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Allan Gates

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The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection

I. INTRODUCTION

It has long been a matter of common knowledge that securities[1] investment involves an element of financial risk. In addition to the obvious hazards of injudicious investment, such as market decline and failure of the corporate venture, there is an appreciable risk of financial loss to the investor due to the potential insolvency of his broker-dealer.[2] Until recently it had been the policy of the federal government to restrict its protection against this latter risk to measures designed to prevent broker-dealer insolvencies and, when an insolvency did occur, to an ordering of the priorities of customer claims in bankruptcy. In the last session of the 91st Congress, however, a dramatic departure was taken from this traditional federal policy. Disturbed by the financial distress in the securities industry and dissatisfied with the traditional scheme of federal protection, Congress enacted the Securities Investor Protection Act of 1970[3] to insure investors against loss due to broker-dealer insolvency. The purpose of this Note is to present a general overview of this new remedial role of the federal government in the field of investor protection. Specifically, the Note will examine the risks that precipitated the legislation, the prior regulatory efforts to alleviate these risks, and the scope and significance of the 1970 Act.

II. THE SOURCE OF THE RISK

The dangers to the securities investor posed by broker-dealer insolvency arise out of the custodial functions involved in the broker-dealer's business. There are three basic categories of assets in which the

1. The term "securities" is difficult to define in an all-inclusive manner. *See, e.g.*, UNIFORM SECURITIES ACT § 401(1). For the purpose of general discussion in this Note, however, "securities" will be used in its normal sense to mean negotiable stocks and bonds issued by a corporation as evidence of corporate ownership or indebtedness. *See* P. WYCKOFF, DICTIONARY OF STOCK MARKET TERMS 234 (1964).

2. The term "broker-dealer" is used in this Note to refer to anyone in the business of purchasing or selling securities. It should be noted, however, that this term ignores the technical distinction between the functions of a securities broker and a securities dealer. A securities broker is "[o]ne who acts as an agent . . . between the buyers and sellers of securities . . . and charges a commission for his services." P. WYCKOFF, *supra* note 1, at 38. In contrast, a dealer is one "who deals in securities as a principal. . . . A dealer buys from, or sells to, a client . . . whereas a broker buys and sells for the account of a client . . . ." *Id.* at 77-78. Whenever the discussion of this Note is applicable only to brokers or to dealers, the separate terms will be used.

3. Pub. L. No. 91-598, 84 Stat. 1636.

customer has a property interest,[4] but which are in the possession of his broker-dealer: (1) free credit balances; (2) fully paid securities; and (3) securities in margin accounts.[5] The possession of a customer's property by a broker-dealer exposes the customer to the risk that he may not be able to retrieve his property if the broker-dealer fails. Moreover, even though an investor might eventually be able to retrieve his property *in toto* from an insolvent broker-dealer, he may still suffer financial loss due to a prolonged freezing of his account in an adverse market. The extent of these risks and the investor's ability to avoid them vary according to the nature of the property that is left in the broker-dealer's possession. For this reason a brief discussion of the three categories of customer assets in broker-dealer custody is necessary.

A. Free Credit Balances

Free credit balances are the amounts of cash, as distinguished from securities, held by a broker-dealer for his customers but against which the broker-dealer has no claim.[6] Typically, free credit balances may arise in any of four situations. First, the customer may have deposited cash with his broker-dealer in anticipation of making a purchase.[7] Secondly, the broker-dealer may have retained the cash proceeds from the sale of a customer's securities, either on express instructions from the customer or because the customer has failed to give instructions for the disposition of the proceeds.[8] Thirdly, the broker-dealer may have retained interest or dividends that have been paid on a customer's securities that the broker-

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4. This discussion of customers' assets follows the terminology used in SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 1, at 393 (1963) [hereinafter cited as SEC SPECIAL STUDY].

5. Technically, there is a fourth type of customer asset in the possession of broker-dealers—cash equities against which the broker-dealer has a claim. As a practical matter, however, these cash equities can be considered as payments to the broker-dealer on a debit balance owed. Although these equities have not been used to reduce the customer's debt on the broker-dealer's books, they can be withdrawn only after the customer has deposited their equivalent in more cash or securities. For a discussion of this category of customer "assets" see SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 397.

6. *See* 2 L. LOSS, SECURITIES REGULATION 1185 (1961).

7. Normally, a cash purchase is executed immediately, and no free credit balance would arise. It is not uncommon, however, for a customer to deposit funds with a broker-dealer for a purchase, with instructions to buy at a certain price or with advice that instructions will follow.

8. It is the customary practice of most broker-dealers to seek express instructions from a customer concerning the disposition of the proceeds of a sale of the customer's securities. SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 396. In the absence of instructions, practices vary widely concerning whether the proceeds are remitted immediately to the customer or retained pending request. For a statistical sampling of these practices see *id.* at 396, table III-e.

dealer holds in street name.[9] Finally, a margin[10] customer may have deposited cash with a broker-dealer in excess of margin requirements.[11] Although the amount of free credit balances held by any single broker-dealer will vary with the nature of his business, the aggregate amount owed the investing public on these balances is quite large. On the New York Stock Exchange alone, the free credit balances held by member firms currently total some three billion dollars.[12]

On the whole, free credit balances are highly desirable from the standpoint of the broker-dealer. Most broker-dealers pay no interest on the balances, and even those who do usually pay it at a low rate and only to large customers.[13] Moreover, it is a generally accepted practice for broker-dealers to use free credit balances in transactions for their own accounts.[14] Although there may be some technical questions concerning the legality of this procedure,[15] as a practical matter it has been justified

9. Securities that are in "street name" are securities whose title is in the name of a recognized broker-dealer. These securities are freely negotiable by delivery, and those held by one broker-dealer in "street name" may actually be registered in the name of another broker-dealer. The purpose of using a street name is, of course, to facilitate the handling of securities. *See id.* at 446, app. III-D. When a corporation pays interest or dividends on the securities it has issued, the amount paid on street name securities goes to the broker-dealer in whose name the securities are registered. When the broker-dealer receives interest or dividends on a customer's street name securities, he may hold the funds as a free credit balance, either on his own initiative or in accordance with the customer's instructions. As in the case of cash proceeds from sales discussed in note 8 *supra*, most broker-dealers request instructions from customers on the disposition of interest and dividends; in the absence of instructions, practices vary concerning whether the funds are remitted to the customer or retained pending instructions. *Id.* at 396-97 & table III-f.

10. The word "margin" is used to describe various aspects of credit transactions in securities. Thus, a "margin customer" is one who buys or sells securities on credit. These transactions on credit are conducted in a "margin account." "Margin" also is used to refer to the amount of collateral required in a margin account to secure the credit that has been extended to the customer. In common parlance, a margin account that is adequately collateralized is said to be adequately "margined."

11. For a discussion of the regulation of credit in margin transactions see notes 74-84 *infra* and accompanying text.

12. *Hearings on H.R. 13308, H.R. 17585, H.R. 18081, H.R. 18109, & H.R. 18458 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce*, 91st Cong., 2d Sess. 150 (1970).

13. In a sampling of New York Stock Exchange members, the SEC found that less than one-third of the firms paid interest, and they paid it only on balances over a minimum size that varied from $1,000 to $10,000. The interest rate varied from a low of 1% to a high of only 4%. SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 395. The study also revealed that a far lower percentage of broker-dealers outside the New York Stock Exchange pay interest on free credit balances, but this may be partly explained by the fact that many firms hold very little in the way of free credit balances. *See id.* at 394-95.

14. 2 L. LOSS, *supra* note 6, at 1185; SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 395-96.

15. *See* Mintzner v. Arthur L. Wright & Co., 263 F.2d 823, 826 (3d Cir. 1959); *In re* Shapiro Bros., 298 F. 196 (S.D.N.Y. 1923); C. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES § 40 (1931, Supp. 1936); RESTATEMENT (SECOND) OF TRUSTS § 12, comment *g* (1959);

on the theory that a broker-dealer is merely the customer's debtor and not a trustee for the free credit balances.[16] Thus, an investor who maintains free credit balances is potentially in an extremely vulnerable position.[17]

It has long been recognized that the risk to the investor attending the broker-dealer's possession of free credit balances can be effectively reduced by requiring a physical segregation of all or part of the balances.[18] In 1941 the SEC proposed that it be given the authority to require by rule the total segregation of customers' free credit balances.[19] This proposal was vigorously opposed by the securities industry, however, and was never adopted.[20] In the Report of its Special Study on the Securities Markets in 1963, the Commission carefully avoided the issue of total segregation but urged that broker-dealers be required to segregate a portion of their free credit balances into a reserve fund.[21] In addition, the Special Study Report recommended that broker-dealers be required to inform each customer regularly of the following matters: (1) the amount of his particular free credit balance, (2) the fact that the balance might be used by the broker-dealer, and (3) the customer's unqualified right to withdraw immediately the full amount of his balance.[22] This three-prong recommendation was implemented in 1964 in substantially the same form as the Special Study Report had suggested.[23] Until the passage of the Securities Investor Protection Act,

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1 A. SCOTT, TRUSTS § 12.10 (3d ed. 1967); Note, *Federal Regulation of Over-the-Counter Brokers and Dealers in Securities*, 59 HARV. L. REV. 1237, 1272 (1946).

16. 2 L. LOSS, *supra* note 6, at 1185. In proposing the information requirements regarding free credit balances discussed at notes 22-23 *infra* and accompanying text, the SEC stated that: "Many customers of broker-dealers are not aware (1) that when they leave free credit balances . . . with a broker-dealer the funds generally are not segregated and held for the customer, but rather are commingled with the other assets of the broker-dealer and used in the operation of the business, and (2) that the relationship between the broker-dealer and the customer as a result thereof is that of creditor-debtor." SEC Securities Exchange Act Release No. 7266 (Mar. 11, 1964), *reprinted in* 29 Fed. Reg. 3477 (1964).

17. The position of the customer with free credit balances in the possession of his broker-dealer is especially vulnerable because of the confused requirements for specific identification of cash under bankruptcy. *See* note 124 *infra* and accompanying text.

18. For an early government proposal that customers' securities and funds be segregated into a central depository for all stock exchange members see Address of SEC Chairman William O. Douglas, before the Association of Stock Exchange Firms, May 20, 1938, in W. DOUGLAS, DEMOCRACY AND FINANCE 88-89 (1940).

19. SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 399-400.

20. *Id.* For a history of the halting federal efforts to regulate free credit balances see 2 L. LOSS, *supra* note 6, at 1188-89 & n.17; 5 *id.* at 3196-97 (Supp. 1969).

21. *See* SEC SPECIAL STUDY, supra note 4, pt. 5, at 61.

22. *Id.*

23. SEC Securities Exchange Act Release No. 7325 (May 27, 1964), *reprinted in* 29 Fed. Reg. 7239-40 (1964), *codified at* 17 C.F.R. § 240.15c3-2 (1970).

however, the recommendation of partial segregation had not been acted upon, and, with few exceptions, broker-dealers were under no obligation to segregate any portion of customer free credit balances.[24]

On balance, it should be noted that valid arguments can be made against both the feasibility and necessity of requiring total segregation of free credit balances.[25] Furthermore, in the past 35 years the securities industry has witnessed very few instances in which the potential for financial loss flowing from free credit balances has actually been realized.[26] Finally, it must be remembered that the investor can easily eliminate his risk of loss by simply withdrawing the cash owed him from the custody of his broker-dealer.

B. Fully Paid Securities

Fully paid securities are securities held by a broker-dealer in a customer account but against which the broker-dealer has no claim. Stated differently, fully paid securities are the non-cash counterpart of free credit balances. Generally speaking, there are three basic situations in which broker-dealers have possession of customers' fully paid securities: (1) when securities are merely being processed for delivery; (2) when securities deposited as collateral in a margin account exceed credit requirements;[27] and (3) when securities are simply being held for "safekeeping."[28]

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24. For a discussion of the impact of the Securities Investor Protection Act on SEC authority to regulate free credit balances see note 131 *infra.* Three states and Puerto Rico specifically require broker-dealers to segregate free credit balances, but these requirements are subject to broad exceptions. MINN. STAT. ANN. § 80-12 (1968), *supplemented by* Minn. Reg. 11.2, 2 BLUE SKY L. REP. ¶ 26,611 (members of the American, Midwest, and New York Stock Exchanges exempted); Colo. R. 2.44, 1 BLUE SKY L. REP. ¶ 9703, at 5606 ("compliance with the SEC rules and regulations governing use, commingling, and hypothecation of customers' securities and free credit balances shall be deemed compliance witb this provision"); Ohio Reg. COs-1-07(E), 2 BLUE SKY L. REP. ¶ 38,665 (applies only to broker-dealers who have failed to furnish adequate surety bond and whose net capital is less than $10,000 or 15% of his total indebtedness); Puerto Rico R. 12, 3 BLUE SKY L. REP. ¶ 41,812 (members of American, Midwest, and New York Stock Exchanges exempted). *See also* IOWA CODE ANN. § 502.13 (Supp. 1971) ("trust funds and items" placed with broker-dealer must be segregated), *supplemented by* Iowa Sec. Div. Order No. 3, 2 BLUE SKY L. REP. ¶ 18,634 ("items" include fully paid securities).

25. Recognizing the importance of free credit balances as an addition to broker-dealer income, the SEC has stated, "It is apparent . . . that rigidly denying broker-dealers the use of such balances would cause serious dislocation to a significant part of the securities industry." SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 401.

26. *See* note 102 *infra* and accompanying text.

27. For a discussion of the credit requirements for margin transactions see notes 74-84 *infra* and accompanying text.

28. The term "safekeeping" as used in the securities industry merely means that the broker-dealer is holding fully paid securities beyond the delivery date. The term is not used to connote a special degree of care. SEC SPECIAL STUDY, *supra* note 4, pt. I, at 446, app. III-D.

From the standpoint of the investor, there are distinct advantages in leaving fully paid securities with a broker-dealer. In the first place, the broker-dealer gratuitously[29] serves as a convenient and relatively safe repository for security certificates. Moreover, the fact that an investor leaves fully paid securities with his broker-dealer will facilitate future trading by eliminating the necessity of physically delivering the certificates to the broker-dealer before each subsequent transaction. From the standpoint of the broker-dealer, however, customer fully paid securities are not particularly desirable. It is generally recognized, for example, that fully paid securities may not be used by a broker-dealer in transactions for his own account.[30] In addition, while the retention of fully paid securities probably tends to promote customer loyalty in future transactions, it appears that this tendency alone would not justify the expense to the broker-dealer of providing a gratuitous safekeeping service if competing broker-dealers did not do so.[31]

The fact that broker-dealers are not free to use fully paid securities in transactions for their own accounts makes each customer's exposure to risk less extensive than it is with free credit balances. The individual customer may further mitigate his personal risk by either registering his securities in his own name,[32] requiring the broker-dealer to segregate his securities, or simply withdrawing his security certificates. Nevertheless, the total potential loss on all fully paid securities in broker-dealer custody greatly exceeds that involved in free credit balances. For example, while the entire New York Stock Exchange membership now holds some three billion dollars in free credit balances, the aggregate value of customers' fully paid securities held by a single Big Board member currently approximates eighteen billion dollars.[33]

As is the case with free credit balances, physical segregation of fully

29. Broker-dealers generally do not charge customers for the service of holding their fully paid securities. *Id.* at 398.

30. 1 W. BLACK, THE LAW OF STOCK EXCHANGES, STOCKBROKERS & CUSTOMERS § 531 (1940). Securities are generally considered to be fungible, and broker-dealers are therefore not required to keep specific security certificates in safekeeping for a customer. All that is required is that a broker-dealer keep in his possession an amount of securities of the same series and issue as those left with him by his customers.

31. *See* SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 398 & n.343.

32. This remedy may be impractical in some cases because of the lengthy delays frequently involved in obtaining registration. Moreover, broker-dealers frequently request powers of indorsement from customers carrying fully paid securities in their own names. *Id.* at 446, app. III-D.

33. *Hearings, supra* note 12, at 150. The total value of fully paid securities in broker-dealer possession is commonly estimated to be approximately $50 billion. *See* S. REP. No. 91-1218, 91st Cong., 2d Sess. 2 (1970).

paid securities can effectively reduce the customer's risk of loss.[34] Unlike the situation with free credit balances, however, significant progress has been made in effecting a segregation. For many years the rules of the principal stock exchanges have required member firms to segregate their customers' fully paid securities.[35] Similar requirements are imposed upon members of the National Association of Securities Dealers by NASD rules.[36] There can be little doubt that the firms governed by these rules hold the overwhelming majority of all fully paid securities in broker-dealer possession in the United States. Broker-dealers not covered by an exchange or association rule, however, are generally under no obligation to segregate their customers' fully paid securities.[37] Prior to 1970, the Securities and Exchange Commission had made several efforts to obtain the authority to establish a uniform minimum segregation requirement for all broker-dealers holding fully paid securities.[38] It was not until the passage of the Securities Investor Protection Act, however, that these efforts achieved fruition.[39]

C. Securities in Margin Accounts

A margin account is one in which securities are purchased or sold on credit.[40] As used in this Note, the phrase "customer securities in margin accounts" refers to those securities that arise out of a margin transaction and in which the customer has a property interest that is subject to the claims of his broker-dealer.[41] These customer securities in margin accounts may either have been purchased in the margin transaction or pledged to the broker-dealer as collateral for the credit

34. *See* note 18 *supra* and accompanying text.

35. *E.g.*, N.Y.S.E. Rules 402.10-.90, 2 CCH N.Y.S.E. GUIDE ¶¶ 2402.10-.90; *see* SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 403-04 & nn.366-67 (segregation rules of the Boston, National, Pacific Coast, and Pittsburgh Stock Exchanges). Segregation of excess margin securities is generally not required until the market value of the securities exceeds a certain percentage of the customer's aggregate indebtedness in the account. *E.g.*, N.Y.S.E. Rule 402.80, 2 CCH N.Y.S.E. GUIDE ¶ 2402.80 (140%).

36. N.A.S.D. Rules of Fair Practice art. III, § 19(d); CCH N.A.S.D. MANUAL ¶ 2169(d).

37. A few states do require segregation of customers' fully paid securities. Many of these segregation requirements, however, are subject to broad exceptions. In addition to the material cited in note 24 *supra*, see IOWA CODE ANN. § 502.13 (Supp. 1971), *supplemented by* Iowa Sec. Div. Order No. 3, 2 BLUE SKY L. REP. ¶ 18,634; Mich. R. 604.2(g), 2 BLUE SKY L. REP. ¶ 25,618, at 21,505; Puerto Rico R. 11, 3 BLUE SKY L. REP. ¶ 41,811.

38. *See* 2 L. Loss, *supra* note 6, at 1188 n.17; SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 402.

39. For a discussion of the impact of the Securities Investor Protection Act on SEC authority to regulate fully paid securities see note 131 *infra*.

40. For a discussion of the uses of the term "margin" see note 10 *supra*.

41. For a discussion of the broker-dealer's lien see C. MEYER, *supra* note 15, § 65.

extended in the transaction. The property interest of an investor in securities in a margin account is clearly distinguishable from the interest of a customer with free credit balances or fully paid securities in the hands of a broker-dealer; the margin customer's securities are subject to a general lien of the broker-dealer to the extent of the debit balance owed on the account by the customer.[42] Nevertheless, a margin customer has a definite property interest in the securities in his account, and this interest is exposed to a number of risks that accompany the possibility of broker-dealer insolvency. Financial failure of a broker-dealer, for example, might well mean that his margin customers will be unable to retrieve the securities they have pledged as collateral in a margin transaction. Moreover, when the margin transaction has been a purchase, the insolvent broker-dealer may be unable to deliver the securities purchased even though payment in full is tendered.[43] Finally, when the margin transaction has been a sale, broker-dealer insolvency may force a liquidation of the short position[44] at a time when it is economically undesirable to do so.

The risks of financial loss to the investor with securities in a margin account are complicated by the rights accruing to the broker-dealer by virtue of his lien on the securities. First, the broker-dealer may retain all customer securities in a margin account until his lien has been satisfied.[45] Secondly, the broker-dealer can insist that these securities be carried in street name rather than registered in the name of the customer.[46] Thirdly, the broker-dealer has, as a matter of law, the right to hypothecate a customer's securities in a margin account to the extent of the debit balance owed by the customer on the account.[47] In addition to the

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42. *Id.*

43. Generally a customer has a right to delivery of margin securities upon tender of payment. This right is cut off at the institution of a bankruptcy proceeding, however, and the margin customer only has a claim in the amount of his equity against the single and separate fund. *See* notes 118-19 *infra* and accompanying text.

44. A sale of securities on credit is commonly known as a "short sale." In a short sale the customer executes a sell order for securities that he does not own. The broker-dealer secures the purchase of the securities being sold short and delivers to the buyer securities obtained from some source other than the seller. Generally speaking, the short seller anticipates a profit from the transaction by obtaining the securities sold short at a later date and at a price lower than the original sale. For a generalized discussion of the short sale see G. LEFFLER & L. FARWELL, THE STOCK MARKET 219-37 (3d ed. 1963).

45. C. MEYER, *supra* note 15, § 65, at 313.

46. *Id.* § 66. For a discussion of the term "street name" see note 9 *supra.*

47. C. MEYER, *supra* note 15, § 69. "Hypothecation" is the term used to describe the act of pledging securities as collateral to secure a loan. *See* P. WYCKOFF, *supra* note 1, at 127. Frequently, the term "rehypothecation" is used. A typical example of a rehypothecation arises when a customer has pledged securities to his broker-dealer to secure a margin transaction, and the broker-dealer

rights that derive from the lien on margin securities, it is a common practice among broker-dealers to require margin customers to submit to even broader control as a part of their margin account contractual agreements.[48] Typically, these agreements authorize the broker-dealer to commingle the customer's securities together with those of other customers in a single hypothecation *en bloc.*[49] The broker-dealer is also usually given the authority to lend the customer's securities to other broker-dealers to the extent of the amount owed by the customer on the securities.[50]

It is readily apparent that the broker-dealer has extremely broad powers to use customer securities in margin accounts. The breadth of these powers, however, can be justified not only on the ground that the broker-dealer has a claim against the securities, but also on the ground of practical necessity in financing margin transactions.[51] Furthermore, these powers are subjected to extensive regulation.

The most important restrictions on the scope of broker-dealer authority over margin account securities are the SEC rules relating to the hypothecation of customers' securities.[52] There are three basic prohibitions in these rules. First, a broker-dealer may not commingle a customer's securities with those of other customers unless each customer has previously consented in writing.[53] Secondly, no broker-dealer may hypothecate a customer's securities in a manner that would permit a commingling with securities belonging to anyone other than a bona fide customer of the broker-dealer.[54] Thirdly, broker-dealers are prohibited

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repledges, or rehypothecates, the securities to a bank as collateral for a loan to finance the margin transaction.

48. SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 390-91. For sample forms of margin account contractual agreements see G. LEFFLER & L. FARWELL, *supra* note 44, at 340, figure 20-3; SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 444-45, app. 111-C.

49. *See* G. LEFFLER & L. FARWELL, *supra* note 44, at 340, figure 20-3; SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 444, app. 111-C. A broker-dealer frequently commingles several customers' securities in a single block hypothecation because the bank loan to the broker-dealer usually is made in an amount far larger than the value of any single customer's securities that are available for hypothecation. Customarily, these bank loans are in multiples of $100,000.

50. *See* G. LEFFLER & L. FARWELL, *supra* note 44, at 340, figure 20-3; SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 391, 445, app. 111-C. A loan of securities must be distinguished from an hypothecation of securities. When securities are hypothecated, they are pledged as collateral for a loan, and the primary obligation is on the pledgor to repay the loan. When securities have been loaned, the borrower usually pledges to the lender an amount of cash equal to the value of the securities borrowed, and the primary obligation is on the borrower of the securities to return them on demand.

51. *See, e.g.*, C. MEYER, *supra* note 15, § 69, at 331.

52. 17 C.F.R. § 240.15c2-1 (1970).

53. *Id.* § 240.15c2-1(a)(1).

54. *Id.* § 240.15c2-1(a)(2).

from hypothecating customers' securities to secure an amount in excess of the total owed to the broker-dealer by all his customers.[55] In addition to the SEC regulation of hypothecation, the Securities Exchange Act of 1934 forbids any member of a national securities exchange and any broker-dealer who transacts business in securities through the medium of an exchange member from lending a customer's securities without the written consent of the customer.[56] Although the foregoing restrictions on hypothecation and lending of customers' securities have been viewed by the Commission as "generally satisfactory to the extent of their protection,"[57] the principal stock exchanges and the NASD have supplemented these restrictions with somewhat more stringent rules of their own.[58]

III. Prior Protection Against Broker-Dealer Insolvencies

A. Federal Regulation and the Self-Regulatory Scheme

Federal regulation[59] of the securities industry is based on a combination of direct governmental supervision and industry self-

55. *Id.* § 240.15c2-1(a)(3).

56. Securities Exchange Act of 1934, § 8(d), 15 U.S.C. § 78h(d) (1964).

57. SEC Special Study, *supra* note 4, pt. 1, at 405.

58. *E.g.*, A.S.E. Rule 412, 2 CCH A.S.E. Guide ¶ 9432 (regardless of consent, member may not pledge a customer's securities in an amount that is unreasonable in view of the indebtedness of the customer); N.Y.S.E. Rule 402(a), 2 CCH N.Y.S.E. Guide ¶ 2402(a) (same); *see* SEC Special Study, *supra* note 4, pt. 1, at 405-06.

59. Although this Note discusses only federal and voluntary industry measures for the protection of securities investors, it should be noted that almost every state has blue sky laws regulating certain aspects of securities transactions. Historically, these state laws sought to prevent the distribution of fraudulent securities by requiring registration of securities sold within the state and of those persons involved in their issuance. *See* L. Loss & E. Cowett, Blue Sky Law 1-10 (1958). Today, the blue sky laws typically contain one or more of 3 basic regulatory provisions: (1) general prohibitions against fraud; (2) registration requirements for securities; and (3) registration requirements for certain persons engaged in the securities business. *Id.* at 19. Although the first 2 of these provisions have little relevance to the problem of protecting securities investors against broker-dealer insolvency, the state requirements for broker-dealer registration relate directly to the issue of financial responsibility. Virtually every state, for example, requires registered broker-dealers to post a surety bond and to file annual financial reports. *See, e.g.*, Uniform Securities Act §§ 202(e), 203(b) (the Uniform Securities Act has been adopted in 25 states, Puerto Rico, and the District of Columbia (*see* National Conference of Commissioners on Uniform State Laws, 1969 Handbook 193)). Many states also require registered broker-dealers to maintain a minimum net capital or net capital to aggregate indebtedness ratio. *See, e.g.*, Uniform Securities Act § 202(d) & Commissioners' Note; L. Loss & E. Cowett, *supra*, at 265-66. Although many of the state blue sky requirements copy the standards set by federal law (*see, e.g.*, Uniform Securities Act § 203, Commissioners' Note), few state requirements are stricter than their federal counterparts. L. Loss & E. Cowett, *supra*, at 43. *But see* notes 24 & 37 *supra* and accompanying text. Furthermore, the state machinery for enforcing broker-dealer financial responsibility is generally far less extensive than the federal regulatory scheme. L. Loss & E. Cowett, *supra*, at 57-62.

regulation. The Securities Exchange Act of 1934 requires broker-dealers who conduct nonexempt interstate businesses in securities other than on a national securities exchange to register with the SEC and to comply with the Commission's rules and regulations.[60] The Act permits any national securities association and national securities exchange to apply for registration with the SEC.[61] If a broker-dealer is not a member of a national exchange or association, he is subject to direct regulation by the SEC.[62] If, on the other hand, the broker-dealer is a member of a national exchange, he is not required to register individually with the Commission, and, in large part, the rules and enforcement procedures of the exchange are substituted for those of the SEC.[63] Similarly, members of the National Association of Securities Dealers, the only national securities association currently registered with the SEC, are provided a certain degree of self-regulatory discretion.[64] While the self-regulated bodies of the securities industry have by no means been given unlimited autonomy,[65] the success of the system of self-regulation depends

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60. Securities Exchange Act of 1934, § 15(a), 15 U.S.C. § 78o(a) (1964).

61. *Id.* §§ 6, 15A, 15 U.S.C. §§ 78f, 78o-3.

62. *Id.* § 15(c), 15 U.S.C. § 78o(c).

63. The basic source of authority for direct SEC regulation of broker-dealers is § 15(c) of the 1934 Act, which expressly exempts broker-dealers who conduct their business on a national securities exchange. 15 U.S.C. § 78o(c) (1964). In the place of this authority the SEC is given control over the national exchanges' self-regulation. *Id.* §§ 6(b)-(d), 15 US.C. §§ 78f(b)-(d); *see* Note, *Protection of Accounts of Stockbrokerage Customers,* 77 HARV. L. REV. 1290, 1291 (1964). The Securities Investor Protection Act of 1970 makes an important alteration to § 15(c)(3) of the 1934 Act by deleting the exemptions for national exchange members from the SEC financial responsibility rules. *See* note 131 *infra* and accompanying text.

64. Members of national securities associations are permitted to register with the SEC under § 15A of the Act. 15 U.S.C. § 78o-3 (1964) (enacted as the Maloney Act of 1938, ch. 677, 52 Stat. 1070). Unlike members of national securities exchanges, members of registered national associations of securities dealers are not expressly exempted from the direct regulatory authority of the SEC. Nevertheless, under § 15A the NASD is permitted by the SEC to police and discipline its members to a large degree. The rationale for allowing this partial self-regulation is to provide a body that can police members' compliance with minimum ethical standards as well as minimum legal requirements. L. LOSS, *supra* note 6, at 1361. For a detailed discussion of the structure and operation of the NASD's self-regulatory authority see Rutter, *The National Association of Securities Dealers: Continuing Government-Industry Cooperative Regulation in the Over-the-Counter Securities Industry,* 7 VILL. L. REV. 611 (1962). *See also* Comment, *Over-the-Counter Trading and the Maloney Act,* 48 YALE L.J. 633 (1939). In addition to the qualified measure of autonomy, there are financial inducements for an unaffiliated broker-dealer to join NASD. *See* Securities Exchange Act of 1934, § 15A(i)(1), 15 U.S.C. § 78o-3(i)(1) (1964) (registered securities association may set prices at which members may deal with nonmembers).

65. The SEC, for example, has the general authority to require any national exchange or securities association to repeal, amend, or alter its rules as the Commission may deem necessary. Securities Exchange Act of 1934 §§ 15A(k), 19(b), 15 U.S.C. §§ 78o-3(k), 78s(b) (1964). Furthermore, any national exchange or securities association may have its registration revoked by the SEC, and any single member may be suspended by the Commission. *Id.* §§ 15A(*l*), 19(a), 15 U.S.C. §§ 78o-3(*l*), 78s(a).

primarily upon the industry's assumption of a large measure of voluntary responsibility. As a noted former chairman of the SEC has observed, if voluntary responsibility is exercised, there are two basic advantages to self-regulation:

> First, it [permits] the necessary elasticity required because of varying conditions on the various exchanges [and associations]. And second . . . it [adds] the weight of the exchange [or association] itself as an enforcement agency having jurisdiction over its own members.[66]

Within the framework of self-regulation, federal protection of the securities investor from financial loss due to the insolvency of broker-dealers has been limited to measures designed to prevent insolvencies. In addition to the previously discussed efforts to restrict the broker-dealer's use of customer assets,[67] there are three basic regulatory measures designed to prevent broker-dealer financial irresponsibility. Specifically, these measures govern financial reporting and examination, extension of credit by broker-dealers, and the amount of net capital maintained by broker-dealers.

1. Financial Reporting and Examination.—The Securities and Exchange Commission requires every registered broker-dealer and all members of a national securities exchange who transact business directly with nonmembers to keep a detailed set of specified books and records.[68] In addition, the SEC requires each broker-dealer and exchange member to file a certified annual report of its financial condition.[69] These annual financial statements must follow the form provided by the SEC and conform to prescribed standards.[70] The financial reports are supplemented by surprise audits conducted by the SEC, NASD, and the national exchanges.[71] Any registered broker-dealer or exchange member who refuses to permit an audit may be suspended from conducting his business by the SEC.[72] Generally speaking, the requirements for financial reporting and surprise audits have proven quite satisfactory.

66. W. DOUGLAS, *supra* note 13, at 65-66.

67. For a discussion on segregation of free credit balances see notes 18-26 *supra* and accompanying text. For a discussion on segregation of fully paid securities see notes 34-38 *supra* and accompanying text. For a discussion on hypothecation of customers' securities see notes 52-58 *supra* and accompanying text.

68. 17 C.F.R. § 240.17a-3(a) (1970). For a discussion of these bookkeeping rules see 2 L. LOSS, *supra* note 6, at 1344-46, and 5 *id.* at 3407-12 (Supp. 1969).

69. 17 C.F.R. § 240.17a-5 (1970). For a discussion of the SEC's financial reporting requirements see 2 L. LOSS, *supra* note 6, at 1346-55, and 5 *id.* at 3413-32 (Supp. 1969).

70. 17 C.F.R. §§ 240.17a-5(a), (b) (1970).

71. *See* 2 L. LOSS, *supra* note 6, at 1356-57; 5 *id.* at 3432-33 (Supp. 1969).

72. Tobey Royalties Co., 26 S.E.C. 442 (1947).

The effectiveness of the reporting and surprise audits, however, is necessarily dependent upon the staff and budget of the Commission itself.[73]

2. *Extension of Credit by Broker-Dealers.*—The Securities Exchange Act of 1934 requires the Federal Reserve Board to prescribe rules and regulations to govern the amount of credit that may be extended on registered securities.[74] Under Regulation T, the Federal Reserve Board forbids broker-dealers from effecting a transaction for a customer in a margin account[75] that creates or increases an excess of the customer's "adjusted debit balance"[76] over the "maximum loan value"[77] of the securities in the account.[78] If within five days a customer fails to make a deposit of cash or securities sufficient to prevent the creation or increase of an excess debit balance, the broker-dealer is required to sell the amount of securities purchased in the transaction that

73. An example of this limitation is seen in the audit system in which economic necessity has forced the SEC to rely extensively on the financial inspection programs of the NASD and the principal exchanges. *See* note 70 *supra* and accompanying text; *Hearings on Securities Acts Amendments Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce,* 86th Cong., 1st Sess. 83-84 (1959). For a description of the NASD member inspection program see SEC SPECIAL STUDY, *supra* note 4, pt. 4, at 647-59. For a discussion of the NYSE member surveillance see *id.* at 519-21.

74. Securities Exchange Act of 1934, § 7(a), 15 U.S.C. § 78g(a) (1964).

75. The basic credit requirements of Regulation T apply to general accounts, and the term "general account" is defined to include all customer margin accounts. 12 C.F.R. § 220.3(a) (1970). "Special accounts," such as customer cash accounts and omnibus accounts for other broker-dealers, are exempted from these basic credit requirements. *Id.* § 220.4. Exempted special accounts, however, must be scrupulously separated from general accounts and may not be used "in any way for the purpose of evading or circumventing any of the provisions of [Regulation T]." *Id.* §§ 220.4(a)(2), (3). For a discussion of the regulation of special customer accounts see 2 L. Loss, *supra* note 6, at 1252-56; 5 *id.* 3267-73 (Supp. 1969).

76. A customer's adjusted debit balance is essentially the total amount owed by the customer to his broker-dealer. In the case of a margin purchase the debit balance, excluding commissions and other charges, is simply the price paid for the securities purchased on margin. When the transaction has been a short sale, however, the customer owes the broker-dealer the amount of securities sold plus commissions and charges. Thus, a short seller's debit balance will vary with the market price of the securities owed the broker-dealer. For a discussion of the short sale see note 44 *supra.*

77. The maximum loan value that a broker-dealer may allow on a security is expressed by the Federal Reserve Board as a percentage of the security's current market value. This percentage is more commonly known by the name of its complement, the initial margin requirement. Thus, for example, the current maximum loan value for equity securities in a general account is 35%. 12 C.F.R. § 220.8(a)(1) (1970), *as amended by* 35 Fed. Reg. 7376 (1970). This results in a 65% initial margin requirement for general accounts. Equity securities that are neither listed on a national exchange nor granted special recognition by the SEC or the Federal Reserve Board have no loan value under Regulation T. 12 C.F.R. §§ 220.2(d)-(g), .3(c)(2) (1970).

78. 12 C.F.R. § 220.3(b)(1) (1970). The credit requirements of Regulation T may be expressed best in terms of an example: *I* opens a general account with *B-D* by purchasing on margin 1,000 shares of *XYZ* stock at $10 per share. Disregarding commissions and other charges, *I's* debit balance on the account is $10,000, the purchase price of the *XYZ*. Assuming a maximum loan rate

is necessary to liquidate the excess debit balance created.[79] The Federal Reserve Board, however, does not make any requirement for margin accounts that become undermargined when there has been no

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of 20%, the maximum loan value of the securities in *I's* account is $2,000 (20% x $10,000 worth of *XYZ*). To avoid creating an excess of debit balance over maximum loan value in his account, *I* must deposit $8,000 in cash, or an amount of securities with a loan value of $8,000.

	$10,000	Debit Balance in *I's* Account
less	2,000	Maximum Loan Value of Securities in *I's* Account
	8,000	Excess of Debit Balance Before Deposit
less	8,000	Cash (or securities loan value)
	No Excess Created	

As one might expect, the credit requirements for short sales operate in reverse of those for margin purchases. Under Regulation T, the Federal Reserve Board prohibits any broker-dealer from effecting a short sale for a customer unless the customer deposits an amount of cash or securities equal in value to a specific percentage of the market value of the securities sold. *Id.* § 220.3(d)(3). For example, *S* opens a general account with *B-D* by selling 1,000 shares of *XYZ* short at $10 per share. Disregarding commissions and assuming a margin rate of 80%, *S's* debit balance on the account is $10,000 (the current market value of the securities sold short) plus $8,000 (the 80% initial margin requirement times the current market value of the securities sold short), or $18,000. This debit balance is set off against the $10,000 in proceeds of the short sale. To avoid creating an excess of debit balance over maximum loan value, therefore, *S* must deposit $8,000 in cash or securities with a loan value of $8,000.

	$10,000	Debit Balance in *S's* Account
plus	8,000	Short Sale Margin Requirement
	18,000	Excess Debit Balance
less	10,000	Proceeds of the Short Sale
	8,000	Excess Before Deposit
less	8,000	Cash (or securities loan value)
	No Excess Created	

79. 12 C.F.R. § 220.3(e) (1970). With reference to the margin purchase example in note 78 *supra*, assume that *I* deposits only one-half of his $8,000 initial margin requirement. To eliminate the excess of adjusted debit balance over maximum loan value in *I's* account, *B-D* would be required to sell one-half of *I's* shares of *XYZ* (assuming no change in market value).

	$10,000	Debit Balance in *I's* Account
less	4,000	Cash Deposit (or securities loan value)
	6,000	Excess
less	5,000	Proceeds from *B-D's* Sale of 500 Shares of *I's XYZ* stock
	1,000	Excess
less	1,000	Loan Value of *I's* remaining 500 Shares of XYZ
	No Excess Created	

(Footnote 79. cont.)

"transaction."[80] If a customer sells securities in an undermargined account, the broker-dealer is required to retain a percentage of the proceeds known as the retention requirement.[81] Similarly, a withdrawal of cash or securities from a margin account may be made only if it does not exceed the Federal Reserve Board retention requirement.[82] By varying the maximum loan values allowed on securities, the Federal Reserve Board maintains an effective and flexible control over the amount of credit extended to customers by broker-dealers.[83] Furthermore, the rules of many of the national exchanges provide even greater controls against the overextension of credit by member firms.[84]

3. *Net Capital Requirements.*—The Securities and Exchange Commission requires all broker-dealers, unless exempted,[85] to maintain a minimum "net capital" of five thousand dollars[86] and a ratio of "net capital" to "aggregate indebtedness" of not less than one to twenty.[87] The "net capital" of a broker-dealer is essentially the total of his net liquid assets, including the proceeds of adequately subordinated loans.[88]

In the case of a short sale there are, of course, no securities for the broker-dealer to sell. Instead, the broker-dealer is required to purchase the amount of securities sufficient to prevent the creation of an excess debit balance. With reference to the short sale example in note 74 *supra,* assume that *S* deposited only one-half of his $8,000 initial margin requirement. To eliminate the excess of debit balance, *B-D* would be required to purchase 500 shares of *XYZ* with the proceeds of *S's* short sale.

	$10,000	Debit Balance in *S's* Account
less	5,000	Market Value of Securities Repurchased by *B-D*
	5,000	New Debit Balance
plus	4,000	New Margin Requirement (80% x $5,000 securities)
	9,000	New Debit Balance
less	5,000	Remaining Proceeds from Short Sale After Repurchase
	4,000	Excess Debit Balance
	4,000	Cash Deposit (or securities loan value)
	No Excess Created	

80. 12 C.F.R. § 220.7(b) (1970). An account that was once adequately margined may become undermargined without a transaction either by a change in the market value of the securities in the account or by a change in the maximum loan value rate set by the Federal Reserve Board.

81. *Id.* § 220.3(b)(2).

82. *Id.*

83. *See* 2 L. Loss, *supra* note 6, at 1244-48.

84. *E.g.,* A.S.E. Rule 462, 2 CCH A.S.E. Guide ¶ 9472; N.Y.S.E. Rule 431, 2 CCH N.Y.S.E. Guide ¶ 2431.

85. Members who are subject to the net capital rules of the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington, or Pittsburgh Stock Exchange are specifically exempted from the SEC net capital rule. 17 C.F.R. § 240.15c3-1(b)(2) (1970).

86. *Id.* § 240.15c3-1(a).

87. *Id.*

88. *See id.* § 240.15c3-1(c)(2).

To the extent that the liquid assets consist of securities, however, they must be adjusted downward in value by a percentage fixed according to their classification.[89] The "aggregate indebtedness" of a broker-dealer is basically the total of the cash liabilities that are neither adequately collateralized by his own assets nor physically segregated from his personal accounts.[90] Aggregate indebtedness also includes loans made to the broker-dealer that are not adequately subordinated to customer claims. Liabilities of the broker-dealer on open contractual commitments, however, are not included in the computation of aggregate indebtedness.[91]

The SEC net capital rules specifically exempt members of the principal stock exchanges, who are governed instead by the rules of their respective exchange.[92] In terms of the formal requirements, the rules of the exempt exchanges tend to be more stringent than those of the SEC. Occasionally, these rules will require a higher ratio of net capital to aggregate indebtedness than is required by the SEC.[93] Similarly, many of the exchanges require that members maintain a larger minimum net capital than the five thousand dollars required by the SEC.[94] Certain exempted exchanges also require greater downward adjustments in the valuation of particular types of securities included in the members' net capital computation.[95] In addition to these formal requirements, the informal policies of the exchanges in policing members' net capital further strengthen the overall net capital requirements.[96]

Although the system of regulating the net capital of broker-dealers has not been changed significantly since its inception, there seem to be indications that it could be substantially improved. For one thing, the adequacy of the ratio of one to twenty has frequently been questioned.[97] It also appears that in some cases the sanctions for violation of the net

89. These adjustments are referred to colloquially as "haircuts." The percentage reductions from current market value vary from 5% for certain debt securities to a maximum of 30% for most equity securities. *Id.* § 240.15c3-1(c)(2)(*iii*).

90. *Id.* § 240.15c3-1(c)(1).

91. *Id.* § 240.15c3-1(c)(2)(*v*).

92. *See* note 85 *supra*.

93. SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 408 & n.384.

94. For example, the minimum net capital for members of the New York Stock Exchange who carry accounts for customers is $50,000. N.Y.S.E. Rule 325(a), 2 CCH N.Y.S.E. GUIDE ¶ 2325(a).

95. SEC SPECIAL STUDY, *supra* note 4, pt. 1, at 408.

96. *Id.* at 408-09.

97. *Hearings on S. 2348, S. 3988, & S. 3989 Before the Subcomm. on Securities of the Senate Comm. on Banking & Currency*, 91st Cong., 2d Sess. 27-28 (1970); Note, *supra* note 63, at 1297.

capital rules may tend to induce a hesitant system of enforcement.[98] Moreover, it has been suggested that some limitations might be imposed on the inclusion of the proceeds of subordinated loans in the computation of a broker-dealer's net capital.[99] This inclusion has generally been justified on the ground that the proceeds are available to satisfy customer claims. This argument, however, overlooks the possibility that this source of capital may be impermanent and subject to market fluctuations if it is in the form of subordinated debentures or accounts.[100] Finally, it appears that the uses to which a broker-dealer's capital may be put have been inadequately regulated.[101]

B. *The Special Trust Funds: The Rise and Fall of Voluntary Industry Protection*

For more than 25 years after the entry of the federal government into the field of securities regulation, insolvencies of self-regulated broker-dealers were almost nonexistent, and the measures designed to prevent insolvencies seemed clearly sufficient.[102] With the failure of a member firm of the New York Stock Exchange in 1960, however, the self-regulating bodies of the securities industry began to show a willingness to go beyond mere prevention and to offer restitution to customers who would otherwise suffer loss due to broker-dealer insolvency.[103] Finally, in 1964, the New York Stock Exchange voluntarily established a special trust fund to indemnify customers of

98. One sanction for net capital violation is suspension from trading. A suspension, however, may force the distressed broker-dealer into an even more dangerous position. Note, *supra* note 63, at 1297. For an account of this type of dilemma see Loomis, *The Unbelievable Last Months of Hayden, Stone,* FORTUNE, Jan. 1971, at 114, 154.

99. *Hearings, supra* note 97, at 28.

100. *Id.*

101. *Id.*

102. On the New York Stock Exchange, for example, there were only 3 member insolvencies between 1934 and 1960, and all 3 occurred in 1938. 2 L. Loss, *supra* note 6, at 1191.

103. The member firm that failed was DuPont, Homsey & Co. To avoid the embarrassment of customer losses in the former member's liquidation, the New York Stock Exchange paid $700,000 into the firm's receivership. N.Y. Times, Nov. 4, 1960, at 1, col. 3; Wall Street J., Nov. 4, 1960, at 3, col. 1. The failure of DuPont, Homsey & Co. had been precipitated by defalcation on the part of one of the firm's partners. This fact prompted both the New York and the American Stock Exchanges to expand their member fidelity bond requirements to include coverage against partner dishonesty. *See* A.S.E. Rule 330, 2 CCH A.S.E. GUIDE ¶ 9380; N.Y.S.E. Rule 319, 2 CCH N.Y.S.E. GUIDE ¶ 2319. Furthermore, the New York Stock Exchange itself took out a fidelity bond to give added protection to customers against fraud on the part of member firms. N.Y. Times, Mar. 23, 1961, at 50, col. 2. Nevertheless, the President of the New York Stock Exchange warned that the indemnification of DuPont, Homsey's customers "could not be a precedent binding the exchange to a similar course in the future." Wall Street J., Nov. 21, 1960, at 26, col. 2.

member firms that failed.[104] This unprecedented step met with widespread popular approval[105] and was followed by the creation of similar funds by other national exchanges.[106] For several years the securities industry as a whole fared well, and the funds seemed to provide more than adequate protection.[107] In 1968, however, the securities industry entered into the most difficult two-year period of business it had experienced since the depression.[108] Rapid growth in the volume of trading in 1968 forced a precipitate and costly expansion in the number of back-office employees and equipment used by broker-dealers. Then, as the costly expansions seemed to be solving the "paperwork crunch," the volume of trading dropped off sharply, reducing the commissions that were badly needed to pay for the hasty back-office enlargements. In 1969 broker-dealers of all sizes posted losses, and firms began to disappear at an almost unparalleled rate. As liquidations forced heavy commitments of the New York Stock Exchange's special trust fund,[109] the limitations of the industry's voluntary funds became apparent. First, it was obvious that the amounts in the special trust funds were inadequate.[110] Secondly, payments to customers out of the funds were completely voluntary on the part of the exchanges.[111] Thirdly, each fund was entirely controlled by the governing body of the exchange, and rumors began to circulate about the propriety with which the funds were

104. N.Y.S.E. Const. arts. X, § 8, XIX, 2 CCH N.Y.S.E. GUIDE ¶¶ 1458, 1841-42. The creation of the Big Board's special trust fund was caused by the failure of Ira Haupt & Co. in the wake of the "phantom salad oil swindle" of 1963. For an account of the incredible events surrounding the swindle see N. MILLER, THE GREAT SALAD OIL SWINDLE (1965). For a discussion of the New York Stock Exchange indemnification of Ira Haupt's customers and the creation of the special trust fund see 5 L. LOSS, *supra* note 6, at 3199-201 (Supp. 1969).

105. *See* N.Y. Times, Aug. 1, 1964, at 20, col. 1.

106. *E.g.*, A.S.E. Const. arts. VII, § 5, XIII, 2 CCH A.S.E. GUIDE ¶¶ 9060, 9117-18. The exchanges that have established special trust funds are the New York, American, Midwest, Philadelphia-Baltimore-Washington, and Pacific Coast Stock Exchanges. *Hearings, supra* note 97, at 10.

107. *See* 5 L. LOSS, *supra* note 6, at 3201 (Supp. 1969).

108. *See* Wall Street J., Jan. 31, 1969, at 1, col. 6.

109. As of April 14, 1970, the New York Stock Exchange had committed just over half of the total amount of its special trust fund and more than three-quarters of the fund's liquid assets in the liquidation of 5 member firms. Wall Street J., Apr. 15, 1970, at 3, col. 2.

110. *See* note 109 *supra*. In March 1970, a New York Stock Exchange staff study recommended enlargement of the Exchange's special trust fund. As a result of this study, a blue ribbon committee was appointed to "determine the appropriate size of the fund and ways to enlarge it." Wall Street J., Mar. 26, 1970, at 6, col. 3. While this committee was conducting its study, the Exchange approved a loan of $30 million in standby credit to the special trust fund out of the Exchange's general funds. Wall Street J., June 15, 1970, at 15, col. 4.

111. 5 L. LOSS, *supra* note 6, at 3200 (Supp. 1969).

being used.[112] Finally, inadequate as the funds might be, customers of broker-dealers who were not members of one of the protected exchanges were afforded no protection.[113] It was against this background of special trust fund inadequacy and general industry distress that Congress enacted the Securities Investor Protection Act of 1970.[114]

C. *Section 60e and Stockbroker Bankruptcies*

Before turning away from this discussion of pre-1970 investor protection against broker-dealer insolvencies, it is appropriate to examine briefly the special procedure for dealing with stockbroker bankruptcies established by section 60e of the Bankruptcy Act.[115] Section 60e was enacted in 1938 to effect uniformity in the treatment of customer claims in stockbroker bankruptcies.[116] The section divides the claimants against bankrupt stockbrokers into three classes: (1) cash customers who are able to specifically identify their securities; (2) all other customers; and (3) general creditors.[117] In a proceeding under section 60e, cash customers who are able to specifically identify their securities are permitted to reclaim their property.[118] All remaining property held by the stockbroker for customer accounts is then liquidated, and the proceeds go into a "single and separate fund" that is

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112. These rumors intimated that the NYSE Board of Governors was exhibiting favoritism in the use of the special trust fund assets. BUS. WEEK, Aug. 22, 1970, at 28. The rumors were apparently based on the use of the special trust fund to make a subordinated loan to the ailing member firm Hayden, Stone. *See* Loomis, *The Unbelievable Last Months of Hayden, Stone,* FORTUNE, Jan. 1971, at 114, 154-55.

113. The special trust funds were voluntary and covered only the customers of member firms. When a firm held multiple exchange memberships, the fund of the larger of the exchanges covered the firm's customers.

114. For an indication of the congressional concern over the securities industry's woes see S. REP. No. 91-1218, 91st Cong., 2d Sess. 2-4 (1970).

115. 11 U.S.C § 96(e) (1964).

116. Section 60e was enacted in 1938 as part of the Chandler Act. Act of June 22, 1938, ch. 575, 52 Stat. 870. Prior to the enactment of § 60e, customer claims against a broker-dealer in bankruptcy were subject to complex artificial distinctions; conflicting rules governing these distinctions further confused the status of the claims. Gilchrist, *Stockbrokers' Bankruptcies: Problems Created by the Chandler Act,* 24 MINN. L. REV. 52, 53-57 (1939); Legislation, *The Bankrupt Stockbroker: Section 60(e) of the Chandler Act,* 39 COLUM. L. REV. 485-90 (1939). In the words of the chief draftsman of the provision, "[Section 60e] has been added in order to make uniform the rules applicable to the liquidation of the assets of bankrupt stockbrokers and to secure greater approximation to equality in distribution . . . ." *Hearings on H.R. 6439 Before the House Comm. on the Judiciary,* 75th Cong., 1st Sess. 96 (1937). For a detailed discussion of the origin of § 60e see McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act,* 4 U. CHI. L. REV. 369 (1937).

117. 11 U.S.C. § 96(e) (1964); 3 W. COLLIER, BANKRUPTCY ¶ 60.73 [1.2], at 1170-71 (14th ed. 1969); Gilchrist, *supra* note 116, at 59.

118. 11 U.S.C. § 96(e) (1964); 3 W. COLLIER, *supra* note 117, at ¶ 60.74.

eventually distributed pro rata to all other customers.[119] The personal assets of the debtor also are liquidated, and the proceeds become part of his bankruptcy estate, which is shared pro rata by general creditors and any customers whose claims were not satisfied out of the single and separate fund.[120]

Although the basic scheme of section 60e seems relatively simple, as a practical matter its application raises several problems. First, by its own terms the section applies only "[w]here the bankrupt is a stockbroker."[121] In construing the meaning of this language, the courts have occasionally been troubled by the technical distinction between a broker and a dealer.[122] Secondly, because of the unusual punctuation of section 60e(2), it could be argued that the proceeds of customers' property that has been rightfully transferred or unlawfully converted by the stockbroker should not be included in the single and separate fund.[123] Thirdly, inconsistencies in the statutory language raise considerable doubt about the rights of cash customers to reclaim specifically identifiable cash, as opposed to securities.[124] Finally, the practice of bulk

119. 11 U.S.C. § 96(e)(2) (1964). When the stockbroker has pledged margined securities and the pledge is liquidated by the trustee, the proceeds are distributed between the single and separate fund and the stockbroker's general estate in proportion to the respective claims in the pledged securities of the margin customer and the stockbroker. *Id.* § 96(e)(3).

120. *Id.* § 96(e)(5). The special provisions of § 60e only pertain to distributions to customers of property held by the stockbroker for customers' accounts. The treatment of general creditors and the distribution of the assets belonging to the stockbroker are handled under the standard provisions of the Bankruptcy Act.

121. *Id.* § 96(e)(1).

122. *E.g.*, Gordon v. Spaulding, 268 F.2d 327, 330-32 (5th Cir. 1959) (when bankrupt had dealt with claimant as a principal, § 60e did not apply despite the fact that bankrupt "conducted his business regularly and usually as a stockbroker"). Commentators on § 60e have intimated that a strict adherence to the distinction between the terms "broker" and "dealer" could result in a subversion of the section's recognized purpose of uniformity. *See* Legislation, *supra* note 116, at 490 n.40. *See also* 3 W. COLLIER, *supra* note 117, ¶ 60.73[1.1]. As a practical matter, this problem has been minimized by the infrequency of litigation under § 60e.

123. The absence of a comma at the end of the clause excepting cash customers' specifically identifiable property from the single and separate fund has led to this confusion. Section 60e(2) reads in part: "All property at any time received, acquired, or held by a stockbroker from or for the account of customers, *except* cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivison *and* the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund . . . ." 11 U.S.C. § 96(e)(2) (1964) (emphasis added). Scholars have unanimously rejected the interpretation of § 60e(2) excluding proceeds of customers' property that has been transferred or converted as inconsistent with the other provisions of § 60e and with legislative history. 3 W. COLLIER, *supra* note 117, ¶ 60.73[2], at 1171-72; Gilchrist, *supra* note 116, at 59-61. Apparently no court has adopted the criticized interpretation.

124. Section 60e(1) defines cash customers as those customers entitled to immediate possession of securities without payment of any sum to the stockbroker. 11 U.S.C. § 96(e)(1) (1964). Cash is not mentioned in the definition. Under strict application of this definition, therefore,

segregation of customer securities and the development of an automated central certificate service have created problems with the provisions outlining the requirements for specific identification in section 60e(4).[125]

IV. THE SECURITIES INVESTOR PROTECTION ACT OF 1970

A. *SIPC, the SEC, and Self-Regulation*

The Securities Investor Protection Act of 1970 creates an independent, nongovernmental corporation known as the Securities Investor Protection Corporation (SIPC).[126] The SIPC is governed by an appointive seven-man board of directors,[127] and the general membership includes all registered broker-dealers and members of national securities exchanges.[128] The Act charges the Corporation with two primary duties: the establishment of the SIPC fund and the initiation of liquidation proceedings whenever the customers of a member of the Corporation need this protection. In fulfilling these duties, the SIPC is theoretically an independent corporate entity. In practice, however, the Corporation is completely subordinated to the discretionary powers of the SEC,[129] and, to a large degree, the independence of the self-regulated exchanges

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cash customers would appear to have the right only to reclaim securities. For a discussion of this problem see 3 W. COLLIER, *supra* note 117, ¶ 60.75; Gilchrist, *supra* note 116, at 71-79.

125. *See* 3 W. COLLIER, *supra* note 117, ¶ 60.74[2]; Gilchrist, *supra* note 116, at 68-70; Note, *Stockbrokerage Bankruptcies: Implementing CCS*, 54 CORNELL L. REV. 750 (1969).

126. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 3(a), 84 Stat. 1637.

127. The 7 members will be appointed for staggered 3-year terms: (1) one director to be appointed by the Secretary of the Treasury from the Treasury Department; (2) one director to be appointed by the Federal Reserve Board from the Federal Reserve System; (3) three directors to be appointed by the President with the advice and consent of the Senate from the securities industry; and (4) two directors to be appointed by the President with the advice and consent of the Senate from the general public. *Id.* §§ 3(c)(2), (4), 84 Stat. 1638.

128. *Id.* § 3(a)(2), 84 Stat. 1637. Broker-dealers whose securities business consists exclusively of such activities as the sale of variable annuity contracts or the distribution of securities to registered open end investment companies are exempted from SIPC membership. *Id.* Any broker-dealer or national exchange member not automatically made a member of the SIPC may apply voluntarily for membership. *Id.* § 3(f)(1), 84 Stat. 1639.

129. "The Securities and Exchange Commission is given in this [Act], plenary authority over the Corporation's exercise of its powers and responsibilities." S. REP. NO. 91-1218, 91st Cong., 2d Sess. 1 (1970). *See also* H.R. REP. NO. 91-1613, 91st Cong., 2d Sess. (1970), *reprinted in* U.S. CODE CONG. & AD. NEWS 7390, 7401-02 (1970). The primary source of SEC control over the SIPC stems from Commission control over the bylaws and rules of the Corporation. Under § 3(e)(1) of the Act, the SIPC is required to conduct its business pursuant to such bylaws and rules as it may adopt. All bylaws and rules must be submitted to the SEC for approval, and the SEC is given the power to require "the adoption, amendment, alteration of, supplement to, or rescission of any bylaw or rule of SIPC whenever adopted." Securities Investor Protection Act of 1970, Pub. L. No. 91-598, §§ 3(e)(2), (3), 84 Stat. 1639. An especially important result of this power is that it gives the SEC discretionary control over the general assessments that the SIPC levies against members. *See id.* § 4(c)(2), 84 Stat. 1640.

and associations is preserved.[130] Thus, although the SIPC represents a new factor in the federal regulatory formula, the relationship between the SEC and the self-regulatory bodies of the securities industry has been preserved virtually unchanged.[131]

B. The SIPC Fund and Member Assessments

As previously mentioned, one of the primary duties of the Corporation is the establishment of the SIPC fund. Although this fund is similar in nature to the industry special trust funds,[132] it avoids many of the demonstrated weaknesses of these voluntary funds. The size of the SIPC fund, for example, leaves little doubt about its adequacy. Starting almost immediately at a level of 75 million dollars, the fund is to grow to

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130. Members of registered national securities exchanges and associations of broker-dealers are insulated from direct supervision by the SIPC. The Act expressly designates the governing bodies of these organizations as the collection agents and examining authorities for their respective members. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, §§ 9(a), (c), 84 Stat. 1654. Although tbe SIPC may require self-regulatory bodies to file reports of the examinations they conduct, these requirements are subject to SEC review. Furthermore, any extraordinary reports, examinations, or required rule changes will be ordered by the Commission rather than the SIPC. *Id.* § 9(f).

131. The Act makes one important change in the relationship between the SEC and the securities industry, but this change has little to do with the SIPC. The change increases the rulemaking power and responsibility of the SEC by amending § 15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(c)(3) (1964). In the 1934 Act, the rulemaking authority of the SEC was couched in discretionary language: "[S]uch rules and regulations as the Commission *may* prescribe . . . ." (emphasis added). In amending this section, the Act deleted the word "may" and sustituted for it the word "shall." Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 7(d), 84 Stat. 1653. Section 15(c)(3) was further amended to eliminate the exemption of national securities exchange members from the SEC financial responsibilty rules issued under this section. *See* note 63 *supra* and accompanying text. Finally, the section was amended to clarify the authority of the SEC to make rules governing the use of customers' fully paid securities and free credit balances. Although the nature of these rules is generally left to the judgment of the SEC, a specific mandate to require broker-dealers to establish reserves against free credit balances was included in the amending language. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 7(d), 84 Stat. 1653; *see* S. REP. No. 91-1218, 91st Cong., 2d Sess. 15-16 (1970). For strong language directing the SEC to act vigorously in exercising this new authority see H.R. REP. No. 91-1613, 91st Cong., 2d Sess. (1970), *reprinted in* U.S. CODE CONG. & AD. NEWS 7390, 7402 (1970), and H.R. CONF. REP. No. 91-1788, 91st Cong., 2d Sess. (1970), *reprinted in* U.S. CODE CONG. & AD. NEWS 7417, 7420 (1970). For an SEC reaction to this mandate see 116 CONG. REC. S 21103 (daily ed. Dec. 22, 1970) (letter from SEC Commissioner Owens to Senator John Sparkman, Chairman of the Senate Banking & Currency Committee).

132. The Federal Deposit Insurance Corporation seems to have served as a useful precedent in obtaining congressional support for SIPC. The FDIC even served as a model for some of the early versions of the legislation. One early proposal followed the Federal Deposit Insurance Corporation Act so closely that the draftsman forgot to substitute the words "insured broker and insured dealer" for the words "insured bank" in one section. *See* S. 2348, 91st Cong., 1st Sess. § 16(c) (1969). Nevertheless, the true ancestry of the SIPC lies in the voluntary special trust funds and not in the FDIC. *See, e.g., Hearings, supra* note 97, at 29.

an optimum size of some 150 million dollars in liquid assets.[133] The liquid assets in the fund are backed at all times by a general borrowing authority and a one billion dollar line of credit with the United States Treasury.[134] In addition, customer claims against the SIPC fund are a matter of right,[135] subject only to a maximum 50 thousand dollar limit on claims from each customer's account.[136] Moreover, the fund is controlled completely by an independent corporate body with a majority of the board of directors having no direct connections with the securities industry.[137] Finally, coverage under the fund extends to the customers of all registered broker-dealers who were not covered under the voluntary special trust funds.[138]

Financing for the SIPC fund will be provided by customer assessments levied on the "gross revenues"[139] of members of the

133. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, §§ 4(b), (d), 84 Stat. 1640, 1641. The initial $75 million level of the SIPC fund is expected to be made up of $18 million in liquid assets and $65 million in confirmed lines of credit. The $10 million in liquid assets will be drawn from an initial assessment on the industry of $7 million and a transfer of $3 million from the industry special trust funds. It is anticipated that the $65 million in credit will be reduced by $10 million each year and replaced by liquid assets from member assessments. Assuming no member liquidations and a 5% growth rate in the securities industry, the fund should total $150 million in 5 years. For discussion of the funding of SIPC see S. REP. No. 91-1218, 91st Cong., 2d Sess. 5-6 (1970); *Hearings, supra* note 12, at 182-85.

134. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, §§ 4(f), (g), 84 Stat. 1642-43.

135. *See* note 147 *infra*.

136. Advances will be made by the SIPC to satisfy claims of customers, except customers who have a proprietary interest in the debtor or who are themselves broker-dealers trading on their own account. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, §§ 6(f)(1)(C), (D), 84 Stat. 1651. These advances are limited to $50,000 per customer. This limit is reduced to $20,000, however, if the customer's claim is for cash on deposit with the debtor. *Id.* § 6(f). The rationale behind the lower limit on advances arising out of claims for cash was to avoid undesired comparison with the $20,000 limit in FDIC claims. A customer who holds separate accounts with the debtor in separate capacities is considered a different customer in each capacity for purposes of computing the limit. *Id.* § 6(f)(1)(B).

137. *See* note 127 *supra* and accompanying text. As noted previously, rumors suggesting misuse of the exchanges' special trust funds had been generated by the use of the New York Stock Exchange fund to make a subordinated loan to a member firm. *See* note 112 *supra* and accompanying text. A joint securities industry Task Force proposed that the SIPC be given discretionary authority to make similar subordinated loans to SIPC members in lieu of initiating liquidation proceedings. *Hearings, supra* note 12, at 178 (introduced as H.R. 18109, 91st Cong., 2d Sess. § 4 (1970), proposing new § 36(a)(3) of the Securities Exchange Act of 1934). This proposal was included in a compromise bill drafted by the Task Force and the SEC. *Hearings, supra* note 12, at 323 (introduced as H.R. 18458, 91st Cong., 2d Sess. § 2 (1970), proposed new § 35(m)(3) of the Securities Exchange Act of 1934). The provision was deleted from the Act as finally passed, however, apparently to avoid any suggestion of impropriety in the use of SIPC funds. *See* H.R. REP. No. 91-1613, *reprinted in* U.S. CODE CONG. & AD. NEWS 7390, 7404-05 (1970).

138. *See* note 128 *supra* and accompanying text.

139. "Gross revenues from the securities business" is defined in the Act to include 11 enumerated items, each of which may be further defined by the SIPC. Securities Investor Protection

Corporation. After consulting with the self-regulatory bodies[140] and subject to SEC approval,[141] the SIPC has general authority to set the rate of assessment for each member. The factors that the Corporation may consider in levying assessments include the amount of risk the member's business involves, the degree of probability that the risk will be realized, and the ability of the member to pay.[142] The assessment rate for each member, however, may not exceed one percent of the member's gross revenues from the securities business for the period during which the assessment is to be paid.[143] Furthermore, whenever the annual rate of assessment for a member exceeds one-half of one percent of the member's gross revenues, the SIPC is required to make an affirmative determination "that such rate of assessment . . . will not have a material adverse effect on the financial condition of its members or their customers . . . ."[144] Failure on the part of any member of the Corporation to pay his assessment when demanded by the SIPC makes it unlawful for the member to engage in business as a broker-dealer.[145] If any member denies that he owes the assessment demanded by the Corporation, he must pay the amount demanded and then challenge the Corporation in federal court.[146]

C. Liquidation Proceedings

The second basic duty of the SIPC is to initiate liquidation proceedings whenever the customers of a member need this protection.[147]

Act of 1970, Pub. L. No. 91-598, §§ 4(i)(1), (3), 84 Stat. 1644. Computation of a member's gross revenues will be made by consolidating the gross revenue of all subsidiaries conducting a seeurities business with the gross revenue of the parent. *Id.* § 4(i)(2), 84 Stat. 1651.

140. *Id.* § 4(c)(2), 84 Stat. 1640.

141. *See* note 129 *supra* and accompanying text.

142. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 4(c)(2), 84 Stat. 1640.

143. *Id.* § 4(c)(3)(B), 84 Stat. 1640-41.

144. *Id.*

145. *Id.* § 10(a), 84 Stat. 1655.

146. *Id.*

147. The general authority of the SIPC to initiate liquidation proceedings is not couched in mandatory terms, but rather the decision of when to initiate liquidation is left to the discretion of the SIPC and the SEC. *See id.* §§ 5(a)(2), 7(b), 84 Stat. 1644-45, 1653. The discretion allows the SIPC to refrain from immediately initiating liquidation proceedings whenever a member is in the position of satisfying the conditions precedent to a liquidation adjudication. For a discussion of these conditions see note 149 *infra* and accompanying text. Thus, the SIPC might temporarily refrain from initiating liquidation proceedings even though a member was "in danger of failing to meet its obligations to its customers" and was in violation of the net capital rule in order to permit an attempt to effect a merger or some other arrangement that would bring the member firm out of danger. This discretion is available, however, for determining only when the SIPC should act to protect customers, and not whether it must eventually act. Although there is no procedure specified in the Act by which a customer of an SIPC member can force the Corporation to institute a

Because the SIPC has no direct responsibility in policing the financial condition of its members, most liquidation proceedings will begin by a notification of the Corporation by either the SEC or the member's self-regulatory governing body that the member is in or is approaching financial difficulty.[148] If the SIPC determines that any member has failed or is in danger of failing to meet obligations to its customers, and that any one of five specified conditions exists,[149] the Corporation is authorized to apply to a federal district court for liquidation of the member.[150] If the court finds that the Corporation's determinations are correct, it will rule that the customers need the Act's protection and appoint a trustee selected by the SIPC to liquidate the member.[151]

The liquidation procedure provided for in the Act is essentially a modified version of the section 60e stockbroker bankruptcy.[152] With few exceptions, the court in a liquidation proceeding is vested with the powers and jurisdiction of a bankruptcy court,[153] and, with certain limitations, the trustee in a liquidation is vested with the powers and title of a trustee in bankruptcy.[154] The Act continues the section 60e division of claimants into the separate classes of cash customers who are able to specifically identify their property, all other customers, and general creditors. In addition to being able to reclaim specifically identifiable securities as under section 60e, however, cash customers also are permitted to reclaim specifically identifiable cash from the debtor.[155]

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liquidation proceeding, it would seem wholly inconsistent with the history and purpose of the Act to say that the SIPC can refrain from acting when the obligations of a member of the Corporation to its customers cannot otherwise be met.

148. *See* note 130 *supra* and accompanying text.

149. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 5(a)(2), 84 Stat. 1644-45. The 5 conditions are that the member: (I) is insolvent; (2) has committed an act of bankruptcy; (3) is the subject of a court proceeding in which a liquidator, trustee, or receiver has been appointed for the member; (4) is in violation of the financial responsibility rules governing the conduct of his business; or (5) is unable to make the computations necessary to show that he is not in violation of the finanical responsibility rules governing his business. *Id.* § 5(b)(1)(A), 84 Stat. 1645. The broad scope of these 5 conditions is a significant improvement of the bankruptcy provisions. As a practical matter, the purpose of § 60e of the Bankruptcy Act, 11 U.S.C. § 96(e) (1964), has frequently been frustrated by the institution of a state liquidation or SEC proceeding before an act of bankruptcy had been committed. Note, *supra* note 63, at 1304-05. For a discussion of the purpose of § 60e see note 116 *supra* and accompanying text.

150. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 5(a)(2), 84 Stat. 1645.

151. *Id.* §§ 5(b)(1)(a), (3), 84 Stat. 1645, 1646.

152. The Act expressly incorporates all of the general provisions of the Bankruptcy Act except § 60e. *Id.* § 6(c)(1), 84 Stat. 1647. The language of § 60e, however, is copied almost verbatim in the provisions of § 6(c)(2), 84 Stat. 1647-50, of the Act.

153. *Id.* § 5(b)(2), 84 Stat. 1645.

154. *Id.* § 6(b)(I), 84 Stat. 1647.

155. *Compare id.* §§ 6(c)(2)(A)(*iii*), (B), (C), 84 Stat. 1648-50, *with* 11 U.S.C. §§ 96(e)(1), (2), (4) (1964). *See also* note 124 *supra* and accompanying text.

Moreover, the manner in which customers may specifically identify their property is broadened to alleviate the problems created by bulk segregation and central certificate services.[156] The concept of the single and separate fund is continued from section 60e by the Act. In a liquidation proceeding, however, the trustee is not required to liquidate the securities and other property in the single and separate fund.[157] Instead, the trustee in a liquidation proceeding will distribute to the customers from the single and separate fund, to the greatest extent practicable, securities of the same class and series as those on which the customer's claim is based.[158] In order to provide for prompt satisfaction of customer claims, the procedure for proving claims has been simplified,[159] and the time for making claims has been shortened.[160] As under section 60e, customers share pro rata in the estate of the debtor with the general creditors to the extent that their claims are not satisfied out of the single and separate fund.[161]

There are two basic differcnces between a section 60e bankruptcy and a liquidation proceeding that rcsult from the availability of SIPC funds in the liquidation. The first of these differences relates to the mechanics of paying customer claims out of the SIPC fund. After the appointment of a trustee in a liquidation proceeding, the SIPC advances the amount of funds to the trustee that is necessary to satisfy the claims of customers to the extent that the claims do not exceed the 50 thousand dollar per customer limit.[162] To the extent that a claim is satisfied out of SIPC advances, the Corporation is subrogated to the claims of the customer.[163] The second basic difference between a section 60e bankruptcy and a liquidation proceeding relates to the completion of the debtor's open contractual commitments. While the completion of a bankrupt's executory contracts is left to the unfettered discretion of the

156. *Compare* Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(c)(2)(C), 84 Stat. 1649, *with* 11 U.S.C. § 96(e)(4) (1964). *See also* note 124 *supra* and accompanying text.

157. *See* Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(b)(2), 84 Stat. 1647. *See also* note 119 *supra* and accompanying text.

158. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(c)(2)(B), 84 Stat. 1649.

159. *Id.* §§ 6(g), (h), 84 Stat. 1651-52 (proof of claims required only of persons who are associated with or have a proprietary interest in the debtor's business).

160. *Compare id.* § 6(e), 84 Stat. 1650-51, *with* Bankruptcy Act § 57n, 11 U.S.C. § 93(n) (1964).

161. *Compare* Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(c)(2)(B), 84 Stat. 1648-49, *with* 11 U.S.C. § 96(e)(2) (1964).

162. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(f)(1), 84 Stat. 1651. For a discussion of the limits on customer claims see note 136 *supra*.

163. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(f)(1), 84 Stat. 1651.

trustee in bankruptcy,[164] the trustee in a liquidation is obligated to complete open contractual commitments in which any investor has an interest, unless the SEC should order otherwise.[165] To expedite the trustee's action, the SIPC will advance to the trustee the funds necessary to complete these commitments.[166] The theory behind this provision is not that the position of the debtor's customers will be better protected, but rather that the completion of the contractual commitments will insulate other broker-dealers from adverse effects of the debtor member's failure.[167]

V. CONCLUSION

The Securities Investor Protection Act of 1970 represents an important new addition to the federal role as protector of the securities investor. By synthesizing the social policy of the industry's special trust funds and the technical procedures of stockbroker bankruptcies into a coherent and workable scheme, Congress has departed from its traditional policy of preventive protection. As a matter of social policy, the protection afforded by the SIPC seems clearly justifiable.[168] As a practical matter, the Act will virtually eliminate stockbroker bankruptcies as far as customers are concerned[169] and replace them with

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164. Bankruptcy Act § 70b, 11 U.S.C. § 110(b) (1964).

165. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(d), 84 Stat. 1650.

166. *Id.* § 6(f)(2), 84 Stat. 1651.

167. S. REP. No. 91-1218, 91st Cong. 2d Sess. 11 (1970).

168. There are 2 basic arguments supporting the entry of the federal government into the field of insuring investors against the risk of broker-dealer insolvency. The first argument is that the securities industry, as a means of routing savings into investment in private enterprise, is a national asset. The SIPC, as a measure to protect the investor, could be viewed as merely a logical effort to preserve this asset to the nation's economy. The second argument is that society has a legitimate interest in protecting the consumer from risks he does not understand. The risk of selecting a losing investment is commonly known and is directly related to the anticipated gain. The risk of loss due to a broker-dealer's insolvency is not generally known, however, and it is totally unrelated to the anticipated gain. As a hidden risk to the unwary investor, broker-dealer insolvencies are an appropriate object of governmental protection.

169. For the customer whose claim is satisfied out of the reclamation of specifically indentifiable property and the distribution of the single and separate fund, including advances from the SIPC fund, the liquidation proceeding is the only action in which he participates. Although customers whose claims are not so satisfied share in the subsequent disposition of the debtor's estate in bankruptcy, it is cstimated that 94.5% of the customers of SIPC members will be covered completely by the $50,000 limit on SIPC advances alone. *Hearings, supra* note 12, at 340 (estimate from study conducted for SEC). It should be noted, however, that the SIPC liquidation will not necessarily reduce the claims with which general creditors will have to compete in the distribution of the debtor's estate in bankruptcy. To the cxtent that customers have been satisfied by the SIPC, the Corporation may participate in the distribution of the debtor's estate in bankruptcy as subrogee of the customers' claims. Furthermore, an enormous dollar value of claims is concentrated in the hands of a very few SIPC customers. Thus, it is estimated that while 94.5% of the customers who

the faster and simpler operation of the liquidation proceeding. In short, when the Act is judged on its own terms, it seems to be a successful and desirable addition to federal protection of securities investors.

When the Act is measured in the broader context of securities regulation as a whole, however, it is clearly a palliative and not a cure. Although the Act significantly expands some of the powers of the SEC relating to broker-dealer financial responsibility,[170] the manner in which these new powers will be exercised remains to be seen. Moreover, the basic problems of broker-dealer back-office management have gone completely unresolved.[171] There are indications that congressional efforts to solve some of the more fundamental problems will soon be forthcoming.[172] Traditionally, serious congressional action in the field of securities regulation has come as a response to crisis in the industry. At this writing, however, the securities industry seems to be steadily emerging from the extended crisis of the last two years.[173] It is submitted that the limitations of the protection afforded by the SIPC should be carefully kept in mind, and that neither the creation of this new federal protection nor the apparent advent of renewed prosperity on Wall Street should be permitted to obscure the problems that remain to be solved.

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have accounts with SIPC members could be satisfied out of SIPC advances alone, the potential value of the claims of the remaining 5.5.% of the customers amount to an estimated 92.9% of the total dollar value of all claims in the liquidation proceeding. *Id.*

170. *See* note 131 *supra.*

171. For discussion of the unresolved problems of broker-dealer financial responsibility and stability see *Hearings, supra* note 97, at 27-29. *See also* NEW REPUBLIC, Jan. 23, 1971, at 9-10; Davant, *Wall St.: You Get What You Pay For,* N.Y. Times, Jan. 10, 1971, § 12, at 28, col. 1; Haack, *Help for the Big Board,* N.Y. Times, Feb. 14, 1971, § 3, at 14, col. 3.

172. *See, e.g.,* Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 11(h), 84 Stat. 1656; 116 CONG. REC. S 21109 (daily ed. Dec. 22, 1970) (hearings to be held on further legislation needed to improve federal regulatory effectiveness).

173. *E.g.,* Robards, *Stocks: Dam Is Holding,* N.Y. Times, Feb. 14, 1971, § 3, at 1, col. 3.