in circumstances where the customer accounts could not be transferred to a qualified broker-dealer, as normally takes place under SIPA. Thus, the FDIC has been granted the power to create a "bridge broker or dealer,"[14] which is the single largest departure from the liquidation procedures under SIPA.

"Bridge" Broker-Dealers and the Protection of Customer Accounts

Once a covered broker or dealer has been placed in receivership with the FDIC by the Secretary, the FDIC appoints SIPC as trustee over the covered broker or dealer. After appointing SIPC as trustee, the FDIC may create a bridge broker or dealer, which is subject to FDIC oversight,[15] and into which the FDIC may transfer the contents of customer accounts while SIPC organizes the liquidation of the covered broker or dealer. The FDIC may also transfer other assets and liabilities to the bridge broker or dealer.[16] Although certain processes and provisions may differ between SIPA and the Proposed Rules, the Proposed Rules would require all customer accounts to be treated in at least as beneficial a manner as such accounts would be treated in a liquidation under SIPA.

With the intention of guaranteeing customers access as quickly as practicable to the entire value of their accounts – thereby minimizing the impact of the failure of a covered broker or dealer on the financial system – the Proposed Rules provide that all customer accounts and customer securities are *required* to be transferred to the bridge broker or dealer, unless either: (i) the transfer of assets to a "qualified" broker-dealer is imminent; or (ii) the transfer to a bridge broker or dealer would have "serious adverse effects" on the financial stability of, or economic conditions in, the United States.[17] Further, in the interests of speed and efficiency, the Proposed Rules would permit the transfer to a bridge broker or dealer to be performed in the absence of consent by any other party, including the customer.

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[12] The Proposed Rules are not intended to result in significant modifications of the covered broker or dealer provisions of Title II. The Agencies note in the Proposing Release that "the definitions in the Proposed Rule are very similar or identical to the corresponding definitions in SIPA and Title II ... and where they differ, it is for purposes of clarity only and not to change or modify the meaning of the definitions under either Act."

[13] Dodd-Frank Act, § 205(f)(1) (emphasis added).

[14] Under the Proposed Rules, a "bridge broker or dealer" is a newly created broker-dealer with a two-year life span (subject to three one-year extensions) into which customer accounts of the covered-broker dealer may be transferred to guarantee customers access to their accounts as quickly as practicable.

In the case of a covered financial company, the FDIC is similarly authorized to establish a bridge financial company.

[15] The bridge broker or dealer succeeds to all of registrations and memberships of the covered broker or dealer undergoing liquidation, including: those with the SEC under the Exchange Act; SIPC; and any self-regulatory organization of which the covered broker or dealer is a member or registrant. Proposed Rules 12 C.F.R. § 380.63(f) and 17 C.F.R. § 302.103(f). This automatic succession under the Proposed Rules would appear to subsume the process for successor broker-dealer registration pursuant to Rule 15b1-3 under the Exchange Act. *See* 17 C.F.R. 204.15b1-3.

[16] However, such transfers are subject to the restrictions of 12 U.S.C. § 5390(h)(1) and 5390(h)(5), which require, among other things, that all similarly-situated creditors be treated equitably. Proposed Rules 12 C.F.R. § 380.63(c) and 17 C.F.R. § 302.103(c).

[17] Proposed Rules 12 C.F.R. § 380.63(b) and 17 C.F.R. § 302.103(b).

Overview of Differences in Treatment of Broker-Dealers under SIPA and the Proposed Rules

In addition to the bridge broker or dealer provisions of the Proposed Rules, significant differences between the procedures under SIPA and the Proposed Rules include the following:

Issue	Treatment under SIPA	Treatment Under Proposed Rules
Entering Receivership		
Initiation of receivership	Initiated by SIPC.	Recommended by SEC and the Board (in consultation with FDIC); Determination made by the Secretary.
Entity serving as receiver	Receiver may be any suitable trustee. Receiver appointed by SIPC.	FDIC is receiver. FDIC appoints SIPC as trustee for covered broker or dealer.
Court process; notice and protective decree	SIPC petitions U.S. District Court for stay of bankruptcy via "protective decree;" if granted, case moved to bankruptcy court and SIPC liquidation results.	SIPC (as trustee) must file a notice[18] and an application for a "protective decree" in U.S. District Court.[19]
Judicial oversight	Conducted under bankruptcy court supervision.	Almost wholly administrative in nature – limited judicial oversight or recourse by customers or creditors.[20]
Receivership Policies		
Bridge broker or dealers	No provision.	Creation of bridge broker or dealers permitted. A bridge broker or dealer created by the FDIC steps into the shoes of, and assumes all registrations of, the covered broker or dealer.
Repurchase agreement treatment	Whether repo counterparties are "customers" under SIPA is currently subject to rulings in the Lehman Brothers litigation.	Proposed Rules seek to "preserve customer status as would be the case in a SIPA proceeding."[21]
Estimation of customer account values	SIPA trustee determines each customer's net equity and amount of customer property available, based on verification of books and records of the broker-dealer and counterparties.	Similar proceeding with respect to determining customer's net equity. However, Proposed Rules also provide that allocations at the bridge broker or dealer may initially be derived from estimates based on the books and records of the broker-dealer.[24]

18 The Proposing Release indicates that the purpose of the notice is to "inform interested parties that the covered broker-dealer is in orderly liquidation and to highlight … certain provisions of the orderly liquidation authority…" However, the Proposed Rules have no specific content requirements.

19 This must be filed in the district court in which a liquidation under SIPA is pending (if any); if not, then in the district in which the broker-dealer's principal place of business is located. Proposed Rules 12 C.F.R. § 380.62(a) and 17 C.F.R. § 302.102(a).

20 A claimant against the covered broker or dealer may seek judicial review of any claim that is allowed in whole or in part with a specified U.S. district court. Proposed Rules 12 C.F.R. § 380.64(d) and 17 C.F.R. § 302.104(d).

21 The Proposing Release goes on to note "the proposed rule clarifies that moving assets to a bridge financial company as part of a Title II orderly liquidation is not determinative as to whether the holder of such an account qualifies as a "customer' or if the property so transferred qualifies as 'customer property' or 'customer name securities.'"

24 *See* Proposing Release, 10804.

Issue	Treatment under SIPA	Treatment Under Proposed Rules
	Each customer receives a *pro-rata* share of the "street name" customer securities (plus SIPC Fund[22] insurance).[23]	Each customer should receive access to their accounts through the bridge broker or dealer, or be otherwise treated at least as favorably as under SIPA.
Consent to transfer	Trustee may sell or transfer customer accounts to another SIPC member without the consent of a customer or court.	FDIC is not required to obtain customer consent for transfer of customer's assets; customers have no right to object.[25]
Judicial review	Claimants may seek judicial review. Any customer who objects to the trustee's claim determination may file a suit with the bankruptcy court within six months of the trustee publishing notice of the determination.	Claimants may seek judicial review.[26] Any customer who objects to the FDIC's determination may file suit in the relevant U.S. district court within 60 days of the notice of the rejection of any claim.
Prioritization of claims	Following distribution of customer assets, unsecured claims are heard by bankruptcy court (akin to Chapter 7 proceedings).[27]	Unsecured claims against the covered broker or dealer are prioritized in accordance with the FDIC's current Title II regulations, although modified in certain respects.[28]
Qualified financial contracts (QFCs)	QFCs are treated as exempt from stays against counterparty claims under SIPA.	Proposed Rules implement one-day stay on counterparty remedies regarding QFCs.[29]
Funding of receivership or of a bridge broker or dealer	SIPC receivership is funded by the SIPC Fund, which is financed by SIPC members.	A bridge broker or dealer is intended to be funded by private sector borrowings. However, it may possible to use funding from the Orderly Liquidation Fund and borrowings by the FDIC.[30]

22 The SIPC Fund is a member-financed fund that is used to pay for the administrative costs of liquidations and to insure customer accounts.

23 SIPA emerged from the "back office" overload of 1969, where bookkeeping errors, alleged fraud and theft, in combination with a stock-market slump, led to a wave of brokerage failures that rendered the accounts of customers inaccessible. Two primary concerns of SIPA, therefore, were to restore confidence in the brokerage firms and to take accurate account of the value of customers' securities holdings. In contrast, as Title II is designed to keep securities markets liquid, customers' speed of access to their accounts is a primary concern, thus explaining the change in policy to an "estimation" with future revision possible. Securities Investor Protection, Report to Congressional Requestors, U.S. General Accounting Office (Sept. 1992), 12-13, *available here*.

25 Proposed Rules 12 C.F.R. § 380.63(e) and 17 C.F.R. § 302. 103(e).

26 Proposed Rules 12 C.F.R. § 380.64(d) and 17 C.F.R. § 302.104(d).

27 Customer claims in excess of the $500,000 SIPC Fund limit are placed in the category of "unsecured claims."

28 Proposed Rules 12 C.F.R. § 380.65(c) and 17 C.F.R. § 302.105(c).

29 As a general matter, except with respect to QFCs, no person may exercise any right or power to terminate, accelerate, or declare a default under any contract to which the covered broker or dealer is a party or to obtain possession or exercise control over any property of the covered broker or dealer or affect any contractual rights of the covered broker or dealer without the consent of the FDIC upon consultation with SIPC during the 90 day period following the appointment of the FDIC as receiver.

With respect to QFCs, a person who is a party to a QFC with a covered broker or dealer may not exercise any right that such person has to terminate, liquidate, or net such contract solely by reason of or incidental to the appointment of the FDIC as receiver (or insolvency or financial condition of the covered broker or dealer for which the FDIC has been appointed as receiver) until 5:00 p.m. (eastern time) on the business day following the appointment, or after the person has received notice that the contract has been transferred.

30 The FDIC as receiver is authorized to use funds available from the Orderly Liquidation Fund established by section 210(n) of Title II, or to borrow from the Treasury Department to provide funding for the operation of the bridge broker or dealer.

This update was authored by:

Elliott R. Curzon
Partner
Washington, D.C.
+1 202 261 3341
Send email

K. Susan Grafton
Partner
Washington, D.C. / New York
+1 202 261 3399
+1 212 698 3611
Send email

Robert H. Ledig
Partner
Washington, D.C.
+1 202 261 3454
Send email

Thomas P. Vartanian
Partner
Washington, D.C.
+1 202 261 3439
Send email

Nathaniel T. Dreyfuss
Associate
Washington, D.C.
+1 202 261 3377
Send email

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