

2016

When All Else Fails: The Evolution of Customer Asset Protections after Brokerage Bankruptcy

Ronald H. Filler

New York Law School, ronald.filler@nyls.edu

Follow this and additional works at: http://digitalcommons.nyls.edu/fac_articles_chapters



Part of the [Banking and Finance Law Commons](#), and the [Bankruptcy Law Commons](#)

Recommended Citation

Financial History (Issue 118, Summer 2016) at 32-34, 38-39

This Article is brought to you for free and open access by the Faculty Scholarship at DigitalCommons@NYLS. It has been accepted for inclusion in Articles & Chapters by an authorized administrator of DigitalCommons@NYLS.

The Evolution of Customer Asset Protection After Brokerage Bankruptcy

By Ronald H. Filler

ON “BLACK MONDAY,” October 19, 1987, the Dow Jones Industrial Average dropped 22%. It was an unusually volatile trading day in which the US stock market experienced its largest single-day decline. The market volatility caused many brokerage firms to fail and resulted in losses to customers beyond the declining price of their holdings. These losses were caused by the bankruptcy of their brokerages.

Over the past 80 years, laws and regulations have evolved to provide greater protections to customers of US brokerage firms. However, they are not always effective, particularly on volatile trading days.

The US Congress and market regulators want all US residents to open bank accounts, and to feel comfortable that their funds deposited in banks are protected. To that end, the government provides insurance protection on bank account deposits through the Federal Deposit Insurance Corporation (FDIC). Thanks to FDIC insurance, people no longer need to fear the “Wild, Wild West” stories of bank robbers fleeing with their deposits.

However, banks can freely use customer deposits for legitimate business reasons, such as making auto and small business loans, issuing home mortgages, etc. To support these banking arrangements and to encourage people to deposit their funds in a bank account, the FDIC program provides important insurance protections to bank customers in the event their bank is robbed, or fails for any reason.

Historically, FDIC insurance topped out at \$100,000, but it was increased

in 2008 to \$250,000. For married couples, the \$250,000 ceiling applies to each spouse’s account and a joint account in their names, as each account is for a different beneficial owner. Therefore, for singles the maximum coverage is \$250,000, but for married couples it could be as high as \$750,000. If a person has more cash than is covered by these ceilings, he or she should open accounts at multiple banks.

The same is true for stock brokerage accounts. The US Securities and Exchange Commission (SEC) has adopted specific regulations that protect customers who fully pay for their securities (SEC Rule 15c3-3), but stock brokerage firms also use customer funds and securities for other purposes, especially when customers buy stocks on margin. Under these circumstances, the Securities Investor Protection Corporation (SIPC) program caps out at \$500,000 (no more than \$250,000 in cash) for a single person, but it also expands its insurance coverage for married couples, similar to the FDIC program.

There are exceptions to these rules, however. An example from recent financial history is the Bernie Madoff case. Madoff stole more than \$50 billion from his stock customers in an elaborate Ponzi scheme. Several court cases resulted when his scheme was unraveled. The courts held that many of Madoff’s customers could not receive additional insurance coverage if they had previously withdrawn amounts from their accounts with him over the years.

For example, if someone had deposited \$700,000 with Madoff in 1998, let’s assume his account increased in value to \$1.8 million. If that person withdrew \$500,000 in 2004 (leaving a balance of \$1.3 million) and tried to claim his \$500,000 in insurance coverage once the Ponzi scheme was discovered in December 2008, he would be out of luck. The SIPC Trustee appointed to

oversee the Madoff estate said, in essence, that since he had already received more than \$500,000 in 2004, he was not entitled to additional insurance coverage.

Futures and Swaps

Unlike bank and brokerage accounts, there is no insurance coverage program for accounts used to trade futures contracts and swaps, even though these financial products are subject to significant laws and regulations. The reason is simple; these markets are primarily institutional in nature, so they do not have the same public policy reason for the insurance as banks and stock brokerage firms, which are primarily retail in nature. The US Congress recognized this as far back as 1936, when it adopted the Commodity Exchange Act and added Section 4d, which required then, and still mandates today, that all futures commission merchants (FCM)—e.g., futures brokerage firms—maintain all customer assets held by the FCM in a “customer segregated” account at a custodian bank.

This concept can be visualized as a ring fence around a specially protected customer asset account. Thus, if the FCM fails for any reason, creditors of that FCM cannot pierce that ring and use the customer assets held inside it to satisfy its debts. Moreover, FCMs cannot commingle its own assets with the customer assets held in this protected account.

Customer segregation has worked quite well over the past 80 years. There have been a few bumps along the way but, for the most part, any time an FCM has failed, its customer assets have been protected. However, if there were not sufficient customer assets in the segregated account—and thus a shortfall occurred—pursuant to the US Bankruptcy Code (the Code), the remaining non-defaulting customers would be treated on a

Bank failure notice from the Federal Deposit Insurance Corporation is tacked up on the New Jersey Title Guarantee and Trust Company's door in 1939. At the time, it was by far the largest bank failure to be paid off by the FDIC since its inception.

The Philadelphia Inquirer

Vol. 317, No. 112 b

© 1987, Philadelphia Newspapers, Inc.

Tuesday, October 20, 1987

Thirty-Five Cents
Call 800-724-7646 for more home delivery rates

Dow Dives 508.32 Points In Panic on Wall Street

Navy blasts Iran oil site in retaliation

By Owen Ullmann
and David H. Fox

further confrontation with Iran ...
We consider this matter is now
closed.
The 90-minute barrage depicted



Billions lost in trading

By Jennifer Liu
and Tom Wolf

NEW YORK — Panic gripped Wall Street yesterday during a historic day of selling that left the Dow Jones industrial average an estimated 508.32 points lower, investors and billions poorer and experts and analysts alike wondering if the worst was over — or just beginning. Investors and traders were said to disbelieve and horror as stock prices tumbled into the abyss of the crash.

Headline from the *Philadelphia Inquirer* during the Crash of 1987.

pro rata basis, and each would share equally based on the percentage of the shortfall.

For example, if a segregated account should hold \$100 million of customer assets, but only \$98 million was in the account at the close of a business day, there would be a 2% shortfall. If the customer had deposited \$100,000 with that FCM to meet his margin requirements, then he would only receive \$98,000 back, taking into effect that shortfall.

Notable Bankruptcies: Lehman, MF Global and Peregrine

There have been some noteworthy FCM bankruptcies in recent years. The largest involved Lehman Brothers, which filed for bankruptcy in September 2008. On Monday, September 15, Lehman had approximately \$10 billion in customer assets. By the close of business on Friday, September 19, all futures positions had been either transferred to other FCMs or liquidated, and all customer assets were properly transferred without a dollar lost by any of Lehman's futures customers. It showed

that if an FCM follows the applicable laws and regulations, then the system works.

That is not always the case, however. On October 31, 2011, another large FCM, MF Global, filed for bankruptcy with a shortfall of approximately \$1.2 billion in customer funds. While MF Global's customers did eventually receive 100% of their assets, they initially got back only 70%. The remaining 30% was transferred to them over the next few years.

A few months later, another FCM, Peregrine Financial Group, filed for bankruptcy with a shortfall of approximately \$200 million. That FCM only had \$400 million in customer assets, so the shortfall totaled nearly 50%. Because of these two bankruptcies and the resulting shortfalls in their customer segregated accounts, a number of regulatory changes have recently taken place. Most notably, all FCMs and their custodian banks holding customer assets must now report their account balances each morning to the regulators. Thus, the regulators can now compare the amount that should be held in its customer segregated account to the totals shown in its various

custodian accounts. If any significant difference occurs, the regulators can take immediate action to determine the reason for the difference. Prior to this rule, FCMs only reported their balances on a monthly basis.

Another major regulatory change requires the CEO or his designee to approve any transfer of 25% or more out of the customer segregated account. Most FCMs today deposit a large amount of their own capital into the segregated account to ensure, to the extent possible, that no shortfall in the account will occur. This FCM capital investment is called the "residual interest." Once the FCM's capital is so deposited into the customer segregated account, it is deemed to be "customer property." This means that if the FCM fails for any reason, its capital so deposited will first be treated to protect the FCM's customers and may not be used by any of its creditors until the customers receive 100% of their assets back.

Assuming the FCM is doing well but wants to transfer back some of its own capital that was held in the customer segregated account, » *continued on page 38*

When All Else Fails

continued from page 34

the senior-most officer of that FCM must approve that transfer. This is commonly referred to as the “Jon Corzine Rule.” Corzine was the CEO of MF Global at the time of its bankruptcy, and a large amount of funds had been transferred out of the segregated account.

There are some key legal distinctions involving the failure of an FCM versus that of a stock brokerage firm. The insolvency of a stock brokerage firm is governed by the Securities Investor Protection Act and Section III of the US Bankruptcy Code. These laws provide the special SIPC insurance coverage noted above. An FCM’s bankruptcy is governed by Section IV of the US Bankruptcy Code and Part 190 of the CFTC regulations. Together, they deal with the *pro rata* treatment of the non-defaulting customers of the failed FCM. They also do not treat property of a customer that can be specifically identified as belonging to that customer.

This is not the case for stock brokerage firms that fail. If a customer owns 100 shares of ABC, then he will receive back those 100 shares. On the other hand, if a customer deposits US Treasury bills to satisfy his margin requirements in a futures account, those government securities will be sold and converted to cash, with the customer receiving his *pro rata* share if a shortfall occurs

Customer Protection in Global Markets

The industry has learned quite a bit in recent years given these large FCM bankruptcies, but there is more to be done given that today’s markets are clearly global in nature. People living in the United States can now easily trade financial products on more than 35 non-US exchanges. Yet, the bankruptcy laws in those countries vary greatly from the US Bankruptcy Code, which has specific provisions dealing with the failure of a stock brokerage firm (Section III) and the failure of an FCM (Section IV). Outside the United States, many countries do not have laws protecting customers of failed financial firms.

What is now urgently needed is for the G-20 countries to devise a plan to harmonize the bankruptcy laws of these countries so that customers of failed financial



Bloomberg / Andrew Harrer

Jon S. Corzine, former chairman and CEO of MF Global, testifies before the House Financial Services Committee on December 15, 2011. US authorities were investigating whether MF Global intentionally tapped customer funds to cover the bankrupt firm’s margin payments on European government bond trades.

firms are treated fairly, hopefully with similar, or approximately similar, results. Most of the focus since the financial crisis in 2008 has dealt with how OTC derivatives should be regulated. The G-20 countries are gaining ground on the promise they all made in Pittsburgh in September 2009 to have a more harmonized global regulatory system in place that regulates OTC derivatives. Now, they need to focus on protecting customers of failed financial firms in a more harmonized way. 💰

Ronald H. Filler is a Professor of Law and the Director of the Financial Services Institute at New York Law School. He is a Public Director and Member of the Executive Committee of the National Futures Association, a Public Director and Chair of the Regulatory Oversight Committee (ROC) of SWAP-EX and a Board Member of Global Clearing & Settlement.

Sources

- Commodity Exchange Act, 7 USC 1 ET SEQ.
- Filler, Ronald H. “The 7th Circuit and Sentinel—Five Times a Charm.” *Futures & Derivatives Law Report*. April 2016.
- Filler, Ronald H. “Are Customer Segregated/ Secured Amount Funds Properly Protected

After Lehman?” *Futures & Derivatives Law Report*. November 2008.

Filler, Ronald H. “Ask the Professor: What Is the Impact on MF Global From the Recent UK Supreme Court Decision Involving Lehman Brothers International (Europe)?” *Futures & Derivatives Law Report*. April 2012.

Filler, Ronald H. “Energy Derivatives: Which Country (U.S. or U.K.) Provides the Best Customer Asset Protections to an Energy Trading Firm If Its Brokerage Firm/Counterparty Files for Bankruptcy?” *The Energy Law Journal*. Fall 2016.

Filler, Ronald H. and Jerry W. Markham. *Regulation of Derivative Financial Instruments (Swaps, Options and Futures)*. West Academic. 2014.

Federal Deposit Insurance Corporation, at www.fdic.gov.

Securities Investor Protection Corporation, at www.sipc.org.

US Bankruptcy Code, 11 USC 701–784.

US Commodity Futures Trading Commission (CFTC) Rules 1.20–1.29, Part 22, Part 30 and Part 190, 17 CFR 1.20–1.29, Part 22, Part 30 and Part 190.