

April 24, 2016

Mr. Brent J. Fields, Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: Covered Broker-Dealer Provisions under Title II of the Dodd-Frank  
Wall Street Reform and Consumer Protection Act—File No. S7-02-16

Dear Mr. Fields:

Thank you for the opportunity to comment on the proposed provisions regarding the orderly liquidation of covered broker-dealers. While we agree with the stated purposes of the proposed rule, we believe it presents two issues that delay or obstruct consumer access to property: 1) overly broad discretion for the covered broker-dealer and SIPC as trustee to allocate to customer accounts at the bridge broker-dealer (hereinafter the “bridge allocation provision”); and 2) prejudice against a customer’s liquidation claims when a customer’s allocation of customer property, combined with SIPC advances, are insufficient.

Regarding the first issue, the bridge allocation provision of the proposed rule provides an allocative power to the SIPC as trustee that is a) overly vague and broad; b) not well supported by *In Re Lehman Brothers* as cited; and c) does not resolve the problems in delays to customer account access. We believe limiting this allocative power to only when the liquidated party acts in bad faith would better serve the stated purposes of the proposed rule.

Regarding the second issue, there are two possible scenarios that prejudice a customer’s liquidation claims under the proposed rule relative to that customer’s distribution under SIPA: a) when SIPC recovers customer advances from the general estate; and b) when administrative expenses exceed those that would have been incurred by the trustee under SIPA. To remedy this, we suggest modifying the proposed regulation to explicitly place customer deficiency claims above both the receiver’s administrative expenses and any rights of recovery SIPC acquires pursuant to customer advances.

### **1. Overly Broad Discretion in the Bridge Allocation Provision**

We are concerned about the provision of the proposed rule that allows that “allocations to customer accounts at the bridge broker-dealer may initially be derived from estimates based upon the books and records of the covered broker-dealer or other information deemed relevant by the Corporation as receiver, in consultation with the SIPC as trustee,” before the reconciliation has been finalized.<sup>1</sup> This bridge allocation

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<sup>1</sup>Covered Broker-Dealer Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 81 Fed. Reg. 41 (proposed Mar. 2, 2016), at 26.

provision is intended to “accelerate customers’ access to their accounts,”<sup>2</sup> but the proposed rule provides little insight into why such an allocative power is necessary. Further, the provision itself is too broad and provides few, if any, meaningful limitations on the trustee’s discretion to make pre-reconciliation allocations. Instead, we believe that the rule would better serve its stated purposes by allowing pre-reconciliation distributions only where the liquidated party acts in bad faith to impede the liquidation proceedings.

*a. The proposed regulation is too vague, providing no guidance for or limitation on the trustee’s discretionary power to make “conservative” pre-reconciliation allocations.*

As written, the bridge allocation provision provides few meaningful limitations on the manner in which such allocations are made. The SEC and the FDIC “preliminarily believe that initial allocations will be made conservatively, which with the backstop of the availability of SIPA advances to customers in accordance with the requirements of SIPA, should minimize the possibility of an over-allocation to any customer.”<sup>3</sup> This requirement, however, is not written into the provision, providing little recourse for a customer involved in a proceeding in which such allocations were not made “conservatively.” Moreover, neither the provision nor the reasoning elucidate what, precisely, a “conservative” allocation strategy would be. This adds considerable uncertainty to the regulation and provides the trustee with license to make allocations that may not be accurate or warranted. The rule should, at the very least, codify the “conservative allocation” requirement and provide a more meaningful definition of a “conservative” allocation strategy.

*b. The Agencies’ primary support for the estimated allocation provision – In re Lehman Brothers – does not indicate that the bridge allocation provision is necessary or useful, and in fact provides evidence that allocations should generally not be made until reconciliation is finalized.*

The SEC and the FDIC note that this provision is “based upon experience with SIPA liquidations where, for example, there were difficulties reconciling the broker-dealer’s records with the records of central counterparties or other counterparties or other factors that caused delay in verifying customer accounts.”<sup>4</sup> The only proffered example, however, is the “Trustee’s Preliminary Investigation Report and Recommendations” (hereinafter “Trustee Report”) from *In re Lehman Brothers*.<sup>5</sup> Upon examination, the facts in the *In re Lehman Brothers* Trustee Report do not bear out any evidence that the allocative process is itself in need of a change; instead, the facts suggest that the bridge period can be marked by a lack of complete and accurate information, which in turn would caution against the rule’s allowance of pre-reconciliation allocations. Moreover, the Trustee Report suggests that pre-reconciliation allocations may be warranted only where the liquidated party acts in bad faith to impede the proceedings, which would be a better standard for the SEC’s rule.

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<sup>2</sup> *Id.* at 59.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 26.

<sup>5</sup> Case No. 08-01420 (JMP) SIPA (Bankr. S.D.N.Y. 2008); *see* 81 Fed. Reg. 41 at 26.

The *In re Lehman Brothers* Trustee Report offers substantial evidence that the pre-reconciliation period is often not amenable to making allocations, because accurate and complete information regarding the relevant accounts is simply not yet available. The Trustee Report makes it clear that informational shortfalls were central to the delays in the allocative process: “The Trustee had no independent access to records or personnel and was provided only rough, high-level estimates both about assets that had already been divided up among other parties and about what was left behind at the broker.”<sup>6</sup> Accordingly, we are concerned that the proposed rule would allow pre-reconciliation allocations to be made based on inaccurate or incomplete information, as the Trustee Report indicates that accurate allocations would not have been possible at this stage.

According to the Trustee Report, the informational shortfalls in the pre-reconciliation process were neither marginal nor easy to overcome. These shortfalls included lack of access to the insolvent parties’ bank accounts<sup>7</sup>; lack of information regarding the location and nature of certain assets<sup>8</sup>; lack of full and immediate access to records and computer screens and systems normally available to a broker-dealer<sup>9</sup>; lack of medallion authority (on the part of the Trustee) for transferring physical securities<sup>10</sup>; “shutdown of account access screens by clearing banks and other organizations, lack of access to records, frozen overseas accounts, the functioning of the DTCC system, . . . lack of clarity in the purchase agreement, and simple human confusion as employment relationships and job functions changed.”<sup>11</sup> Additionally, uncooperative counterparties were another significant source of delay. As the Trustee Report details, “over 5,000 hours of accounting professional time and a substantial amount of legal as well as administrative staff time had to be expended in locating and researching amounts potentially owed by counterparties, contacting those counterparties, convincing them to share necessary information, and negotiating with them to cause them to pay amounts that they, themselves, sometimes recognized they owed to the estate.”<sup>12</sup> These issues plainly impair the Trustee’s ability to make accurate allocation estimates during the pre-reconciliation period, and the rule does not provide enough guidance or limitation to ensure that allocations are not made based on inaccurate or incomplete information.

At no point does the Trustee indicate that the process would have been improved had they been able to make allocations prior to final reconciliation. In fact, the informational shortcomings of the process make it clear that allocations could not have been made accurately or efficiently until the full accounting and reconciliation had been

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<sup>6</sup> Trustee’s Preliminary Investigation Report and Recommendations, at ¶ 195, *available at* [http://som.yale.edu/sites/default/files/files/Giddens\\_James\\_W\\_Investigative\\_Report\\_and\\_Recommendations\\_8-25-10.pdf](http://som.yale.edu/sites/default/files/files/Giddens_James_W_Investigative_Report_and_Recommendations_8-25-10.pdf).

<sup>7</sup> *Id.* at ¶ 190.

<sup>8</sup> *Id.* at ¶ 133.

<sup>9</sup> *Id.* at ¶ 198.

<sup>10</sup> *Id.* at ¶ 190.

<sup>11</sup> *Id.* at ¶ 196.

<sup>12</sup> *Id.* at ¶ 293.

completed.<sup>13</sup> Given that the SEC provides only this report from *In re Lehman Brothers* to justify the inclusion of the pre-reconciliation allocation process in the rule, we believe that the bridge allocation provision should comport with the Trustee Report's actual recommendations and that the rule should generally disallow bridge allocations based only on estimates.

The only instance in which the Trustee Report can be interpreted to support bridge allocations is its discussion of bad-faith actions by the liquidated entity. The report notes "the Trustee has been regularly disappointed in the performance and attitudes of many entities with which he has had to interact or which hold LBI property or information."<sup>14</sup> The primary problems were that "parties have seemed all too willing to take extreme positions in order to claim a right to what was intended to be customer property, to claim customer status for themselves for ordinary financial or intercompany transactions, or to withhold property clearly belonging to the LBI estate until the last possible moment under threats of litigation."<sup>15</sup>

We believe that this is the primary target of the bridge allocation provision, and we would support a refinement of the rule to state that bridge allocations are proper where the liquidated party acts in bad faith to impede the reconciliation process and allocation proceedings. This would ensure that parties are not denied their property due to simple intransigence or bad faith by the liquidated party while still ensuring that the trustee may not make bridge allocations based on inaccurate or incomplete information.

*c. The bridge allocation provision does not resolve the true problems behind delays in consumer account access and may actually exacerbate them.*

The very problem that this provision attempts to resolve – the fact that certain allocations are uncertain and require additional adjudication to resolve – cautions against the proposed rule's approach: Insofar as the specified allocations are not straightforward and require additional information and proceedings to resolve, the proposed rule should not allow trustees to make determinations and shift resources without the confidence that those determinations are final. Shifting resources among parties with the knowledge that further shifting may be needed as the proceeding progresses is irresponsible and inefficient.

Notably, the rule proposal states that "this approach is based upon experience with SIPA liquidations where, for example, there were difficulties reconciling the broker-dealer's records with the records of central counterparties or other counterparties or other factors that caused delay in verifying customer accounts."<sup>16</sup> This experience indicates that the estimates upon which the trustee would make initial allocations are both contingent and contested. Where interested parties cannot agree on the correct allocation

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<sup>13</sup> The Trustee indicates that the process could have been improved only by "advance planning and analysis as well as *more time*." *Id.* at ¶ 197 (emphasis added).

<sup>14</sup> *Id.* at ¶ 14.

<sup>15</sup> *Id.*

<sup>16</sup> 81 Fed. Reg. 41 at 26.

strategy, an allowance to make allocations based only on estimated account values is misguided and likely to yield unnecessary errors.<sup>17</sup>

The SEC acknowledges these errors, stating that “[t]o the extent that initial estimates are excessive, it is possible that customer funds may need to be reallocated after customers initially gain access to their accounts, which could result in costs for customers.”<sup>18</sup> The SEC discounts this possibility for two reasons: first, it believes that the “conservative” allocation suggestion “would minimize the possibility of an over-allocation to any customer and mitigate potential costs and uncertainty associated with allocation refinements”<sup>19</sup>; and second, “[w]e currently lack data concerning the impact or costs that might be associated with this possibility.”<sup>20</sup> Both of these answers are unsatisfying justifications for the rule. The “conservative” allocation suggestion, as stated above, fails both because it is too vague and is not codified in the rule itself.<sup>21</sup> The lack of data is equally unconvincing: the notion that the rule should implement this change without fully understanding its potential costs to customers – the very parties whom the bridge allocation provision is intended to benefit – is irresponsible. Moreover, as noted in the discussion of *In re Lehman Brothers*, the SEC also lacks data that customers’ account access delays actually constitute an actionable problem.<sup>22</sup> If, as the facts in *In re Lehman Brothers* suggest, delays are largely caused by informational shortfalls that could be solved only by more time and further proceedings, then the bridge allocation provision is merely a solution in want of a problem, creating uncertainty without any added benefit to consumers.

Again, our recommendation is that the proposed rule should be changed to allow the trustee to make pre-reconciliation allocations only where the liquidated entity acts in bad faith to impede the reconciliation process. This approach, which is based on the experiences of trustees in such proceedings,<sup>23</sup> would best balance customers’ need for quicker assets to their property with all parties’ interests in ensuring that all allocations are accurate and final.

## **2. Prejudicial Scenarios for Customer Liquidation Claims**

There are at least two possible scenarios in which customers of broker-dealers liquidated under the proposed Title II regulations would be worse off than under a liquidation under the provisions of the Securities Investor Protection Act, 15 U.S.C. §§

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<sup>17</sup> It may be that the SEC intends its “conservative allocation” suggestion to mean that contested estimates are not distributable. As noted above, however, this is neither clear nor codified in the rule. *See supra* note 3 and accompanying text.

<sup>18</sup> 81 Fed. Reg. 41 at 59.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *See supra* note 3 and accompanying text.

<sup>22</sup> *See supra* notes 6-13 and accompanying text.

<sup>23</sup> *Id.*

78aaa et seq.<sup>24</sup> Each circumstance arises where the customer's allocation of customer property, combined with SIPC advances made to that customer pursuant to 15 U.S.C. § 78fff-3(a), are insufficient to clear the customer's net equity claim. In such a situation, the remainder of the customer net equity claim becomes a general unsecured claim against the covered broker dealer's estate.<sup>25</sup> Under such a circumstance, two scenarios could prejudice a customer relative to that customer's distribution under SIPA.

*a. Scenario 1: SIPC recovers customer advances from the general estate*

The first scenario arises whenever a customer's net equity claim is not fully satisfied by the allocation of customer property and the SIPC advance. Under the proposed regulations, this residual claim, which becomes a general unsecured claim against the covered broker-dealer's estate, is only satisfied *after* the SIPC is repaid for its advances to customers.<sup>26</sup> This is in contrast to the distributional priority under SIPA, under which SIPC receives limited subrogation rights against customer property in exchange for the advance.<sup>27</sup> SIPA therefore does not allow SIPC to recover its advance before a customer with a residual net equity claim is made whole. While, under SIPA, SIPC may also have a claim against the bankruptcy estate pursuant to the subrogation right, allowing this SIPC claim to prime that of the customer would undermine the distributional scheme outlined in SIPA.<sup>28</sup>

*b. Scenario 2: Administrative expenses exceed those that would have been incurred by the trustee under SIPA*

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<sup>24</sup> This section responds to the first question posted by the Agencies; specifically: "are there any circumstances in which the application of the proposed rule would result in delivery or distributions to customers . . . in an amount less than such customers would receive if the covered broker-dealer were subject to a SIPA liquidation?" Release at \*40.

<sup>25</sup> 15 U.S.C. § 78fff-2(c)(1) ("To the extent customer property and SIPC advances . . . are not sufficient to pay or otherwise satisfy in full the net equity claims of customers, such customers shall be entitled, to the extent only of their respective unsatisfied net equities, to participate in the general estate as unsecured creditors.").

<sup>26</sup> 17 CFR 302.105(c) (placing "[a]mounts advanced by SIPC for the purpose of satisfying customer claims for net equity" above general unsecured claims in the priority scheme); 12 CFR § 380.21.

<sup>27</sup> 15 U.S.C. § 78fff-3(a) ("To the extent moneys are advanced by SIPC to the trustee to pay or otherwise satisfy the claims of customers . . . SIPC shall be subrogated to the claims of such customers with the rights and priorities provided in this chapter. . . ."); *In re Bernard L. Madoff Inv. Securities LLC*, 721 F.3d 54, 74 (2d Cir. 2013) ("SIPA thus allows only a narrow right of subrogation—for SIPC to assert claims *against the fund of customer property* and thereby recoup any funds advanced to customers once the SIPA trustee has satisfied those customers' net equity claims." (emphasis added)).

<sup>28</sup> *In re Picard v. HSBC Bank Plc*, 454 B.R. 25, 33-4 (S.D.N.Y. 2011) ("Under this priority scheme, SIPC cannot recover as subrogee until the customers are made whole."); *see also Lopez v. Zaremba*, No. 3:08CV01132, 2009 WL 36617 at \*4 (N.D. Ohio Jan. 5, 2009) ("First, SIPC may assert its claim against the fund of customer property, and second, SIPC may assert its claim against the general estate as an unsecured creditor (along with customers not made whole by SIPC advances and distributions from the fund of customer property).").

The second scenario arises where the administrative costs incurred by the trustee and the receiver operating under their Title II authority exceed the administrative costs that would have been incurred by the trustee in a SIPA liquidation. In a straightforward SIPA liquidation, the residual claim of a customer whose net equity is not fully cleared by the allocation of customer property and the SIPC advance is treated as a general unsecured claim in a Chapter 7 proceeding under the Bankruptcy Code.<sup>29</sup> These residual claims have lower priority than administrative expenses claimed by the trustee.<sup>30</sup> In contrast, under the proposed regulations, the residual general unsecured claim has lower priority than both the expenses the SIPC incurs acting as trustee *and* the expenses of the FDIC acting as receiver.<sup>31</sup>

To the extent that the administrative costs of the trustee and receiver under Title II exceed the costs of the trustee under a SIPA proceeding, the customer will be worse off. The expenses of the receiver under Title II could conceivably exceed those of a trustee in Chapter 7 bankruptcy. The most important duty of the trustee in bankruptcy is “to close [the] estate as expeditiously as is compatible with the best interests of parties in interest.”<sup>32</sup> In contrast, the receiver’s primary goal under Title II is to mitigate systemic financial risk.<sup>33</sup> Where the receiver prolongs the period of receivership, assumes liabilities, or incurs other marginal expenses pursuant to this mandate, the customer will realize less of her residual general unsecured claim, which will come after such expenses in the liquidation of the general estate.

We suggest modifying the proposed regulation to explicitly place customer deficiency claims above both the receiver’s administrative expenses and any rights of recovery SIPC acquires pursuant to customer advances. Although Dodd-Frank §§ 205(g)(2) and 210(b), operating together, would otherwise place residual customer claims below the receiver’s expenses in distributional priority, the mandate to keep customers in at least the position they would be under SIPA should be observed “[n]otwithstanding any other provision” of Title II.

To conclude, we believe our recommendations will enhance the stated purposes of the rule without sacrificing consumer access to property. Thank you again for the opportunity to comment and we hope that the Commission will consider our recommendations.

Sincerely,

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<sup>29</sup> 15 U.S.C. 78fff(b).

<sup>30</sup> 11 U.S.C. §§ 507(a)(2), 726(a); 15 U.S.C § 78fff(e).

<sup>31</sup> 12 CFR § 380.21(a)(2); 17 CFR § 302.105(a).

<sup>32</sup> 11 U.S.C. § 704(a)(1); *In re Hutchinson*, 5 F.3d 750, 753-4 (4th Cir. 1993) (“[T]he duty to close the estate expeditiously is the trustee’s main duty . . . and overriding responsibility. (internal citations and quotation marks omitted)).

<sup>33</sup> Dodd-Frank § 204(a).

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<sup>34</sup> This comment does not purport to express the views of Yale Law School, if any.