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INDUSTRY REPORT

Safeguards To Protect Customer Assets In Broker-Dealer And Bank Custody

Schwab INSTITUTIONAL®

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SAFEGUARDS TO PROTECT CUSTOMER ASSETS IN BROKER-DEALER AND BANK CUSTODY [1]

I. Introduction and Executive Summary

The purpose of this white paper is to provide an objective overview of the key regulatory provisions related to the safekeeping of customer securities and funds left in custody with banks and broker-dealers.[2] The paper also discusses common business arrangements undertaken by broker-dealers and banks with respect to maintaining customer assets, such as private bond protections. While intended to provide a general overview of bank and broker-dealer custody issues, the paper does not address issues and considerations that may be of special relevance to any particular custody client (*i.e.*, ERISA or other specific fiduciary requirements that may be imposed by federal or state laws on certain custody clients).[3]

Both broker-dealers and banks are subject to comprehensive regulation. At the federal level, broker-dealers are regulated by the U.S. Securities and Exchange Commission ("SEC") pursuant to provisions of the Securities Exchange Act of 1934 ("Exchange Act") and rules and regulations promulgated thereunder. Broadly stated, federal regulation of broker-dealers is intended to protect investors and the securities markets.[4] The primary means of implementing these goals are by regulations designed to (1) ensure the basic competency of registered broker-dealers, (2) promote the financial solvency of broker-dealers, (3) provide the public with information regarding the business and integrity of broker-dealers, and (4) subject broker-dealers to the jurisdiction, rules and oversight of various self-regulatory organizations ("SROs").[5]

More specifically, the federal securities laws address a number of factors directly impacting the custodial activities of broker-dealers including, among others: imposing minimum net capital requirements; mandating that broker-dealers maintain physical possession and control of "fully-paid" and "excess margin" securities carried for customers; requiring customer consent to the use of customer securities as collateral for a broker-dealer's debt; prohibiting fraud and manipulation by broker-dealers and their associated persons; giving the SEC the authority to inspect, examine and, in appropriate instances, bring enforcement actions against, broker-dealers; and imposing supervisory obligations on broker-dealers with respect to the activities of their associated persons. Federal regulation of broker-dealers is supplemented by the activities of SROs, including the various stock exchanges and the National Association of Securities Dealers ("NASD"). These SROs impose financial and operational requirements, books and records obligations, and mandate qualification and periodic testing of associated persons. To reduce duplicative regulation, state oversight of broker-dealers generally is limited to requiring the registration and licensing of broker-dealers and their associated persons transacting business within a given state, and the regulation of sales practices by broker-dealers.

Depending on their charter and status as members of the Federal Reserve System, banks are regulated by the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), and/or state banking regulators. Because an exhaustive comparison of the rules and regulations of the various federal and state banking regulators is beyond the scope of this paper, the discussion herein focuses primarily on the OCC's supervision of national banks as representative of the regulatory system applicable to all depository institutions. As described below, notwithstanding differences among federal and state banking regulators, the OCC has frequently been at the forefront of the supervision and regulation of the fiduciary activities of national banks, which include the custodial activities of such entities, and its practices are widely followed by other banking regulators.

Federal banking laws have many purposes, from facilitating the role of the FRB in establishing domestic monetary policy to preserving the viability of the banking system as the primary payment system for the U.S. economy. One goal of bank regulation is to preserve the financial viability of banking institutions, to avoid bank failures and to minimize losses when failures occur. In order to accomplish that goal, Congress and the banking regulatory agencies have established a comprehensive regulatory scheme in which all aspects of a bank's activities are closely monitored and supervised. A bank's financial condition and operations are evaluated and rated on a regular basis. A bank is expected to maintain adequate capital commensurate with the nature and extent of the risks that it incurs. A bank must also comply with "safety and soundness" standards established by the banking regulatory agencies relating to, among other subjects, internal controls and information systems. Bank examinations are one of the principal tools used by banking supervisors to assure that banks comply with all applicable regulatory standards.

Banks generally can engage only in "core" banking activities (such as deposit taking, lending and negotiation of checks and similar instruments), other activities that are incidental or necessary to the performance of banking activities, and other non-banking activities that are expressly authorized by law. Banks are expressly authorized to engage in fiduciary activities, such as maintaining custody and safekeeping of securities. Banks that are engaged in fiduciary activities are subject to additional supervision. National banks are required to keep the assets of fiduciary accounts separate from the assets of the bank. Consequently, assets held by a bank in trust normally are not subject to the claims of creditors or depositors of the bank even if the bank becomes insolvent.

Although both banks and broker-dealers are subject to comprehensive regulation, there are differences in how they are regulated. For example, the twin goals of securities regulation generally are described as protecting investors and promoting the efficiency of the market, whereas banking regulators are concerned with the "safety and soundness" of banks. In addition, the system of self-regulation of broker-dealers encompassed in the Exchange Act has no equivalent under federal banking laws. And while both broker-dealers and banks are subject to regulatory capital requirements, the methodology for determining required capital differs. Broker-dealers are subject to the SEC's net capital rule, which requires that, in computing their minimum net capital, broker-dealers reduce the market value of securities they own by certain percentages specified by the SEC in order to provide a cushion against adverse market movements, liquidity, operational and other risks faced by firms. Bank regulatory capital is assessed using, among other factors, a risk-based standard and a leverage standard.

The overwhelming majority of securities held in custody by both broker-dealers and banks are, in fact, held by the central securities depository, Depository Trust and Clearing Company ("DTCC").[6] However, there is an important difference between banks and broker-dealers in how they hold securities at DTCC. Broker-dealers typically hold both customer securities and proprietary securities in the name of the broker-dealer (in so-called "street name"). Because banks are under a legal obligation to keep fiduciary assets separate from bank assets, a bank will use a nominee for holding securities in trust that is different than the nominee used for the bank's proprietary securities. DTCC links more than 11,000 broker-dealers and custodian banks and facilitates the clearing and settlement of trades.

Despite the regulatory safeguards noted above, it is possible for both broker-dealers and banks to fail. For example, regulatory requirements relating to the custodial activities of broker-dealer and bank custodians are of little utility without the implementation of adequate internal controls. Examples may be found where customers of both broker-dealer and bank custodians have incurred losses due to operational problems, fraud and/or theft due to the failure of such firms to implement and monitor procedures designed to safeguard customer funds and securities.

In the event of a failure of a broker-dealer, the task of assisting investors in the recovery of their assets lies with the trustee appointed pursuant to the Securities Investor Protection Act of 1970 ("SIPA"). The trustee generally will attempt to arrange a transfer of customer accounts to other broker-dealers to minimize disruption of customer access to their accounts and facilitate the payment of customer claims. Customer securities held by an insolvent broker-dealer are protected by the Securities Investor Protection Corporation ("SIPC") up to a maximum of $500,000 per customer, of which up to $100,000 per customer is available for claims of cash. In the event of insolvency of a broker-dealer, SIPC prescribes procedures for the processing of claims related to identifiable securities, and has more stringent requirements relating to claims involving securities of multiple customers (and, perhaps, the broker-dealer) that have been commingled. SIPC protection has significantly limited the extent to which customers have incurred losses due to the insolvency of their broker-dealer. During the period of 1970 – 1999, the percentage of claims that were not fully satisfied by SIPC was approximately .07 percent.

When a bank fails, fiduciary assets held in trust by the bank will be transferred to another financial institution or returned to their owner so long as the ownership of the assets is properly identified. The FDIC provides deposit insurance coverage for cash deposits up to $100,000 per owner of an account. However, it should be noted that FDIC deposit insurance does not apply to securities held by a bank's trust department in a custodial capacity. The custodial assets remain the property of the customer and are not considered to be assets or deposits of the bank.

In addition to federal SIPC and FDIC coverage, it is common for prudent broker-dealer and bank custodians to purchase private bond protection with respect to their custodial activities. Excess securities bonds and blanket fidelity bond protection are examples of private protection procured by banks and broker-dealers. When combined with the regulatory safeguards discussed herein, SIPC protection and appropriate risk management and internal controls, these factors have significantly reduced the risks to investors associated with the custodial activities of broker-dealers and banks.

II. Broker-Dealer Custody of Customer Assets

A. Broker-Dealer Regulation Generally

Most broker-dealers are regulated at three different levels to ensure the protection of investors. Together, these regulations are intended to ensure that broker-dealers have sufficient operational and financial capacity to service their customers and to safeguard customer assets.

At the federal level, broker-dealers are subject to various provisions of the Exchange Act, and the regulations under that statute, promulgated by the SEC. These provisions provide for comprehensive and substantive regulation of broker-dealers, including requiring registration with the SEC and membership in SIPC. SEC rules also prohibit fraud, impose margin and financial responsibility requirements on broker-dealers, require the maintenance of accurate books and records, and provide the SEC with the authority to examine and inspect broker-dealers and bring enforcement proceedings.

The Exchange Act also sets forth a system of industry self-regulation pursuant to which broker-dealers are regulated by those SROs in which they are members. All broker-dealers must be members of the NASD or another SRO. In addition to rules relating to fraud, financial responsibility and margin requirements, SRO rules require broker-dealers to adhere to "just and equitable principles of trade" and require principals and registered representatives of member firms to satisfy certain competency and knowledge standards on a periodic basis.

Finally, individual states play a more limited role in the regulation of broker-dealers. In 1996, Congress amended the Exchange Act preempting state laws that are inconsistent with or that exceed federal financial responsibility, margin, custody and books and records requirements applicable to broker-dealers under the Exchange Act. This amendment was intended to eliminate duplicative or differing state law requirements with the federal requirements. However, state laws continue to govern the registration of broker-dealers transacting business in-state and the licensing of in-state associated persons, as well as certain sales practices related to the offer or sale of securities.

B. The Role of the Central Securities Depository and Clearinghouse

Clearance and settlement of securities transactions are handled through a centralized clearinghouse and depository. As the central clearinghouse for equity transactions, NSCC assists in the comparison of trades and removes counterparty risk from the settlement process by guaranteeing buyers and sellers of securities that they will receive securities or payment, as appropriate. Through interfaces with the various exchange and over-the-counter markets, clearing member firms, and credit banks for payment and collections, NSCC is largely responsible for the efficiency in our system of "continuous net settlement." NSCC provides clearance and settlement services to more than 2,000 broker-dealers, banks and other financial institutions. In 1998, NSCC processed over 946 million transactions totaling $44.6 trillion.[7]

NSCC also interfaces with DTC, the central depository for equity securities. DTC records and arranges legal transfer of ownership of securities. It also holds the vast majority of securities for safekeeping. DTC links more than 11,000 broker-dealers, custodian banks, institutional investors, transfer agents, paying agents and redemption agents, and held almost $23 trillion in assets in 1999 for its participants and their customers. In addition, during 1999 DTC processed over 189 million "book-entry" deliveries valued at almost $94 trillion.[8]

Today, most securities are held at DTC in the name of the broker-dealer (i.e., in "street name") for the benefit of their customers. This type of ownership provides many benefits for the customer, such as reducing concerns about securities certificates being lost or stolen, reducing settlement risks by facilitating "book-entry" clearing of securities and making it easier to settle trades within the required settlement period (currently three days after trade date). Through the netting process, NSCC calculates a net long or short position for each eligible security that was traded by a member broker-dealer. NSCC then informs the DTC of the net amount of a security or cash payment that each counterparty owes on the settlement date. The DTC, using its book entry system, then records the transfer of ownership from one account to another by a simple debit or credit entry on its books. Thus, NSCC and DTC are able to eliminate the actual movement of more than 90% of the total number of securities to be delivered or received and cash payments.

Both the DTC and NSCC are "clearing agencies" registered with the SEC. As clearing agencies, they are subject to the SEC's oversight. Among other things, a registered clearing agency must have the capacity to safeguard securities and funds in its custody or control or for which it is responsible.[9]

C. SEC Rules Affecting Broker-Dealer Custody Of Assets

There are several SEC rules designed to protect customer assets held by broker-dealers.

1. ***Financial Responsibility: Customer Protection Rule (Exchange Act Rule 15c3-3)—***The SEC adopted the Customer Protection Rule ("CPR") in 1972 in response to the "paperwork crisis." Although the SEC identified eight separate purposes of the rule, the main objectives were to protect customer assets through a clear delineation of specifically identifiable property of customers and to facilitate liquidations of insolvent broker-dealers.[10]

   The CPR basically has two parts. Under the first part, a broker-dealer must have physical possession or control of all "fully-paid securities" and "excess margin securities" carried for customer accounts. "Fully-paid securities" generally include those securities deposited by a customer with a broker-dealer for safekeeping, securities purchased by a customer and left with the broker-dealer in "street name," or securities paid for by the customer but which have not yet been delivered. "Excess margin securities" are those securities carried for a customer account whose market value exceeds 140% of the amount owed by the customer to the broker-dealer by virtue of a margin account. Broker-dealers must assess compliance with this aspect of the CPR on a daily basis.

   The second part of the CPR covers customer funds and requires broker-dealers to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers." This special account must be separate from any other bank account of the broker-dealer. The broker-dealer must maintain in the reserve account a minimum amount calculated pursuant to a "Reserve Formula." The Reserve Formula generally requires the comparison of amounts held for customers or owed to customers by a broker-dealer (credits) with amounts owed by customers to the broker-dealer (debits). Any excess of credits over debits must be deposited in the reserve account. This aspect of the CPR is intended to limit a broker-dealer's ability to put customer cash and securities at risk by using them to finance its own business activities. The Reserve Formula calculation, and any required deposits, must be made on a weekly basis.

2. ***Financial Responsibility: Net Capital Rule (Exchange Act Rule 15c3-1)—***Various purposes have been ascribed to the SEC's Net Capital Rule ("NCR"), such as protecting the public and customers of broker-dealers, assuring customers that their securities investments can be liquidated upon reasonable demand, and assuring the financial competence of broker-dealers. In short, the NCR requires a broker-dealer to maintain sufficient liquid assets to enable it to liquidate its business in an orderly manner, without the need for a formal proceeding to satisfy customer claims.

The NCR imposes various minimum net capital requirements depending on a firm's business. There are two methods of calculating minimum net capital. Under the basic method, a broker-dealer must maintain net capital in excess of 6 2/3% of its aggregate indebtedness. In other words, aggregate indebtedness may not exceed 15 times its net capital. Because aggregate indebtedness includes most of the unsecured borrowings of a broker-dealer, this method limits a firm's leverage. Under the alternative method, the firm must maintain net capital in excess of the greater of $250,000 or 2% of its customer-related receivables as computed under the CPR.

The NCR also limits the withdrawal of equity capital out of a broker-dealer. Broker-dealers are prohibited from withdrawing equity capital if the firm's net capital would be less than 120% of its minimum net capital after giving effect to such a withdrawal.[11] A firm also must notify the SEC and its Designated Examining Authority ("DEA")[12] if equity withdrawals would exceed certain percentages of the firm's excess net capital.[13]

3. ***Recordkeeping and Financial Reporting Requirements—***SEC rules require broker-dealers to make and keep accurate books and records relating to their business, including records of all transactions and debits and credits of each account of every customer.[14] Broker-dealers must submit to the SEC and their DEA detailed information relating to their financial and operational health on a monthly and quarterly basis—so-called "FOCUS Reports."[15] They also must file with the SEC and their DEA annual audited financial statements containing detailed information regarding their financial condition.[16] Some firms also must file a supplemental report that includes an opinion of an independent public accountant on the status of the firm's SIPC membership and reconciliation of the firm's annual SIPC assessment.[17] In addition, if a firm's capital is less than 120% of the required minimum or if a firm's aggregate indebtedness exceeds 12 times its net capital (or its net capital is less than 5% of its aggregate indebtedness under the alternative method), the firm must provide an early warning notification to the SEC and its DEA within 24 hours of such event.[18] If a firm's capital falls below its required minimum net capital, it must immediately notify the SEC and its DEA.[19] These requirements are intended to ensure that regulators receive timely notice before a broker-dealer faces major financial difficulties, and that, in the event of insolvency, accurate customer records are available for an orderly liquidation of the broker-dealer or transfer of accounts to a solvent firm.

4. ***Inspections and Enforcement Proceedings—***The SEC has authority to inspect all business records of broker-dealers.[20] The inspection program, administered through the SEC's Office of Compliance Inspections and Examinations ("OCIE"), is one of the most important elements in the detection of financial difficulties and prevention of securities law violations by broker-dealers. In appropriate cases, OCIE refers cases to the SEC's Division of Enforcement for further investigation. Ultimately, it is the SEC's

enforcement authority that serves as a powerful incentive for compliance with the securities laws and as a significant deterrent against wrongdoing by broker-dealers and their employees. Sanctions resulting from an enforcement action can include suspensions or bars from the securities industry as well as monetary penalties.[21] Although OCIE examinations are not conducted on a periodic cycle, as a general matter the top twenty broker-dealers may expect to be examined by OCIE at least once every four years.[22]

5. ***Hypothecation Restrictions and Other Requirements*—**Hypothecation is the pledging of securities as collateral for a debt. SEC rules prohibit broker-dealers from hypothecating customer securities under circumstances that permit the commingling of one customer's securities with those of another customer without first obtaining written consent from each customer or that permit the commingling of customer securities with securities of any person other than a bona fide customer.[23] These rules also prohibit the hypothecation of securities carried for customer accounts for an amount that exceeds the aggregate amount customers owe to the broker-dealer. When hypothecating customer securities, broker-dealers also must provide written notice to pledgees that the pledged securities belong to customers. In practice, many broker-dealers include a provision in their customer agreements, or as part of a margin agreement, that permits the broker-dealer to pledge customer securities held in a margin account.

   SEC rules require broker-dealers to establish adequate procedures (such as sending a notice to customers) in order to use "free credit balances" in connection with their business.[24] Free credit balances are the amount a broker-dealer owes to its customers that must be paid immediately to the customer upon demand. Broker-dealers also are required to count and verify the locations of all securities they hold or that are in transit or pledged at least once in each quarter, and compare the results with its records.[25]

6. ***Supervisory Obligations*—**The Exchange Act requires broker-dealers to reasonably supervise their employees with a view to preventing violations of the securities laws.[26] Among other things, broker-dealers must have procedures and a system for applying such procedures that would reasonably be expected to prevent and detect any violations of the federal securities laws by the employees. Broker-dealers may be, and are routinely, sanctioned for failing to reasonably supervise their employees.

D. SRO Regulation

The SEC's efforts to protect customers by regulating broker-dealers are supplemented by the activities of various SROs. There are four kinds of SROs—national securities exchanges (such as the NYSE), the NASD, clearing agencies and the Municipal Securities Rulemaking Board. Almost all broker-dealers are members of and subject to rules and regulations of either one or more national securities exchanges or the NASD.

Self-regulation is a long-standing and critical component to the regulation of broker-dealers. In addition to imposing specific rules relating to the financial responsibility, sales practices, and books and records activities of broker-dealers, to name a few, self-regulation is important because it also incorporates industry ethics by imposing an obligation on broker-dealers to promote "just and equitable principles of trade."[27] Thus, in some areas, SROs have rules that are more stringent than SEC rules. This section provides a brief overview of relevant SRO rules.

1. ***Registration and Testing of Associated Persons*—**The Exchange Act requires all natural persons associated with a broker-dealer involved in effecting securities transactions to be registered or approved in accordance with certain standards of training, experience, competence and other qualification standards.[28] The NASD administers the qualification examination and licensing process. There are various examination requirements for principals of a broker-dealer (generally officers and supervisory personnel involved in the management of a broker-dealer's securities business) and registered representatives (generally sales personnel). After passing the required examination, these individuals must register with the NASD by filing a Form U-4 (Uniform Application for Securities Industry Registration or Transfer) together with a fingerprint card. The Form U-4 requires disclosure of such information as employment history, prior disciplinary or criminal actions against the individual, and educational background. Among other things, individuals who have committed certain specified violations of the federal securities laws (*i.e.*, who are subject to a "statutory disqualification") are not eligible to become associated with broker-dealers. This requirement is intended to reduce the possibility of misconduct by employees of broker-dealers.

2. ***Books and Records Requirements*—**SROs generally require their members to make and maintain accurate records in conformity with the federal securities laws and their own rules. They also have specific requirements as to how order tickets must be marked and what information must be included in customer account statements. In addition, a broker-dealer is required to maintain a separate file of all written customer complaints and any action taken by the broker-dealer with respect to such complaints.[29]

    a. *Financial and Operational Requirements*—SROs require their members to have sufficient financial and operational capability to conduct their securities business. They have authority to suspend or limit the business activities of a member that is in difficult financial or operating condition.[30] In addition, SROs require their members doing business with the public to maintain a blanket fidelity bond covering their officers and employees. The fidelity bond generally provides against loss covering fidelity, premises, in transit, misplacement, forgery and alteration, securities loss and fraudulent trading.[31]

    b. *Inspections and Enforcement Actions*—Similar to the SEC staff, SROs also have inspection and enforcement authority. They conduct routine and "cause" inspections of their member broker-dealers for compliance with the federal securities laws and their own rules. They may impose sanctions for violations of the Exchange Act, SEC rules (including the NCR and CPR) and their rules. These inspections and enforcement actions supplement the SEC's efforts. The SROs examine every broker-dealer anywhere from annually to once every four years, depending on the type of firm.[32] In appropriate cases, SROs coordinate their inspection and enforcement efforts with the SEC.

E. Securities Investor Protection Act

1. ***Background of SIPC*—**In response to the paperwork crisis of the late 1960s, Congress enacted the Securities Investor Protection Act of 1970 ("SIPA"). SIPC was created pursuant to this legislation with the main purpose of ensuring that customers recover cash and securities (up to certain "protection" or "coverage" limits discussed later) from broker-dealers that fail or cease operations and cannot meet their obligations to customers. SIPA provides for liquidation proceedings under which customer assets are distributed to satisfy the "net equity" claims of customers. A "net equity" claim basically is the amount of securities and cash owed the customer by the broker-dealer less the amount owed by the customer to the broker-dealer firm. Thus, SIPC protection acts as the last resort for protecting customer assets if a broker-dealer becomes financially insolvent.[33]

   With very limited exceptions, all broker-dealers that are registered with the SEC are required to join SIPC.[34] As of December 31, 1999, SIPC had more than 7,300 members. SIPC is funded through an annual assessment of member broker-dealers based on their gross revenues from the securities business (with a minimum assessment of $150 for any given member broker-dealer) and through investment income revenue. In the event the SIPC fund is insufficient, SIPC has a $1 billion credit facility with various financial institutions.[35] In addition, the SEC has the authority to borrow from the Secretary of the U.S. Treasury up to $1 billion and to lend this money to SIPC.

2. ***Relevant SIPC Data*—**It is important to note that financial failures by broker-dealers are relatively rare and that since SIPC has been created most customers of failed broker-dealers have received the return of all of their assets. According to SIPC, between 1970 and 1999, there were 282 customer protection proceedings under SIPA, which represents less than one percent of the approximately 35,000 SIPC members during that time. During this period, SIPC distributed approximately $3.38 billion, of which $3.15 billion came from the assets of failed broker-dealers and approximately $230 million came from the SIPC fund. Customer claims that were

RELEVANT SIPC DATA

Total number of SIPC members:	35,000
Total number of failures:	282
Percentage of member failures:	0.8%
Total number of claims satisfied by SIPC:	427,500
Number of claims in excess of SIPC limits:	305
Percentage of claims that were not fully satisfied by SIPC:	0.07%[36]

Source: SIPC 1999 Annual Report (Period 1970-1999) greater than SIPC limits (305 claims) represented less than one-tenth of one percent of all claims satisfied (a total of 427,500 satisfied by SIPC).[37]

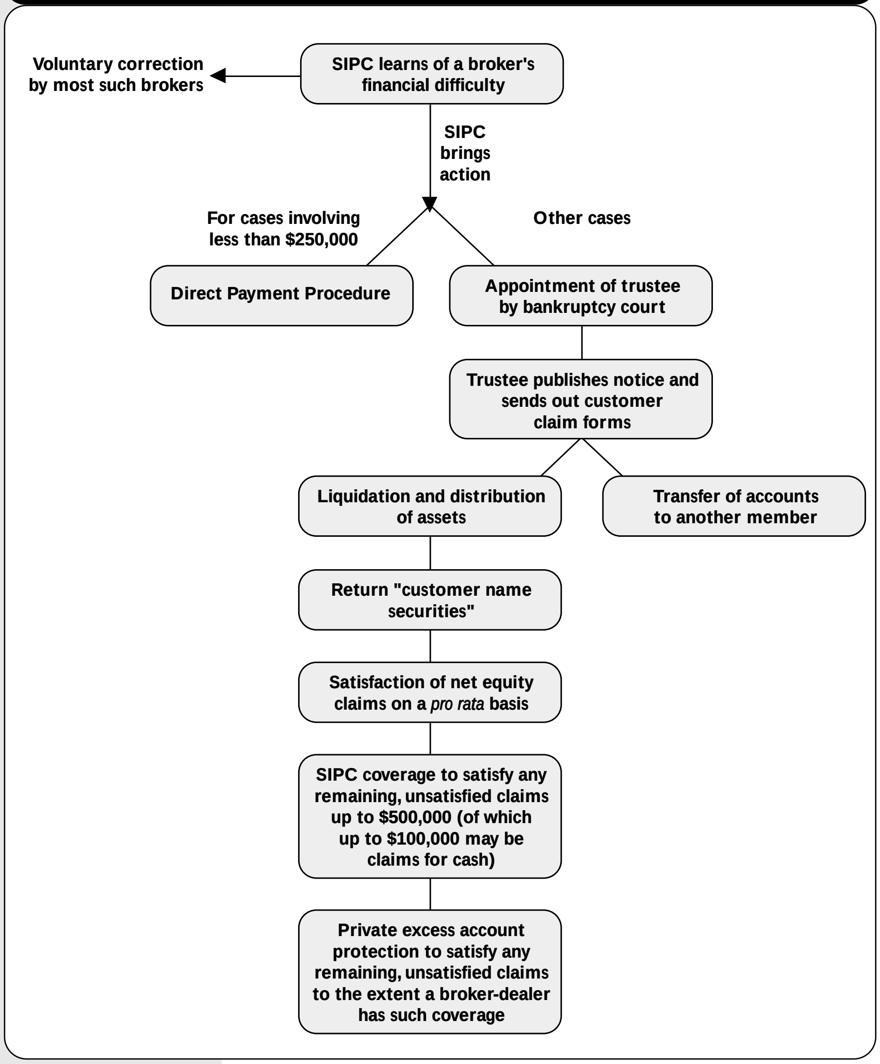
3. ***SIPC Proceedings*—**If the SEC or an SRO believes that a broker-dealer is approaching financial difficulty, it must immediately notify SIPC. In practice, the great majority of broker-dealers referred to SIPC have corrected their financial difficulties voluntarily. If a broker-dealer does not correct its financial difficulties, SIPC then may bring a protective proceeding in bankruptcy court, and such court then has exclusive jurisdiction of the broker-dealer and its property.[38] While the bankruptcy court has jurisdiction over a SIPC proceeding, the Bankruptcy Code provisions regarding stockbroker liquidations apply only to those cases to which SIPA does not apply (*e.g.*, firms that engage in a purely intrastate business) or to which SIPC does not elect to exercise its authority. Since enacted, virtually all broker-dealer liquidations have been conducted under SIPA.

The first step in a SIPC proceeding is the appointment of a trustee by the bankruptcy court. The trustee is required to publish commencement of SIPC proceeding in newspapers, and to mail notices to all persons who appear to have been customers of the failed broker-dealer within the last 12 months. The notice includes a customer claim form that must be completed and returned to the trustee, generally within sixty days. The customer claim form is intended to assist the trustee to determine each customer's net equity claim amount.

The trustee often tries to arrange a transfer of some or all customer accounts to other SIPC members to minimize disruption in customer access to their accounts and to facilitate the prompt satisfaction of customer claims.[39] When a transfer to another member is not feasible, customers of a failed SIPC broker-dealer first receive all securities registered in their names or that are in the process of being so registered that are not in negotiable form (so-called "customer name securities").[40]

Next, the "net equity" claims of customers are satisfied by allocating any remaining "customer property" to claimants to the extent possible. In other words, claimants receive, on a *pro rata* basis, all remaining customer cash and securities held by the firm. If a failed firm does not have sufficient amount of securities on hand to satisfy all customer "claims for securities," the trustee will attempt to purchase shares in the open market. If securities can be found in a fair and orderly market, they will be purchased and returned to the customer. If not, the trustee will allocate available securities pro rata, and the shortage will be paid in cash. The amount of cash paid in lieu of securities reflects their worth on the day customer protection proceedings commenced under SIPC (the "Value Date") and may differ from the value of the securities on the actual payment date. SIPC also does not cover claims based on a decline or loss in market value of securities prior to the Value Date.

Example of a Typical SIPC Proceeding



After the distribution of all available "customer property" to claimants, SIPC protection is applied to satisfy any remaining, unsatisfied securities claims up to $500,000 for each "customer" (of which $100,000 may be for claims for cash). SIPC protection covers most types of securities, such as stocks, bonds, mutual fund shares and certificates of deposit. It does not protect, however, claims involving unregistered investment contracts or commodities. Although it varies from proceeding to proceeding, according to SIPC most customers receive their assets in one to three months, or even earlier if the trustee can transfer the accounts to another SIPC member.[41] Figure 1, at left, is a flowchart showing the various steps involved in a typical SIPC proceeding.

4. SIPC Protection Available to Customers—SIPC protection is limited to "customer" accounts. A "customer" is defined as a person with claims on account of securities received, acquired or held by the failed broker-dealer in the ordinary course of its business from or for securities accounts of such person:

- for safekeeping;
- with a view to sale;
- to cover consummated sales;
- pursuant to purchases;
- as collateral security; or
- for purposes of effecting a transfer.[42]

Thus, investors who deal with broker-dealers in the ordinary course of business would be "customers" for the purposes of SIPA and would be entitled to SIPC protection. The term "customer" does not include persons to the extent that they have claims for property which, by contract, agreement, or understanding, or by operation of law, is part of the capital of the failed broker-dealer or is subordinated to the claims of such failed broker-dealer's creditors.

Accounts held by a single customer in separate capacities are treated as separate customer accounts for purposes of SIPC coverage. For example, a customer who has an individual account, a custodian account for a minor and a trustee account for an estate is entitled to separate SIPC protection for each account. Accounts held by a single person in a single capacity, however, would be deemed a single customer account for purposes of SIPC. A customer with accounts at multiple SIPC members would be entitled to SIPC protection with respect to each account.

5. ***Private Excess Account Protection***—Finally, it is also worth noting that many broker-dealers, as a good business practice, carry excess account protection from private sureties to cover claims over and above the SIPC limits. These "excess securities bonds" generally provide protection up to a set limit, which may vary from broker-dealer to broker-dealer. More conservative broker-dealers may carry coverage up to the full net equity amount of an account. These private excess account protection programs apply in a similar manner as the SIPC coverage. Upon request, broker-dealers generally send verification of excess SIPC coverage to customers.

F. Rationale for Safeguards

Many of the current regulations affecting broker-dealers holding customer assets—such as SIPC protection, the current clearance and settlement systems and some of the SEC/SRO regulations—stem from the so-called "back-office crisis" of 1967–1970. During this period, many broker-dealers had difficulty handling the paper work associated with processing the increasing number of securities transactions. Broker-dealer customers complained in many instances of the delay by broker-dealers in delivering customer funds and securities. Ultimately, this crisis led some broker-dealers to fail.[43] In response, the DTC and NSCC were established in the 1970s to reduce the backlog of paperwork, maintain pace with rising trading volume, accelerate post-trade reporting, and reduce risk associated with securities trading.

The reasons for broker-dealer failures cited by commentators include misconduct by employees, the increased riskiness of trading and business practices and the increasingly complex corporate structures of some broker-dealers and their affiliates.[44] Although these and other reasons may contribute to failures by some broker-dealers, as discussed above, many safeguards have been implemented since the "back-office crisis" to minimize the risk of loss by broker-dealer customers. Furthermore, regulation of broker-dealers and their employees by the SEC and various SROs at the federal level and by the states is intended, and has served, to enhance the safety of customer assets by deterring misconduct and by imposing customer protection requirements. In the rare event of insolvency, SIPC coverage provides protection against loss of customer assets up to the prescribed limits. Finally, private "excess securities bonds" provide additional protection over and above the SIPC limits to the extent a broker-dealer has arranged for such coverage.

III. BANK CUSTODY OF CUSTOMER ASSETS

A. Overview of Bank Regulation

Banks in the United States can be chartered under either federal law or state law. National banks are banks that choose to be federally chartered and regulated under the National Bank Act.[45] The OCC is the chartering authority and primary supervisory agency for national banks.[46]

Banks chartered under state law are supervised primarily by state banking regulators, but nearly every state bank also has a primary federal banking regulator. In the case of state banks that elect to become members of the Federal Reserve System, the primary federal regulator is the FRB.[47]

The Federal Deposit Insurance Act provides a system of federal deposit insurance under the administration of the FDIC.[48] All national banks and state banks that are members of the Federal Reserve System must be insured by the FDIC. Other depository institutions may apply for FDIC insurance coverage.[49] As of September 30, 2000, the FDIC insured approximately 10,000 depository institutions in the United States.[50] The FDIC is the primary federal regulator for state banks with FDIC insurance coverage that are not members of the Federal Reserve System.[51] Because of the FDIC's role as the "guardian" of the Federal Deposit Insurance Fund, the FDIC usually takes the lead in addressing issues and problems that relate to deposit insurance. The FDIC has sole authority for the adoption of a variety of regulations intended to minimize the risk of loss to the insurance fund. In those instances, the regulations adopted by the FDIC are then administered or enforced by the other federal banking regulators with respect to the banks that they supervise.

Accordingly, all insured banking institutions (which includes almost all banks) are supervised by a "primary" federal bank regulatory agency—either the OCC, the FRB or the FDIC. The federal banking agencies have coordinated their policies concerning the examination and rating of banks. Although there are some differences among their respective policies and procedures, for the most part their supervisory practices are very similar. When addressing major issues, the bank regulatory agencies often adopt joint regulations.

Notwithstanding the various differences among the federal banking regulators, for purposes of this paper we focus primarily on the OCC's supervision of national banks as typical of the regulatory system applicable to all depository institutions. This is appropriate for several reasons. The OCC has long taken the lead in the supervision and regulation of fiduciary activities of banking institutions. Its practices and regulations relating to national bank fiduciary powers are widely followed by other bank regulators, state and federal. In addition, most state banking statutes under which state banks are organized have so-called "wild card" provisions permitting state banks organized under such laws to exercise any powers authorized for national banks.[52] Thus, to the extent that the OCC regulates the powers of national banks, its regulations indirectly affect a large number of state banks. Because the regulation of state banks depends in part on the particular banking law of each state, the regulation of state banks is not specifically addressed in this paper. General references to banks in this paper are intended to refer to national banks unless the context otherwise requires.

The bank regulatory agencies have established a Uniform Financial Institutions Rating System under which each financial institution is assigned a composite rating based on an evaluation of six essential components of the institution's financial condition and operations. These components address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the institution's sensitivity to market risk. These ratings serve as a useful vehicle for identifying problem areas at financial institutions.[53]

A bank's capital adequacy is one of the most important factors used to evaluate its financial condition. A bank is expected to maintain capital commensurate with the nature and extent of the risks that it incurs. The types and quantity of risk inherent in a bank's activities will determine the extent to which the bank may be required to maintain capital at levels above required regulatory minimums. The federal banking agencies have adopted capital adequacy standards for domestic banks based on, among other factors, measures of leverage and risk. The risk-based measure is based on a definition of core capital and supplementary core capital. The agencies have established a schedule for achieving a minimum ratio of capital to risk-weighted assets and determining how much of the capital required must consist of core capital.[54]

The basic structure of federal banking regulation has been in place since Congress enacted banking legislation in the 1930s that created the FDIC. More recently, following the savings and loan failures of the 1980s, banking regulation was strengthened significantly by the Financial Institutions Reform, Recovery and Enforcement Act of 1989[55] and the Federal Deposit Insurance Corporation Act of 1991 ("FDICIA").[56] Among other things, FDICIA enhanced bank supervision in the following respects:

- Every national bank that holds assets of $250 million or more must receive a full-scope, on-site examination by its federal regulator every year.
- Every insured depository institution must have an annual independent audit. The independent auditors must attest to management's assertions regarding internal controls and procedures for financial reporting.
- The federal banking regulators were required to adopt regulations that set specific

safety and soundness standards for banks.

- Federal banking regulators were given broad powers to take prompt corrective action to deal with problems facing insured depository institutions. In certain cases, the regulator can appoint a conservator or receiver to take control of the bank.[57]

Under FDICIA, banks are rated by their primary federal supervisor as "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" or "critically undercapitalized" based on three separate capital calculations. Various regulatory implications flow from each category, ranging from certain benefits for well-capitalized banks to corrective actions and restrictions applicable to banks within the other categories. For example, an undercapitalized bank may not acquire any interest in any company or engage in any new lines of business unless it has implemented a capital restoration plan approved by its supervisory agency.[58]

B. Bank Safety and Soundness

A primary goal of bank regulation is to preserve the financial viability of banking institutions and to avoid bank failures. Until FDICIA mandated certain safety and soundness standards, the statutes did not generally define an "unsafe or unsound practice." The banking agencies interpreted that phrase very broadly, which gave them authority to supervise virtually any aspect of a bank's activities that could result in a risk of loss or damage to a bank. The courts accepted this broad interpretation:

> "Generally speaking, an 'unsafe or unsound practice' embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds."[59]

FDICIA required each federal banking agency to codify certain safety and soundness standards by regulation or by guideline for all insured depository institutions. Specifically, the agencies were required to establish three types of standards: (1) operational and managerial standards, (2) compensation standards, and (3) standards relating to asset quality, earnings and stock valuation.[60] It should be noted that the codification of these standards did not displace the authority of the federal banking agencies to order banking institutions to cease practices that the agency considers to be "unsafe" or "unsound" even though the practice is not articulated in any regulation or other agency pronouncement.

The operational and managerial standards are the standards most relevant to bank custodial activities. One category of operational standards relates to internal controls and information systems. A banking institution is required to have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:

1. An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
2. Effective risk assessment;
3. Timely and accurate financial, operational and regulatory reports;
4. Adequate procedures to safeguard and manage assets; and
5. Compliance with applicable laws and regulations.[61]

The appropriate supervisory agency is responsible for reviewing a bank's compliance with these safety and soundness standards. If a bank is not in compliance with one or more standards, the agency can require it to submit a compliance plan describing the steps that the bank will take to correct the deficiency. If a bank fails to submit an acceptable compliance plan or fails to implement its compliance plan, then the supervisory agency will issue an order requiring the bank to correct the deficiency or to take or refrain from taking other actions. Such orders can be enforced in federal court, and a bank that fails to comply with such an order may be subject to a civil money penalty or other enforcement remedies.[62]

Bank examinations are one of the principal tools used by banking supervisors to assure that banks conduct their business in compliance with all regulatory requirements, including the safety and soundness standards. Large banks are examined annually by their banking supervisor. In addition to regular annual examinations, banking supervisors frequently conduct special examinations that focus on specific areas of operations or activity. For example, a trust department examination focuses on the activities of a bank's trust department.

Bank examinations covering the risk management functions of a bank are discussed in Section D below in the context of safeguards for particular risks faced by banks when they perform custodial services for clients.

C. Fiduciary Activities of Banks

Banks, typically acting through their trust departments, have long engaged in fiduciary activities. With respect to securities, these activities include custody, safekeeping, payment, settlement, recordkeeping, transfer agent, investment advice, investment management, securities lending and other reporting functions. Banks may provide custody and safekeeping services in a trustee or agent capacity with or without investment discretion authority.[63] For example, a bank acting as a directed custodial agent will make investments only at the direction of the principal or the principal's designated investment adviser. When acting as an agent, a bank has fiduciary duties with respect to matters within the scope of its agency.[64]

In order to act in a fiduciary capacity, a national bank must apply for and receive approval from the OCC to exercise fiduciary powers.[65] The OCC supervises the fiduciary activities of national bank trust departments,[66] while state banking regulators supervise the fiduciary activities of state bank trust departments. The OCC guidelines are widely followed by state banking regulators.

National banks are required to keep the assets of fiduciary accounts separate from the assets of the bank.[67] Assets held in custody by a bank trust department—whether or not the bank has investment discretion over such assets—are considered to be fiduciary assets, and they are not regarded as assets of the bank in its statement of condition or in its capital determinations for accounting or regulatory purposes. Fiduciary assets are segregated from the bank's assets pursuant to trust department procedures required by OCC regulations and reviewed by banking supervisors in periodic trust department examinations.[68]

Most trust agreements authorize the bank to register securities held in the trust department in nominee form. This simplifies the transfer of the securities between the bank and the central depository for the securities, as well as facilitating the collection of dividends and interest.[69] (Please refer to the discussion of the role of the central securities depository in Section II.B. above.) Because of the legal requirement to keep fiduciary assets separate from the assets of the bank, the nominee used for holding securities in trust is different from the nominee used for the bank's proprietary securities.

D. Safeguards for Particular Risks

Banking supervisors recognize the importance of risk management for banks. Indeed, the first two objectives in the OCC's Large Bank Supervision Booklet in the Comptroller's Handbook are (i) to determine the condition of the bank and the risks associated with current and planned activities and (ii) to evaluate the overall integrity and effectiveness of the bank's risk management systems. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: credit, interest rate, liquidity, price, foreign currency translation, transaction, compliance, strategic and reputation.[70] While these risks apply generally to banking activities, the particular risks that are most relevant to a bank acting as custodian to hold client securities are discussed below.

1. ***Insolvency Risk: FDIC Protection*—**This is the risk that the bank acting as custodian might become insolvent. Banking supervisors attempt to prevent bank insolvencies by enforcing the regulatory requirements discussed above, including the safety and soundness standards. Nevertheless, a number of depository institutions fail every year. For example, stemming from the savings and loan crisis of the 1980s, a total of 382 FDIC-insured banks and thrifts failed in 1990. The number of bank and thrift failures declined significantly during the 1990s, and there were only eight such failures among FDIC-insured institutions in 1999.[71]

   Under the National Bank Act, the Comptroller of the Currency has the discretionary authority to determine whether a national bank has become insolvent.[72] Among the grounds for finding that a bank has become insolvent are the following:

   - The bank's assets are less than its obligations.
   - It is in unsafe or unsound condition.

- The bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital.
- The bank is undercapitalized and has no reasonable prospect of becoming adequately capitalized.[73]

When the Comptroller of the Currency determines that a national bank should be placed into receivership, it must appoint the FDIC to act as the receiver.[74] The FDIC can also be appointed as receiver for insured state depository institutions and for thrifts.[75] When acting as a receiver, the FDIC has broad powers. It can take over the assets of and operate the depository institution. It can place the institution in liquidation and proceed to realize upon its assets. It can organize a new bank to take over the assets of the institution in receivership. It can merge the institution with another depository institution or transfer any assets or liabilities to another depository institution with the approval of that institution's federal supervisory agency.[76] In determining which action to take, the FDIC is required to use the method that has the least cost to its insurance fund.[77]

Since 1994, all failures of FDIC-insured banks and thrifts have been handled through purchase-and-assumption transactions.[78] In a purchase-and-assumption transaction, another insured bank purchases the assets and assumes the liabilities of a failed institution. Under this approach, depositors of the failed institution are fully protected, even if their deposits exceed the FDIC insurance coverage limit, because the purchasing institution assumes the obligation to repay the amount of the deposit. An alternative approach, sometimes used by the FDIC in the early 1990s, is for the FDIC to close the failed institution and pay each depositor up to the limits of the FDIC insurance coverage.[79]

Fiduciary assets held in trust by a bank are not treated as assets of the bank if the bank becomes insolvent. When the owner of securities delivers them to a bank for safekeeping, the owner is entitled to their return upon the bank's insolvency so long as the ownership of the securities is properly identified.[80] Accordingly, assets properly held in trust cannot be reached to satisfy the claims of depositors or creditors of an insolvent bank.[81] (However, as discussed below in the section discussing the risk of fraud or theft, trust assets are not necessarily protected if they have been misappropriated after being commingled with other assets.)

The OCC's regulations provide that the receiver for a national bank shall promptly close or transfer to a substitute fiduciary all fiduciary accounts, in accordance with OCC instructions and the orders of the court having jurisdiction.[82] When the FDIC is appointed receiver, it is expressly authorized to transfer any asset or liability of the insolvent institution (including assets and liabilities associated with its trust business) to another financial institution.[83] Thus, under normal circumstances, the owner of assets held in trust at a bank that became insolvent can expect either to have such assets returned to him or transferred to another financial institution promptly, without needing to wait for the claims procedure described below.

To the extent that a bank trust department holds a trust customer's assets in the form of cash, it will either invest the cash in money market instruments or deposit it in a bank account established in the name of the trust. The manner in which the cash is invested makes a significant difference from a legal standpoint. If the cash is invested in shares of a money market mutual fund, for example, the assets are securities and remain subject to the special protection applicable to custodial assets held in trust.

However, the legal treatment is different if the cash is deposited into a bank account. The deposit of cash into the bank account is treated as a general deposit. That means that the bank (acting as custodian) transfers ownership of the funds to the bank (acting as depository), and the bank as custodian becomes the creditor of the bank as depository.[84] If the bank fails, the transferred funds are treated as assets of the bank, and the bank as custodian is treated the same as any other depositor. Such bank deposits are covered by FDIC deposit insurance up to $100,000 per owner of the account. If the bank were to fail, the FDIC normally would protect depositors by arranging for another FDIC-insured institution to take the insured deposits of the failed institution. When this happens, depositors usually have access to their insured funds on the next regular business day.[85]

The procedures for resolving claims against an insolvent national bank are spelled out in the Federal Deposit Insurance Act.[86] The FDIC must promptly publish a notice to creditors of the receivership to present proofs of claims within 90 days.[87] After a claim is filed, the FDIC has 180 days to determine whether to allow or disallow the claim.[88] There is a procedure for expedited relief for claimants who have a perfected security interest in assets held by the insolvent institution. Under this procedure, the FDIC has a 90-day period in which to determine whether to allow or disallow such claim.[89] Claims of unsecured creditors will be paid in the following order of priority:

- ***a.*** Administrative expenses of the receiver;
- ***b.*** Any deposit liability of the institution;
- ***c.*** Any other general liability of the institution, other than those listed in *d* or *e*, below;
- ***d.*** Any obligation subordinated to depositors or general creditors; and
- ***e.*** Any obligations to shareholders of the institution arising as a result of their status as shareholders.[90]

As noted above, FDIC deposit insurance does not apply to securities or other assets held by a bank's trust department in a custodial capacity, as opposed to cash held in a general deposit account. The custodial assets remain the property of the customer and are not considered to be assets or deposits of the bank.[91]

2. ***Operational Risk***—A bank trust department's ability to engage in fiduciary activities depends on the quality of its operations area. The operations area must provide comprehensive recordkeeping and information systems. The bank's accounting system must be capable of providing detailed account information to management, customers, regulatory agencies and other appropriate parties. Some banks outsource financial recordkeeping to third-party vendors. Serious operational problems can result from:
    - Deficient operating processes and internal controls over information systems and accounting records, particularly during system conversions;
    - Inadequate disaster contingency planning for information systems; or
    - Failure to manage third-party vendors effectively.[92]

    The primary safeguards against operational risks are the bank's risk management systems, its internal controls and periodic examinations by its supervisory agency. Banking supervisors will evaluate whether bank systems and controls can adequately safeguard fiduciary assets, assure the accuracy and reliability of accounting data, and provide timely management and account information. The accounting system should record the location of each asset. In the case of securities held at a depository, the bank should have procedures for the daily reconciliation of changes in the depository position.[93]

3. ***Risk of Fraud or Theft***—When a bank trust department maintains custody of customer assets, possible fraud or theft by bank employees is a risk that must be faced. The bank is required to have a system of internal controls, security precautions, and operational procedures to ensure that trust assets are properly safeguarded against possible loss. The OCC has indicated that bank trust departments should implement the following written internal controls:
    - Ensuring that at least two authorized persons are present when bank employees handle or have access to securities held in trust.
    - Restricting and documenting access to the trust vault and securities processing.
    - Prohibiting persons assigned responsibility to originate entries or trust vault instructions from having access to the vault or securities cage to minimize the possibility of theft.
    - Providing for security devices such as appropriate lighting, alarms and other physical security controls with respect to the vault used for the safekeeping of trust assets.
    - Recording in detail all asset movements, deposits and withdrawals, including the initials of the joint custodians, the date of vault transactions, description and amounts of assets, identity of the affected account and appropriate notations on the source of assets deposited and purposes for which assets are withdrawn.
    - Where securities are deposited with a securities depository, maintaining appropriate dual control procedures for the release of securities from the depository.

All of these internal controls are examined as part of the bank examinations conducted by the appropriate banking supervisor.[94]

A basic principle of risk management is that those risks which carry the potential for significant loss should not be retained if avoidable. In order to protect themselves against losses caused by dishonest or fraudulent acts by their officers and employees, banks purchase blanket bond insurance that includes fidelity insurance protection. A bank's supervisory agency will review the bank's insurance coverage to ascertain whether it is adequate to protect the bank against the risk of fraud or theft by its employees.[95]

As discussed above, banking laws and regulations are intended to protect the safety and soundness of banks, to promote operational safeguards, to reduce the chances of fraud or theft occurring, and to minimize the damage if a bank fails. These regulatory safeguards, however, will not be effective unless they are rigorously enforced. In a situation involving fraud on the part of bank insiders, it is possible that trust assets would not be properly segregated and would be commingled with other assets of the bank. If such assets were then to be misappropriated, the rightful owners of the trust assets could be exposed to risk of loss to the extent that their claims were not covered by FDIC deposit insurance.

4. ***Risks of Securities Lending—***Many bank trust departments offer a securities lending program to their clients so that the securities held in custody for the clients can generate incremental income. This is an optional service which entails certain risks. Each client can decide for itself whether the incremental income earned is worth the additional risk exposure. The potential risks involved in securities lending include borrower bankruptcy, collateral deficiencies and losses due to interest rate exposure. ❖

ENDNOTES

1 This white paper has been prepared by Schiff Hardin & Waite on behalf of Charles Schwab & Co., Inc. The paper has been prepared as an overview of laws, regulations and business practices related to the custody of assets by broker-dealers and banks, and is not intended and should not be viewed as the rendering of a legal opinion or legal advice to any person.

2 Securities firms perform functions as "brokers" and/or "dealers." Although these terms are defined differently under the Securities Exchange Act of 1934, the commonly used term "broker-dealer" is used throughout this paper for ease of reference.

3 Nor is this paper intended to assess differences that may exist in the business or "cultural" environments of banks and broker-dealers, or the extent to which such differences may impact custodial services provided by these entities.

4 See Exchange Act Release No. 27017 (July 11, 1989) (discussing purposes of broker-dealer regulation in context of adopting SEC Rule 15a-6).

5 Lipton, Broker-Dealer Regulation (1992), § 1.03.

6 In 1999, the Depository Trust Company ("DTC") merged with the National Securities Clearing Corporation ("NSCC") to create DTCC. DTCC now operates NSCC and DTC as separate subsidiaries. To distinguish the clearing and settlement and depository functions of DTCC, this paper will refer to NSCC when discussing the former and DTC when discussing the latter.

7 This information is from NSCC's website—<www.nscc.com>.

8 This information is from DTCC's website—<www.dtcc.com>.

9 Exchange Act Section 17A(b)(3).

10 *See* Exchange Act Release No. 9856 (1972). Other objectives included such things as requiring broker-dealers to maintain more current records, requiring a more expeditious securities transaction processing, and inhibiting the unwarranted expansion of a broker-dealer's business by using customer funds. *Id*.

11 Exchange Act Rule 15c3-1(e)(2).

12 Where a broker-dealer is a member of more than one SRO, the SEC designates responsibility of examining the member for compliance with financial responsibility rules to a particular SRO, which then becomes the member's DEA. *See* Exchange Act Rule 17d-1.

13 Exchange Act Rule 15c3-1(e)(1).

14 Exchange Act Rules 17a-3 and 17a-4.

15 Exchange Act Rule 17a-5.

16 Exchange Act Rule 17a-5(d).

17 Exchange Act Rule 17a-5(e)(4).

18 Exchange Act Rule 17a-5(e)(4).

19 Exchange Act Rule 17a-11.

20 Exchange Act Section 17(b).

21 Exchange Act Sections 15(b)(4) (action against broker-dealers) and 15(b)(6) (action against associated persons).

22 SEC Speaks, Office of Compliance Inspections and Examinations Outline (Practicing Law Institute 1999).

23 Exchange Act Rules 8c-1 and 15c2-1. Rules 8c-1 (applicable to exchange members) and 15c2-1 (applicable to over-the-counter firms) are identical in scope and text.

24 Exchange Act Rule 15c3-2.

25 Exchange Act Rule 17a-13. This requirement is known as the "Quarterly Box Counts."

26 Exchange Act Section 15(b)(4)(E).

27 For example, the NASD requires its member broker-dealers to observe "high standards of commercial honor and just and equitable principles of trade." NASD Rule 2110.

28 Exchange Act Section 15(b)(7). *See also* Exchange Act Rule 15b7-1.

29 *See, e.g.*, NASD Rule 3110.

30 For example, the NYSE and the NASD can require a financially troubled member, although not yet insolvent, to limit or reduce its activities until such financial difficulties are adequately addressed. The SROs also may suspend financially troubled member firms. *See generally*, NYSE Rule 475(b)(ii); NASD Rule 3130.

31 *E.g.*, NYSE Rule 319; NASD Rule 3020.

32 SEC Speaks, Office of Compliance Inspections and Examinations Outline (Practicing Law Institute 1999).

33 SIPC is somewhat analogous to the protection the FDIC provides for the accounts of bank depositors. FDIC insurance is discussed later in this paper.

34 Broker-dealers whose principal business is conducted outside the United States or whose business is limited

to the distribution of mutual fund shares, the sale of variable annuities, the insurance business or the investment advisory business for mutual funds are not required to become SIPC members.

35 SIPC 1999 Annual Report.

36 Information regarding the extent to which these unsatisfied claims may have been covered by private excess account protection purchased by some broker-dealers, discussed below, is unavailable.

37 These statistics are from SIPC's 1999 Annual Report. Of course, this white paper is not suggesting that SIPC is a cure-all for the problems resulting from a broker-dealer's insolvency. In fact, there have been some criticisms against SIPC by commentators. There also have been suggestions on ways to improve SIPA (such as increasing the $500,000 limit) and the operation of SIPC to provide more protection to investors. *See, e.g.*, Note, *Investor Casualties in the War for Market Efficiency*, Adm. L. J. of Am. Univ. (Winter 1996).

38 In cases where the claims of all customers are less than $250,000, SIPC may pay claims directly to customers rather than bringing the case to bankruptcy court. SIPA Section 10. This "Direct Payment Procedure" is intended to avoid the relatively high cost of a court-supervised liquidation proceeding.

39 SIPA Section 8(f).

40 In practice today, most broker-dealer customer securities are held in "street" or nominee name for convenience, in which case the customer would not benefit from this priority protection for "customer name securities."

41 *How SIPC Protects You: Questions and Answers About SIPC*, Question Number 16. There could be delays in cases where the failed firm's records are not accurate or where fraudulent activities are involved.

42 SIPA Section 16(2).

43 For a general discussion of the back-office crisis see Seligman, The Transformation of Wall Street at 450-66.

44 *See generally* Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, Southern California Law Review (May 1999) (discussing the causes of failure in the broker-dealer industry). Concern that excessive financial risk associated with unregulated affiliates of a broker-dealer could cause the broker-dealer to become insolvent ultimately led the SEC to adopt what are commonly known as "risk assessment rules" in 1992. Exchange Act Rules 17h-1T and 17b-2T. Because the SEC does not directly regulate these affiliates, they are not subject to the financial responsibility requirements of the NCR. Under the risk assessment rules, a broker-dealer is required to maintain risk assessment information with respect to those affiliates whose business activities are reasonably likely to have a material impact on the financial and operational condition of the broker-dealer (*e.g.*, unregistered affiliates that engage in derivatives trading). A firm also is required to file such information with the SEC on a quarterly basis on Form 17-H. The required information includes the financial data necessary to assess the risks to a broker-dealer that may be caused by the activities of its material affiliates.

45 12 U.S.C. §21.

46 Melanie L. Fein, Securities Activities of Banks (3d ed. 2001) §2.01[A] [hereafter cited as Fein §__]. The pervasive regulation of national banks was described as follows by a U.S. court of appeals:

"National banks are perhaps as meticulously regulated as any industry. Every aspect of their affairs is scrutinized to assure financial soundness and ethical practice. The Comptroller's statutory duties require the closest monitoring and continuous supervision of these institutions."

Independent Bankers Association v. Heimann, 613 F.2d 1164, 1168 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 823 (1980) (footnotes omitted).

47 Fein §2.01[B].

48 12 U.S.C. §§1811 et seq.

49 Robert M. Taylor, III, Banking Law (2000) §42.02 [hereafter cited as Taylor §____].

50 FDIC, Statistics on Banking for Third Quarter 2000 (available on FDIC website – <www.fdic.gov>).

51 Fein §2.01[C].

52 *See, e.g.*, the Illinois Banking Act, 205 ILCS 5/5(11).

53 FDIC Division of Supervision, Manual of Examination Policies, The Uniform Financial Institutions Rating System.

54 Fein §2.02[F][1].

55 Pub. L. No. 101-73 (1989).

56 Pub. L. No. 102-242 (1991).

57 Fein §2.02[E][5].

58 Fein §2.02[F][1].

59 MCorp Financial v. Board of Governors, 900 F.2d 852, 863 (5th Cir. 1990), *quoting* Gulf Federal Savings & Loan Association v. Federal Home Loan Bank Board, 651 F.2d 259, 264 (5th Cir. 1981).

60 12 U.S.C. §1831p-1.

61 Interagency Guidelines Establishing Standards for Safety and Soundness, published at 12 CFR Part 30, Appendix A.

62 12 CFR §§30.3-30.6.

63 Comptroller of the Currency, Comptroller's Handbook for Asset Management (2000).

64 Restatement (Second) Agency §13 (1957). The OCC defines the term "fiduciary capacity" differently depending on the context. For example, it distinguishes between a bank that receives a fee for providing investment advice and a bank that simply provides non-discretionary custodial activities. In the latter case, the OCC believes that the bank should not incur any fiduciary liability for any incidental investment advice it may offer, and therefore the OCC does not regard such activities as "fiduciary" in nature. See OCC Release revising its rules governing the fiduciary activities of national banks, 61 Fed. Reg. 68543, 68545 (1996).

65 12 U.S.C. §92a(a).

66 Comptroller of the Currency, Comptroller's Handbook for Fiduciary Activities (1998) [hereafter cited as Comptroller's Fiduciary Handbook].

67 12 U.S.C. §92a(c).

68 Comptroller's Fiduciary Handbook.

69 *Id*.

70 During their annual examinations of large banks, OCC examiners will make assessments of the bank's risk profile for each of the nine categories of risks. This includes an evaluation of the bank's risk management systems for dealing with these risks. Every risk management system must perform the following functions:

- It must properly identify risks by recognizing and understanding existing risks and risks that may arise from new business initiatives.
- It must measure risks in a timely and accurate manner.
- It must establish and communicate limits and controls through policies, standards and procedures that define responsibility and authority.
- It must monitor risk levels to ensure timely review of risk positions and any exceptions.
- If an examination reveals unacceptable risk levels or deficiencies in a bank's risk management systems, the bank must prepare action plans (with deadlines) to resolve each significant deficiency. The examiners will verify that the bank is executing the plans and evaluate whether the actions being taken adequately address the deficiencies.

Comptroller of the Currency, Comptroller's Handbook for Bank Supervision and Examination Process, Large Bank Supervision Booklet (1998).

71 FDIC, Historical Statistics on Banking, Bank and Thrift Failure Reports (available at www.fdic.gov).

72 12 U.S.C. §191.

73 12 U.S.C. §1821(c)(5).

74 12 U.S.C. §1821(c)(2).

75 12 U.S.C. §1821(c)(3) and (6).

76 Taylor §36.05.

77 12 U.S.C. §1823(c)(4).

78 FDIC, Historical Statistics on Banking, Bank and Thrift Failure Reports (available at www.fdic.gov).

79 Taylor §49.02.

80 11 Am. Jur. 2d §1154.

81 *See* Hibernia National Bank v. FDIC, 733 F.2d 1403 (10th Cir. 1984); American Legion Post No. 90 v. First National Bank and Trust Co., 113 F.2d 868 (2nd Cir. 1940); Office of Thrift Supervision Letter OTS-OGC CS 9/92, Trust Assets in Conservatorship, Receivership, or Insolvency (September 23, 1992).

82 12 C.F.R. §9.16.

83 12 U.S.C. §1821(d)(2)(G).

84 Joseph J. Norton and Sherry C. Whitley, Banking Law Manual (1994) §11.02.

85 FDIC, The Financial Institution Employee's Guide to Deposit Insurance (1999) at 11, 41 [hereafter cited as FDIC Guide].

86 12 U.S.C. §1811 *et seq*.

87 12 U.S.C. §1821(d)(3)(B).

88 12 U.S.C. §1821(d)(5)(A).

89 12 U.S.C. §1821(d)(8).

90 12 U.S.C. §1821(d)(11)(A).

91 FDIC Guide at 3, 11.

92 Comptroller of the Currency, Comptroller's Handbook for Asset Management (2000).

93 Comptroller's Fiduciary Handbook.

94 *Id*.

95 FDIC Division of Supervision, Manual of Examination Policies, Fidelity and Other Indemnity Protection.

About MKT – Market Knowledge Tools™

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