AKIN GUMP
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CLIENT ALERT

WHAT WOULD HAPPEN TO YOUR ACCOUNT HOLDINGS IF YOUR PRIME BROKER FAILED?

During the recent market turmoil, we have received many questions from clients asking what would happen to their account holdings if a prime broker failed. Most of these questions have focused on securities, but we also have been asked about swaps in which broker affiliates are counterparties. Recently we have been asked about bank failures as well. We think you will find it useful to have a brief overview of U.S. stockbroker liquidation and bank insolvency issues as you look at "what if" scenarios.

While it will make sense to consider your particular facts and circumstances, these are the big picture considerations that we expect to be most important in most circumstances. We caution that this Client Alert does not constitute legal advice; it provides merely a sketch of the U.S. regimes applicable to domestic stockbroker liquidation and bank insolvency.

- If a U.S. prime broker (or other broker or dealer) fails, the rights of its customers will be governed by a combination of Securities and Exchange Commission rules and regulations (including Exchange Act Rules 15c3-2 and 15c3-3), the U.S. Bankruptcy Code, the Securities Investor Protection Act (SIPA) and relevant state law, including the UCC.

- Under Exchange Act Rule 15c3-2, subject to certain notice requirements, a non-bank broker is permitted to use funds arising out of any free credit balances carried for the account of its customers in connection with the operation of the business of such broker.

- Under Exchange Act Rule 15c3-3, a broker (i) is required to maintain physical possession and control [1] of fully paid securities and securities (excess margin securities) only with a value in excess of 140 percent of the customer's debit balance (the Fully Paid/Excess Margin Security Requirement), (ii) may treat as its own property and sell, lend, rehypothecate and otherwise use for permitted purposes –

[1] Physical possession and control may be, and typically is, maintained through third parties such as a clearing corporation or other subsidiary organization of a national securities exchange or registered national securities association, another broker or dealer in compliance with Regulation T, or a bank. A broker is not required to maintain physical possession and control of securities it borrows under an agreement that satisfies the requirements of Exchange Act Rule 15c3-3(b)(3).

including margin lending – property of a customer with a value up to 140 percent of such debit balance (the 140 Percent Permitted Use Safe Harbor),[2] and (iii) is required to maintain on deposit in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (Reserve Account), segregated from other accounts of the broker, an amount determined in accordance with a formula (the Reserve Formula) set forth in Exhibit A to Rule 15c3-3.[3] While the Fully Paid/Excess Margin Security Requirement is required to be calculated daily and any deficiency corrected by the following business day, compliance with the Reserve Formula is required to be calculated only weekly, which can give rise to a timing risk.

- Stockbrokers may not reorganize under Chapter 11 of the Bankruptcy Code. Instead, special procedures for stockbroker liquidation are set forth in Subchapter III of Chapter 7 of the Code (§§ 741–753). Alternatively, the Securities Investor Protection Corporation (SIPC) may commence a SIPA liquidation proceeding in the federal courts.

- Generally, SIPA proceedings favor the return of securities to customers, while stockbroker liquidation proceedings under the Bankruptcy Code require the trustee to sell the securities and distribute cash to customers. But in either regime, *customer property is pooled*, and if the total pool is insufficient to pay customers' aggregate net equity claims, *customers share pro rata in the proceeds* based on their respective net equity claims. Put differently, although the Fully Paid/Excess Margin Security Requirement and the 140 Percent Permitted Use Safe Harbor of Rule 15c3-3 are both formulated in terms of an individual customer's holdings and debit balance, the amounts distributed to a particular customer will be such customer's pro rata share of the aggregate amount available for all customers.

  It is important to note that commodities and foreign exchange appear not to be included in the "customer property" pool.

- The only exception to the general pooling and pro rata sharing described in the preceding bullet point is that under SIPA and the Bankruptcy Code, "customer name securities" are to be returned directly to customers without going in the pool. These are non-transferable securities that are registered in the customer's name – not in "street name" or registered with DTC. In a failure of a large broker-dealer, we would expect that there would be very few "customer name securities."

- Generally speaking, offset of debit and credit or short and long positions requires full mutuality – i.e., the legal entities that are party and counterparty in the short position must be identical to the legal entities that are party and counterparty in the long position. Because ISDA agreements typically will be entered into with affiliates of a prime broker rather than with the prime broker itself, offset of net amounts due or payable under a prime brokerage agreement against amounts payable or due under an ISDA agreement likely will not be available absent a master netting agreement. The Bankruptcy Code honors contractual arrangements for cross-netting, including master netting agreements, but these must be reviewed carefully. ISDA agreements in the funds

[2] A further limitation under Exchange Act Rule 15c2-1(a)(3) is that a broker may not hypothecate customer securities for a sum greater than the aggregate indebtedness of all customers with regard to securities carried in their accounts.

[3] A broker is required to deposit in the Reserve Account the excess of credit items in the Reserve Formula (including cash balances in customer accounts and funds obtained through the use of customer securities) over debit items in the Reserve Formula (including debit balances in customers' cash and margin accounts, securities borrowed to effectuate customer short sales and make delivery on securities that customers failed to deliver, and required margin in connection with options and security futures activity in customer accounts).

industry typically will allow the party that receives collateral to deal with the collateral as its own property and will not contain anything similar to Rule 15c3-3 requiring a Reserve Account.

- Some brokers participate in CAPCO and maintain CAPCO insurance coverage or maintain other insurance coverage for their customers' risk in excess of SIPC coverage. These details should be confirmed.

- Bank failures are governed by Title 12 of the U.S. Code, and they are administered by the FDIC. Although we believe that securities properly identified in custodial accounts at banks *should* be construed as customer property and *should* be returned to depositors, the powers of the FDIC as receiver or conservator are very broad, and include the power to repudiate both executory and non-executory contracts, and the FDIC's goal is to maximize the return of cash – not securities – to depositors. If securities are to be deposited in custodial accounts at banks, custodial accounts must be properly and clearly labeled – and there is nevertheless a risk that such securities will be aggregated with other customers' securities, as well as the risk of litigation regarding the treatment of such securities.

We remind you that these comments relate only to U.S. domestic, regulated brokers and banks.

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