MAYER | BROWN

August 20, 2020

Legal Update

U.S. FDIC and SEC Adopt Joint Rules to Govern the Orderly Liquidation of Covered Broker-Dealers

On July 24, 2020, the Federal Deposit Insurance Corporation ("FDIC") and U.S. Securities and Exchange Commission ("SEC" and, collectively with the FDIC, the "Agencies") jointly adopted a final rule in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") to supplement the statutory provisions of Title II of the Dodd-Frank Act (the "Orderly Liquidation Authority" or "OLA") that govern the orderly liquidation of certain SEC-registered brokers or dealers.[1]

Background

The 2008 financial crisis precipitated the failure or near failure of a number of large financial institutions, compelling federal authorities to adopt extraordinary measures in their efforts to preserve financial stability. Partly in response to perceived shortcomings of existing mechanisms for resolving systemically significant financial companies, Congress enacted the OLA "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."[2]

In recognition of the special mandates of the Securities Investor Protection Act of 1970 ("SIPA")[3] and the role of the Securities Investor Protection Corporation ("SIPC") in the liquidation of a broker or dealer SIPC member with "customers" (as defined in SIPA), Section 205 of the OLA delineates the respective powers and duties of SIPC and the FDIC, as trustee and receiver, respectively, and addresses the priority of and means of satisfying customer claims in the liquidation of a covered broker-dealer. Section 205(h) directs the Agencies, after consultation with SIPC, to jointly issue rules to implement Section 205.

In 2016, the Agencies issued a proposed rule in response to this mandate.[4] Following consideration of public comment, the Agencies adopted a final rule that is substantively identical to the proposed rule and provided some additional clarification regarding the liquidation process in the preamble of the adopting release.

OLA Process Adopted by the Agencies

The final rule clarifies how the relevant provisions of SIPA would be incorporated into an OLA proceeding for a "covered broker or dealer"—

i.e., an SEC-registered broker or dealer that is a member of SIPC and for which a systemic risk determination to trigger the application of the OLA has been made ("covered broker-dealers"). The final rule prescribes a process for initiating a liquidation proceeding; transferring customer and non-customer accounts and assets to a bridge broker-dealer; and determining the claims of customers and other creditors.

1. INITIATING A LIQUIDATION PROCEEDING

Section 205(a) of the OLA specifies that the FDIC, upon its appointment as receiver, "shall appoint... [SIPC] to act as trustee for the liquidation under [SIPA] of the covered [broker-dealer]."[5] Upon the appointment of SIPC as trustee for the covered broker-dealer, the OLA requires SIPC, as trustee, promptly to file an application for a protective decree with a federal district court, and SIPC and the FDIC, in consultation with the SEC, jointly to determine the terms of the protective decree to be filed.[6] The filing date of such notice and application (which has significance under SIPA for, *inter alia*, the computation of net equity) is deemed to be the date of the appointment of the FDIC as receiver.

The final rule also sets out a non-exclusive, non-mandatory list of notifications, which may be provided in the notice and application for protective decree relating to: (i) dismissal of any existing Bankruptcy Code or SIPA case or proceeding with respect to the covered broker-dealer; (ii) revesting of assets in the covered broker-dealer; (iii) requests of the FDIC, as receiver, for a stay in certain judicial actions or proceedings affecting the covered broker-dealer; (iv) consent of the FDIC as receiver, upon consultation with SIPC, being required for the exercise of certain termination, default and other rights against the covered broker-dealer (except as otherwise provided with respect to qualified financial contracts ("QFCs")) during the 90-day period beginning from the appointment date; and (v) effects of the OLA on the exercise of rights and performance of obligations by parties to QFCs with the covered broker-dealer.[7] These non-mandatory items are intended to provide useful guidance to customers and other parties who may be less familiar with the process under the OLA than with a SIPA proceeding.

2. TRANSFERRING ACCOUNTS AND ASSETS

Pursuant to the rule, if the FDIC establishes a bridge broker-dealer, all customer accounts and all associated customer name securities and customer property must be transferred to the bridge broker-dealer unless certain exceptions apply. The rule also recapitulates the FDIC's power, pursuant to Section 210(h) of the OLA, to transfer any other assets and liabilities (including any assets and liabilities associated with any trust or custody business), and clarifies that such other assets and liabilities include "non-customer accounts and any associated property." Separately, the rule states that determinations of customer status are to be made by SIPC as trustee in accordance with SIPA. According to the adopting release, "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.' Rather, the status of the account holder and the assets in the orderly liquidation of a covered broker-dealer will depend upon whether the claimant would be a customer under SIPA."

Allocations of customer property and SIPC advances to customer accounts at the bridge broker-dealer may initially be based upon estimates, which may be based upon the books and records of the covered broker-dealer or any other information deemed relevant in the discretion of the FDIC, as receiver, in consultation with SIPC, as trustee. Such estimates may be adjusted from time to time as additional information becomes available. Notwithstanding commenter concerns about the potential for over-allocations based on faulty estimates, the Agencies note in the adopting release that these estimates would be based upon the "relevant facts and circumstances" in order to ensure customers receive their customer account assets and SIPC payments "as quickly as is practicable."

3. CLAIMS OF CUSTOMERS AND OTHER CREDITORS

SIPC, as trustee, is to determine (generally in accordance with SIPA) customer status, claims for net equity, claims for customer name securities, and whether property of the covered broker-dealer qualifies as customer property. The FDIC, as receiver, will determine whether to allow or disallow a claim, in whole or in part, "utiliz[ing] the determination made by SIPC, as trustee, in a manner consistent with SIPC's customary practices in a liquidation under SIPA, with respect to any claim for net equity or customer name securities." SIPC will make advances to customers in accordance with SIPA. Where appropriate, SIPC will make such advances by delivering cash or securities to the customer accounts established at the bridge broker-dealer.

The rule codifies, in language that differs in some respects from the statute, the requirement under Section 205(f) of the OLA that customer claims be satisfied in a manner and amount at least as beneficial to the customer as would have been the case had the actual proceeds realized in the OLA liquidation been distributed in a SIPA proceeding. Additionally, the rule addresses procedures for filing a claim, the claims bar date, the receiver's decision period for claims allowance (including a provision that makes expedited 90-day review under Section 210(a)(5) of the OLA inapplicable to customer claims), and judicial review.

Qualified Financial Contracts

In language substantially mirroring Section 205(b)(4) of the OLA, the regulation provides:

> *"The rights and obligations of any party to a qualified financial contract to which a covered broker or dealer is a party shall be governed exclusively by [Section 210 of the OLA], including the limitations and restrictions contained in [Section 210(c)(10)(B)], and any regulations promulgated thereunder."*

The limitation contained in Section 210(c)(10)(B) of the OLA is a stay on the exercise of *ipso facto* rights to terminate, liquidate or net a QFC until 5:00 p.m. (Eastern Time) on the business day following the appointment of the FDIC as receiver, or after the person has received notice that the QFC has been transferred to a qualifying transferee (which could be the bridge broker-dealer) pursuant to Section 210(c)(9)(A) of the OLA. In the cost-benefit analysis, the adopting release states that "the stay will remain in effect if the QFC contracts are transferred to a bridge broker-dealer," adding that "[w]hile these provisions may impose costs, the Agencies' baseline subsumes these costs because they are a consequence of the statute and are already in effect."

Responses to Commenters

A joint comment letter from financial services trade associations (the "Joint Letter") requested that the Agencies clarify certain aspects of how the OLA would apply in the liquidation of a covered broker-dealer.[8] Although the Agencies' responses helpfully elucidate their views, complete clarity on certain matters may have to await further guidance.

1. LIABILITIES SECURED BY REHYPOTHECATED CUSTOMER PROPERTY

The Joint Letter requested that the final rule clarify that if customer accounts are transferred to a bridge broker-dealer, the FDIC, in consultation with SIPC, will endeavor to transfer to the bridge broker-dealer any liabilities that are secured by customer property that has been rehypothecated by the covered broker-dealer.

In response, the Agencies state in the adopting release that:

> *"While it is possible that a transfer to the bridge broker-dealer of any liabilities secured by customer property would be more expeditious and less burdensome than closing financing transactions in the covered broker-dealer and reopening equivalent financing transactions with the bridge broker-dealer, the Agencies cannot commit to such an approach in the final rule because it is not known whether such an approach would prove appropriate in all cases.... Nevertheless, the Agencies restate their intention that the use of the bridge broker-dealer would be designed to give customers access to their accounts as quickly as practicable in the form and amount that they would receive in a SIPA liquidation."*

However, the Agencies do not explain how the closing of a financing transaction could be reconciled with the OLA requirement for unitary transfer of QFCs and related claims and collateral.[9]

2. OTHER CUSTOMER ESTATES OF THE COVERED BROKER-DEALER

The Joint Letter requested that the Agencies clarify how the orderly liquidation process would operate if the broker-dealer were a joint broker-dealer/futures commission merchant.

In response, the Agencies state in the adopting release that:

> *"The Agencies believe that Title II addresses the commenter's question. More specifically, section 210(m) of the Dodd-Frank Act addresses the resolution of a commodity broker in Title II. The section provides that the FDIC as receiver shall apply the provisions of subchapter IV of chapter 7 of the Bankruptcy Code, in respect of the distribution to any customer of all customer property and member property, as if such commodity broker were a debtor for purposes of such subchapter."*

Although not directly raised by the reported comments, the Agencies' discussion of Section 210(m) might have been an opportune occasion to clarify the treatment under the OLA of a covered broker-dealer that is subject to customer protection requirements in respect of margin received under security-based swaps.[10]

*****

The final rule is intended to provide clearer expectations within a structured framework for the orderly liquidation process for a covered broker-dealer, so that a liquidation can be carried out with efficiency and predictability if the need arises. Overall, the final rule is designed to promote the orderly liquidation of covered broker-dealers in a manner that protects market participants by establishing clear expectations and equitable treatment for customers and creditors of failed broker-dealers, as well as other market participants.

Author contacts:

Matthew Bisanz
+1 202 263 3434
mbisanz@mayerbrown.com

Curtis Doty
+1 212 506 2224
cdoty@mayerbrown.com

Marlon Paz
+1 202 263 3044 / +1 212 506 2307
mpaz@mayerbrown.com

Kyle Swan
+1 202 263 3072
kswan@mayerbrown.com

Jeffrey Taft
+1 202 263 3293
jfaft@mayerbrown.com

Endnotes

[1] *Covered Broker-Dealer Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, ____ Fed. Reg. , (awaiting publication). The Adopting Release is available here: https://bit.ly/2DSE1Jy.

[2] 12 U.S.C. § 5384.

[3] 15 U.S.C. §§ 78aaa-lll.

[4] For a more detailed description of the proposed rule, please see the Mayer Brown Legal Update available here: https://bit.ly/2PZzKWO.

[5] 17 C.F.R. § 302.101; 12 C.F.R. § 380.61.

[6] Despite statutory text in Section 205 that SIPC is to act as trustee for a liquidation "under [SIPA]", the Agencies clarify in the preamble that the liquidation of a covered broker-dealer is in fact not a liquidation under SIPA, but an alternative arrangement under the OLA.

[7] The Agencies note that, although the language relating to QFCs is "rather general", in certain circumstances it may be worthwhile specifically to highlight the one-day stay under 12 U.S.C. § 5390(c), discussed further below under "Qualified Financial Contracts", the provisions relating to the enforcement of affiliate contracts under 12 U.S.C. § 5390(c)(16), and other specific provisions relating to QFCs or other contracts. The Agencies mention also the unenforceability of "walkaway clauses" under 12 U.S.C. § 5390(c)(8)(F).

[8] Letter to Robert E. Feldman, Executive Secretary, FDIC, and Brent J. Fields, Secretary, SEC, from Carter McDowell, Managing Director and Associate General Counsel, SIFMA; John Court, Managing Director and Deputy General Counsel, The Clearing House Association; and Rich Foster, Senior Vice President and Senior Counsel for Regulatory and Legal Affairs, Financial Services Roundtable (May 2, 2016), https://bit.ly/2YctEap.

[9] *See* 12 U.S.C. § 5390(c)(9). *See also In re Madoff Inv. Sec., LLC*, 773 F.3d 411, 418-419 (2d Cir. 2014) (holding that account documents fall within the definition of "securities contract"); 12 U.S.C. § 5390(c)(8)(D)(ii)(V) (listing a "margin loan" as a type of securities contract).

[10] Section 210(m)(1)(A), a parallel clause to the one cited in the excerpt above, requires the FDIC as receiver to apply the distributional scheme of subchapter III of chapter 7 of the Bankruptcy Code (which governs stockbroker liquidations) in the case of a covered financial company that is a stockbroker but is not a member of SIPC. 12 U.S.C. § 5390(m)(1)(A). Read literally at the entity level, this clause would appear not to apply in the orderly liquidation of a covered broker-dealer, because, by definition, a covered broker-dealer is a member of SIPC.

The application of the Section 210(m)(1)(A) is significant because, under Dodd-Frank Act amendments to the Securities Exchange Act, it appears that a counterparty to a non-cleared security-based swap with a broker-dealer would have a "customer" claim, for purposes of subchapter III of chapter 7 of the Bankruptcy Code, to the extent of any margin delivered by or to the counterparty with respect to which there is a customer protection requirement under Section 15(c)(3) of the Securities Exchange Act or a segregation requirement. See 15 U.S.C. § 78c-5(g). This provision is silent, however, as to "customer" status for purposes of SIPA. Therefore, absent clarity as to either SIPA customer status or the applicability of Section 210(m)(1)(A), it is unclear whether there is a gap in the orderly liquidation process for covered broker-dealers with respect to the treatment of claims based on security-based swap margin subject to SEC segregation requirements. For a more detailed description of these segregation requirements, please see the Mayer Brown Legal Update available here: https://bit.ly/3iHSczM.