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Stockbrokerage Bankruptcies Implementing CCS

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NOTES

STOCKBROKERAGE BANKRUPTCIES: IMPLEMENTING CCS

The paperwork logjam[1] which currently cripples securities market transactions will be eliminated on the New York Stock Exchange (NYSE) with the advent of the Central Certificate Service (CCS).[2] Because the new system will, for the most part, replace the physical transfer of securities with automated bookkeeping entries, its implementation has occasioned revision of existing rules governing the custody and transfer of securities.[3]

Still to be amended, however, is section 60e of the Federal Bankruptcy Act,[4] which conditions the right of a cash customer to reclaim his fully-paid securities, in the event of a stockbrokerage bankruptcy, upon physical identification of his property. One response to the new transfer service would entail making all parties general creditors because they relied on the broker's credit. But there are compelling policy reasons for making at least one exception; cash customers should continue to be distinguished from margin customers—not only because of ownership arising out of full payment, but because of their potential for weakening CCS. And although customers with free credit balances should receive increased protection to encourage them

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1 N.Y. Times, Nov. 1, 1968, at 67, col. 6. *See* Jolls, *Can We Do Without Stock Certificates? A Look at the Future*, 23 BUS. LAW. 909 (1968).

Such undesirable consequences of the administrative backlog as the inability of broker-dealers to fill orders within applicable time limits will hopefully be eliminated. 1 SEC, REPORT ON THE SPECIAL STUDY OF SECURITIES MARKETS, pt. I, at 424-25 (1963) [hereinafter cited as SPECIAL STUDY].

2 Implementation of CCS began on June 28, 1968, and was completed on February 24, 1969. *See* N.Y. Times, Feb. 25, 1969, at 53, col. 1. "In 'Full Activation' eligible listed issues are activated for broker to broker delivery at the rate of 5 issues per day, alphabetically by corporate name." Letter from James E. Buck, Executive Assistant for Civic and Governmental Affairs for the New York Stock Exchange, November 11, 1968, on file with the *Cornell Law Review*.

3 The SEC, for example, has specifically amended its own rules to accommodate CCS. The NYSE has successfully promoted the passage of legislation (UNIFORM COMMERCIAL CODE § 8-320) in all but three states effecting changes in provisions of the stock transfer laws which formerly required actual physical delivery of certificates evidencing ownership. *See* SEC Securities Exchange Act Release No. 7896 (May 26, 1966); letter from James E. Buck, *supra* note 2.

4 11 U.S.C. § 96(e) (1964).

to leave their funds with the broker,[5] that protection must be found outside the Bankruptcy Act.

I

CONDUCT OF THE CUSTOMER'S ACCOUNT

A. *Segregation Rules and Systems*

Customers' securities in the possession of NYSE member firms are protected from improper hypothecation by the Exchange's rules and policies on dealing with customer accounts.[6] In particular, rule 402 requires segregation and clear identification of customers' fully paid and excess margin securities.[7]

To comply with these rules, brokers use two basic types of segregation systems: "individual" and "bulk." In the former, each stock certificate on deposit with the firm is either registered in the customer's name, or is held in street name[8] and identified by a tab or by filing in an envelope bearing his name.[9] Bulk segregation is prevalent, especially among larger broker-dealers. Under this system, which requires that all certificates maintained therein be in street name,[10] a member firm places certificates not registered in the names of its customers in a common depository or "box." No indication of ownership appears on the individual certificates. Each customer-owner of a given security

5 Free credit balances may arise in many ways, but under no circumstances is the customer with a cash claim adequately protected in the event of bankruptcy. For example, a cash customer may deposit money with the broker with instructions to buy specified securities, or with the understanding that instructions will follow. If bankruptcy occurs before a purchase is made, the customer might not be able to reclaim his money for one of two reasons: He does not fit within the definition of a cash customer in § 60e(1) since he is not immediately entitled to the possession of *securities* or he cannot meet the physical identification requirements of § 60e(4). *See Hearings on H.R. 6789 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 88th Cong., 1st & 2d Sess., pt. 2, at 1147 (1964). Although brokers may establish separate bank accounts for their customers' free credit balances, commingling of indistinguishable funds may still occur. 3 W. COLLIER, BANKRUPTCY ¶ 60.75, at 1192 n.11 (14th ed. 1967).

6 2 CCH NEW YORK STOCK EXCHANGE GUIDE ¶¶ 2401-11 [hereinafter cited as NYSE GUIDE].

7 Excess margin securities are the securities in a margin account not thought necessary to secure a customer's indebtedness. This has been interpreted to mean those securities in excess of 140% of the customer's debit balance. *Id.* ¶ 2402.70.

8 *I.e.*, the broker's name or that of another broker. Certificates thus registered and indorsed in blank are freely transferrable. They are utilized particularly in trading accounts where indorsement by the customer in each transaction would be burdensome.

9 *See* 3 COLLIER, *supra* note 5, ¶ 60.74, at 1183.

10 2 NYSE GUIDE, *supra* note 6, ¶ 2402.60.

theoretically has an undivided proportional interest in all certificates of that issue held by the firm in bulk segregation. Under both systems of segregation, the rules forbid the pledging of a customer's securities without his authorization.[11] A margin customer's blanket consent is sufficient, but the cash customer's authorization must relate specifically to the securities sought to be pledged.[12]

On the other hand, there is no requirement that the broker segregate or seek authorization to use free credit balances—the cash owed to customers, and to which they have an immediate unrestricted right of withdrawal.[13]

B. *The Central Certificate Service*

The New York Stock Exchange has had a central clearing system in operation for some time, but CCS will greatly expand the present system.[14] Member firms transmit most of their proprietary and non-proprietary securities to the central depository;[15] the securities are then registered in the name of "Cede & Co.," a nominee of Stock Clearing Corporation.[16] The registered certificates, converted to large denominations, are then, with the exception of a small CCS working supply, deposited in custodian banks.[17] All subsequent transactions

11 *Id.* ¶¶ 2402(b), (d).

12 *Id.*

13 Virtually the only restriction upon the broker's use of these funds is SEC rule 15c3-2, which requires only that a written statement be sent to the customer, at least once every three months, of the amount owed him, including a notice that the funds are not segregated and may be used in the broker's business. Prior to the recent promulgation of this rule, brokers were not even required to notify customers that their funds were used in firm operations. *See* SEC Securities Exchange Act Release No. 7325 (May 27, 1964).

Free credit balances are the source of millions of dollars of interest-free capital which brokers use to finance loans to their other customers. "Merrill Lynch, Pierce, Fenner & Smith, Inc., for example, in its annual report to the Commission for 1961 stated that on May 26, 1961, it held approximately $233 million in free credit balances. This is by far the largest firm in the country, but other firms hold free credit balances in amounts running into millions of dollars." 1 SPECIAL STUDY, *supra* note 1, at 394.

On November 1, 1968, Shearson, Hammill & Co., Inc. held $41,419,965 in free credit balances, representing 18% of the firm's total current liabilities. N.Y. Times, Dec. 14, 1968, at 59.

14 The present system involves netted position changes settled through a clearing house, Stock Clearing Corporation (SCC). This netting process eliminates only about 30% of physical deliveries. Stock Clearing Corporation, Central Certificate Service (CCS): Outline of Major Operational Functions of Central Method for Handling Securities 2 (October, 1967) [hereinafter cited as SCC Outline].

15 Included will be fully paid and excess margin securities, as well as margined but unhypothecated shares.

16 Phillip L. West, Vice President of the New York Stock Exchange, Memorandum to Secretaries of Domestic Listed Companies Re: CCS—Central Certificate Service.

17 SCC Outline, *supra* note 14, at 3.

must be cleared through the central system's computer accounting facilities, with appropriate adjustments being made in the accounts of the members involved. Except when specifically requested, no physical transfer of securities takes place. If a customer requests registration in his own name and individual segregation, the clearing member simply instructs CCS to debit appropriately his member account and to forward a "Cede & Co." certificate from the CCS working supply to the transfer agent for registration in the customer's name. Similarly, pledges of shares by brokers to obtain loans to finance their customers' margin accounts are accomplished by a simple bookkeeping entry, transferring the securities to the account of the pledgee bank.[18]

CCS will dramatically increase the efficiency of securities transfers. There will also be an important secondary effect upon segregation systems: Only bulk segregation will be available to a member desiring to utilize the service. Firms that presently individually segregate their customers' fully paid or excess margin securities will be obliged to adopt the bulk method.[19] Furthermore, segregation will be of record only—the securities themselves will be held by CCS. Free credit balances, however, will be unaffected[20] by CCS since they are not maintained within the system.

The interaction of this new system and the Bankruptcy Act should be examined with a view to determining whether the Act can be effectively applied under this altered framework for transfers.

II

SECTION 60e

A. *Legislative History*

The 1938 amendments to the Bankruptcy Act[21] were designed to bring uniformity to the chaotic administration of bankrupt estates under widely divergent and often conflicting state rules. Section 60e

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18 Allocation on the record books is to have the same effect as if the pledged shares were actually delivered, but the pledgee may still ask to have certificates representing pledged collateral physically transferred to it by the custodian bank. SCC Outline, *supra* note 14, at 4.

19 *See* Stock Clearing Corporation, Central Certificate Service: Operating Procedures for Clearing Members 3 (revised April, 1968).

20 For example, cash dividends declared on stock held within CCS will be paid to "Cede & Co." and disbursed immediately to the clearing member. *Id.* at 19; SCC Outline, *supra* note 14, at 4.

21 11 U.S.C. §§ 1, 11, 21-29, 32, 33, 35, 41-55, 62, 63, 65-70, 72-81, 91-96, 101-12, 203(b), 403(j), 501-1103 (1964); 18 U.S.C. §§ 151, 3057, 3284 (1964).

was specifically added to standardize the liquidation rules applicable to the bankrupt stockbroker's assets and to improve the position of margin customers.[22] Under the then-prevailing "New York rule," the margin customer was thought of as the owner of stock in the broker's possession.[23] Stock certificates were considered fungible, and the margin customer could therefore claim his securities, subject to a pledge for the unpaid balance, by merely showing that he was entitled to shares of the same issue as those found in the bankrupt's custody.[24] However, if the broker no longer had the same or similar stock, the customer's reclamation claim failed and he became only a general creditor. Such a result was unfair in most cases since recovery was a function of the irrelevant fact that a broker-dealer had misappropriated one issue of securities but not another.

The members of the National Bankruptcy Conference,[25] the draftsmen of the new subdivision, thought that distribution among margin customers as a class should not depend upon the fortuitous circumstance of whether or not the broker retained a certain type of stock.[26] Accordingly, their express intent was that, unless the certificate was "specifically allocated or physically set aside, it must be thrown into the fund for distribution to all customers of the single class."[27] In effect, the "New York rule"—premised on ownership—was rejected, at least with respect to margin customers, and the so-called "Massachusetts rule," which treated the relationship between stockbroker and customer as that of debtor and creditor, was adopted instead.[28] Equality of distribution among margin customers pervades both the history and the ultimate form of section 60e.

For reasons not apparent from the legislative history, however, unequal distribution remained among cash customers; they continued

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22 HOUSE COMM. ON THE JUDICIARY, REVISION OF THE NATIONAL BANKRUPTCY ACT, H.R. REP. No. 1409, 75th Cong., 1st Sess. 31 (1937). *See also* Gilchrist, *Stockbrokers' Bankruptcies. Problems Created By The Chandler Act*, 24 MINN. L. REV. 52, 57 n.29 (1939); McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369, 395-98 (1937); Note, *The Bankrupt Stockbroker: Section 60(e) of the Chandler Act*, 39 COLUM. L. REV. 485, 490 n.41 (1939).

23 Richardson v. Shaw, 209 U.S. 365 (1908).

24 *Id.*; Duel v. Hollins, 241 U.S. 523 (1916).

25 For an interesting description of the origin and operation of the Conference, see McLaughlin, *supra* note 22, at 376-77.

26 HOUSE COMMITTEE ON THE JUDICIARY, ANALYSIS OF H.R. 12889, 74th Cong., 2d Sess. 193 (Comm. Print 1936).

27 *Id.*

28 Note, *supra* note 22, at 496. For articulation of the drafters' "creditor" approach, see *Hearings on H.R. 6439 Before the House Comm. on the Judiciary*, 75th Cong., 1st Sess. 125-26 (1937).

to be entitled to reclamation in certain narrowly defined situations.[29] The drafters appear to have assumed that their desire to promote distributive equality of all customers by treating them as creditors *inter se* would not be frustrated by allowing reclamation to those few cash customers who could comply with the much stricter identification requirements of the new statute.[30] This assumption was valid since there was then no segregation requirement among the New York Stock Exchange rules governing the conduct of customers' accounts.[31] Barring voluntary segregation by the broker, therefore, few customers would properly be able to identify their securities even if they had not been misappropriated.

B. *Operation*

In broad outline, section 60e provides for a three-tiered system of distribution: (*1*) Cash customers[32] are entitled to reclaim their identifiable cash and securities, apparently on the theory that they are still owners of specific property; (*2*) those cash customers who cannot identify their property[33] and all margin customers share to the extent of their individual net claims against the bankrupt stockbroker in a fund comprised of all customers' property not reclaimed; and (*3*) customers whose claims are not satisfied out of the fund participate with the general creditors in the residue of the estate.

Under subdivision (2), all customers, except those cash customers who are able to specifically identify their property in the manner described in subdivision (4), are entitled to share pro rata, based upon their "net equities,"[34] in a "single and separate fund." The fund is

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29 The primary focus of the drafters was upon the rights of margin customers. *See* Gilchrist, *supra* note 22, at 57 n.29.

30 It may be contended that the broker is the bailee of fully paid securities held in safekeeping for his customers. However, for the view that even the cash customer who fails to insure that his securities are segregated has in fact trusted the credit of the broker and so become a creditor, see McLaughlin, *supra* note 22, at 397.

31 *See* 1 W. BLACK, STOCK EXCHANGES, STOCKBROKERS & CUSTOMERS 880-85 (1940).

32 "Customers" *generally* are persons with claims on account of securities received, acquired or held by the stockbroker from or for their accounts. "Cash customers," however, are only those customers entitled to immediate possession of their securities without further payment to the broker. *Query* whether a customer not entitled to immediate possession of fully paid securities but with a free credit balance in his account is also a "cash customer."

33 "Property" is defined in subdivision (1) to include cash and securities, whether or not negotiable.

34 The "net equity" of a customer's account is his net claim against the broker, based on the liquidation price of his securities on the date of bankruptcy, and after excluding any specifically identifiable securities subject to reclamation under paragraph (4).

comprised of all property at any time received, acquired or otherwise held by the stockbroker from or for the account of his customers, including the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker.[35] If the "single and separate fund" is not sufficient to pay in full the claims of the preferred customer-creditors, they are entitled to share in the residue of the estate with the general creditors.

Finally, subdivision (4) provides for the determination of which securities are specifically identifiable and therefore subject to reclamation. Neither form of property, cash or securities, is reclaimable unless the property either remained in its identical form in the stockbroker's possession until the date of bankruptcy or was allocated or physically set aside for the customer more than four months prior thereto.

C. *Diminished Effectiveness: Problems Posed by Cash Balances, Bulk Segregation Systems and CCS*

Section 60e fails to define adequately the circumstances under which free credit balance cash can be reclaimed. Cash is theoretically subject to reclamation because it is expressly included in the 60e(1) definition of reclaimable property. However, the specified identification requirements of 60e(4) are virtually impossible to satisfy with respect to cash claims because there are no NYSE rules requiring segregation of free credit balances. Since such cash is usually commingled with other funds in the brokers' operating accounts, the right of reclamation is largely illusory.[36] Moreover, free credit balances will be outside the CCS system,[37] so no change is impending. However,

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35 Some confusion, with respect to the property to be included in this fund, is caused by the punctuation in paragraph (2). Because of the insertion of a comma after "customers" in the second line and after "stockbroker" in the fifth line and because of the failure to insert a comma after "subdivision" in the fourth line, it might be urged that the fund in which customers are entitled to share would not include the "proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker" and that customers whose property was so transferred or converted should be relegated to the position of general creditors.

3 COLLIER, *supra* note 5, ¶ 60.73, at 1171.

Both the previous drafts of this paragraph and the language of paragraph (4), however, would seem to indicate the intent that such "proceeds" be included, and that the customers affected share, in the "single and separate fund." *Id.* ¶ 60.73, at 1171 n.17.

36 A New York Stock Exchange attorney expressed to an investigating House subcommittee his doubt that free credit balances are reclaimable under the present statute. *See Hearings on H.R. 6789, supra* note 5, at 1147.

37 Cash dividends on stock held within the system will be paid directly to the clearing member for transfer to the customer or his account. *See* Stock Clearing Corporation, Central Certificate Service: Operating Procedures For Clearing Members, *supra* note 19, at 19 and note 20 *supra*.

requiring segregation to protect the customer under 60e(4) would seriously impair the industry's use of a valuable source of cash; on balance, it is an unacceptable solution.[38] To safeguard both debtor and creditor, the concept of reclamation with its attendant requirement of physical identification must be discarded, and priorities of distribution should be established on some other basis grounded in commercial fact.

Reclamation of securities held in bulk segregation systems seems no more useful as a means of distributing assets than does recovery of individual cash balances from brokers' accounts. Specific identification in either instance is both difficult and irrational as a basis for establishing priorities of distribution. Practices vary, but generally the broker's stock records are the only means of identifying an individual customer's interest in the mass. Although NYSE counsel has stated that securities segregated in this manner are sufficiently identified by allocation in the records to subject them to reclamation under 60e(4),[39] ownership of physically identifiable shares appears too tenuous a theory to support such claims. Underlining this doubt, the SEC's *Special Study* recommended amending 60e to make reclamation from bulk segregation explicitly permissible.[40]

Such an amendment, however, would not solve the additional problems posed by CCS. Obviously, CCS is not merely an automated bulk segregation system. Because it serves as a *central* depository and clearing agent, the resulting commingling will affect not only fully paid and margined securities, proprietary and nonproprietary, but also the securities of many different brokerage firms and their customers. Although the individual customer's interest will be recorded separately, such records will soon be maintained not in visually readable form but rather in some type of random computer storage.[41] Thus any right

38 In testifying before an investigating committee, SEC Chairman Cary endorsed the idea of a reserve requirement, but expressed his opinion that segregation requirements should be imposed only in the event no other means of protecting free credit balances proves practicable. *See Hearings on H.R. 6789, supra* note 5, at 1248. The Special Study noted that "serious dislocation" would occur from denying brokers access to such funds. 1 SPECIAL STUDY, *supra* note 1, at 401.

39 *See Hearings on H.R. 6789, supra* note 5, at 1147. *But cf.* COLLIER, *supra* note 5, ¶ 60.74, at 1187 ("this conclusion is not free from doubt").

40 1 SPECIAL STUDY, *supra* note 1, at 414.

41 CCS utilizes, in its "main line" operation, an IBM 360/50 computer, a 2311 disc storage unit, two 1403 printers and 10 magnetic tape drives. Letter from Charles F. Lynch, Secretary of Stock Clearing Corporation, November 26, 1968, on file with the *Cornell Law Review*.

Collective customer account information could be fed directly into this or similar equipment, stored in machine readable langnage and printed out in the form of individual visually readable records only upon a programmed request.

of reclamation based on physical segregation and specific identification becomes even more attenuated than it was with respect to bulk segregation.

Perhaps the fundamental weakness of 60e in light of current segregation practices and the implementation of CCS is that the same inequities which the drafters of 60e sought to eliminate among margin customers now work against cash customers. Violation of segregation and consent rules can be anticipated, despite the sanctions invoked thereby, in the panic immediately preceding bankruptcy.[42] CCS, at least as presently contemplated, will serve no regulatory function which might remedy the situation; the broker will be free to withdraw customers' securities from the central depository or pledge them as collateral, and he will maintain the records of their individual accounts. The probability continues, therefore, that the rules will be violated under the pressures of impending financial disaster. The result, of course, is inequality of distribution among customers since reclamation is based on the entirely fortuitous circumstance of whether or not the broker has misappropriated all or part of one issue of securities rather than another.

III

GUIDELINES FOR THE PROPOSED AMENDMENT

A. *Distribution of Securities: The Consensual Basis for Treating the Cash Customer as a Creditor*

The foregoing deficiencies, most of which will be aggravated by the implementation of CCS, indicate that section 60e fails to achieve its avowed purpose of insuring uniform disposition of bankrupt stockbrokers' estates based upon fair distribution rather than notions of legal title. Although reclamation may often be desirable, and perhaps constitutionally mandatory,[43] it should be strictly circumscribed to prevent dilution of the distribution to general creditors and other customers with substantially similar claims. In any case, full compensation should not be conditioned upon the anachronistic concept of

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42 "No statute can protect the customer against the dishonest broker who, having possession of securities registered in 'street name,' sells or pledges them to a bona fide purchaser in violation of his legal duty." Israels, *Article 8—Investment Securities*, 16 LAW & CONTEMP. PROB. 249, 259 (1951) (footnote omitted).

43 The federal bankruptcy power is subject to the due process clause of the fifth amendment. *See* Wright v. Vinton Branch, 300 U.S. 440 (1937); Louisville Bank v. Radford, 295 U.S. 555 (1935).

"finding" physically identifiable property. Similarly, the theory of ownership which presently supports the cash customer's reclamation privilege is at best a tenuous justification in view of the realities of securities transactions and the procedures used in the conduct of customer accounts.

First, there is good reason for viewing even the cash customer as a creditor of the bankrupt broker. One of the drafters of 60e observed that "the so-called 'cash' customer who delivers his security for sale to the broker and gets caught in a 'last day transaction' has in fact trusted the general credit of the broker . . . ."[44] Moreover, the cash customer rarely expects to receive a specific certificate,[45] but rather considers all securities of a particular issue to be fungible. Viewed in this way, the cash customer looks more like a creditor than an owner. Indeed, the original intent of section 60e was to treat all customers as creditors[46]—both ease of administration and equality of distribution result from such treatment.

But there must be some reason why the ownership theory and the attendant right of reclamation were retained by the Chandler Act with respect to cash customers. Relegating the cash customer to the same status as the margin customer is open to at least two objections: Limitations upon the federal bankruptcy power probably preclude arbitrarily lumping all customers into a single class of creditors;[47] and customer confidence may be impaired if no priority in distribution is accorded the cash customer. As a practical matter, the insecurity produced by the latter could cause customers to withdraw their securities from CCS in sufficient volume to frustrate the essential purpose of the system.

However, neither objection would obtain if reasonable priorities were established which recognized the superior claim of the cash customer by providing for equitable distribution among a preferred class of creditors rather than by granting reclamation to a few fortunate owners.[48] Present rules requiring the consent of the customer to

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44 McLaughlin, *supra* note 22, at 397.

45 Even if this is not strictly true in the isolated situation where a customer leaves specific securities with the broker for safekeeping purposes, it is certainly the case where a customer permits often-traded securities to be registered in street name and held in bulk segregation or in a central depository.

46 3 COLLIER, *supra* note 5, ¶ 60.75, at 1190 n.1.

47 The federal bankruptcy power apparently does not extend to distribution of property such as fully paid securities in which the bankrupt has *no* property interest. *Id.* ¶ 60.73, at 1176.

48 Due process does not bar equal treatment of claimants of the same standing. *In re* McMillan, Rapp & Co., 123 F.2d 428, 432 (3d Cir. 1941).

the broker's use of his securities, and the cash customer's option under CCS to have his securities withdrawn from the central depository and segregated for his account, provide a framework for establishing a system of priorities.

Before a cash customer's securities may be pledged, specific consent must be obtained.[49] Where no such consent is granted, *and* where the customer specifically requests that his securities be withdrawn from CCS and segregated in his own name, the proposed amendment should permit reclamation of the securities regardless of the broker's compliance with the customer's wishes. Under these circumstances, there is no basis for finding express or implied consent to a waiver of ownership rights. The vast majority of cash customers will not, however, request that their securities be separated from the mass in the central depository. They should be deemed to have relied upon the broker's credit and to have manifested their willingness to share with other customers similarly situated as tenants in common of the securities on hand. Provision should therefore be made for these customers to share as a separate preferred class of creditors in a fund comprised of their aggregate record holdings. In some cases, fewer securities of the issues in which cash customers have an interest will be credited to the CCS account than the bankrupt broker's records indicate should be on deposit. Participation in the fund will then be on a pro rata basis. Because most cash customers are not able to satisfy the identification requirements of the present section and are consequently relegated to participation in the "single and separate fund" diluted by the claims of margin customers, recovery under the proposed amendment will be more favorable.

B. *The Margin Customer as a General Creditor*

Despite the Chandler Act's rejection of reclamation of margined securities on the basis of partial ownership, margin customers under section 60e enjoy a preferred status vis-à-vis general creditors.[50] There is no apparent justification for continuing this priority. Elimination of other legitimate creditor claims[51] from participation in the "single and separate fund" seems highly inequitable for two reasons: The margin customer normally knows the risks involved in dealing with

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49 2 NYSE GUIDE, *supra* note 6, ¶¶ 2402(b), (d).

50 Under prior law, the margin customer who was unable to identify his securities had no better claim than the general creditors.

51 *E.g.*, salary claims, equipment and building rental fees or lease payments, and unsecured bank obligations. The potential magnitude of the latter is illustrated by the $18 million in unsecured "day loans" which the Haupt brokerage firm was unable to repay during the 1963 crisis. *See* N.Y. Times, Nov. 25, 1963, at 27, col. 8.

the broker as well as the excluded general creditors;[52] and the margin customer generally gives blanket consent to the hypothecation of his securities[53]—thereby assuming the risk of misappropriation by the broker. Furthermore, since the margin customer does not have the right to withdraw his securities from CCS by requesting the issuance and segregation of specific certificates, there is no danger that the operation of the new system will be impaired by denying margin customers distributive priority. Accordingly, the proposed amendment should give preference only to the claims of cash customers.

C. *Distribution of Cash: The Free Credit Balance Problem*

CCS is presently only a vehicle for the transfer of securities; cash in the form of free credit balances will still be held by the broker. For this reason, and because the reclamation of cash balances is peculiarly inappropriate even under present practices,[54] the proposed amendment should contain a separate provision to deal with this problem.

Under present section 60e, free credit balances generally fall into the "single and separate fund" for distribution to all customers who are unable to reclaim their securities. There is no reason for this. Participation of customers entitled to free credit balances in the "single and separate fund" dilutes distribution to other margin and non-identifying cash customers. Due to the absence of restrictions upon the use of free credit balances,[55] cash will rarely be contributed to the fund. On the other hand, should there be credit balances available for distribution, there is no reason why margin customers should have any claim thereto. Since cash is not identifiable property, there is no justification for separating it from the general estate of the bankrupt or for preferring free credit balance claimants to general creditors on the basis of ownership.[56] Moreover, the person who leaves

52 The small investor cash customer, on the other hand, may often not be financially knowledgeable.

53 1 SPECIAL STUDY, *supra* note 1, at 390-91.

54 3 COLLIER, *supra* note 5, ¶ 60.75, at 1192 & n.11.

55 Under the laws of some of the States, specific restrictions do exist upon the manner in which customers' free credit balances may be held. For example, Iowa requires that customers' free credit balances be segregated from firm accounts. Ohio requires that customers' free credit balances be segregated if the net capital of a broker-dealer falls below $10,000 or his "total indebtedness" exceeds 15 times his "net worth." Apart from State law, however, there are no direct restrictions on the manner in which customers' free credit balances are held and used by broker-dealers.

1 SPECIAL STUDY, *supra* note 1, at 400 (footnotes omitted).

56 Of course a balancing of policies is involved. If, as a policy matter, it is good to promote cash balances, then they should be protected. If the policy is to promote withdrawal of idle funds from brokerage houses, then they should not be protected. The importance of cash balances to the industry would seem to tip the balance in favor of the former.

his cash with a brokerage firm is ultimately trusting the broker's credit. The proposed amendment, therefore, should assign general creditor status to free credit balance claimants.

CONCLUSION

There is no entirely satisfactory solution to the problem of distributions in stockbrokerage bankruptcies. The best result involves spreading the inevitable losses among as many creditors as possible. To this end, the amendment proposed herein has grudgingly preferred the cash customer, solely on the policy of sustaining confidence in the CCS.[57]

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[57] Ultimately the only truly effective remedy will be to provide preventive measures outside of § 60e. The comparatively unregulated use of the cash surplus in customer accounts makes increased protection of cash balances essential. As an alternative to undesired segregation requirements, the NYSE has considered the voluntary establishment of a reserve fund to reimburse free credit balances losses. *See* NYSE President Funston's statement in *Hearings on H.R. 6789, supra* note 5, at 1093. This would place the burden of maintaining investor confidence in free credit balances on the industry, where it belongs, and not on assorted creditors. Following the *Ira Haupt* debacle, a $25 million fund was created. *See* N. MILLER, THE GREAT SALAD OIL SWINDLE 232 (1966). However, in order to avoid the self-imposed role of insurer, the Exchange has repeatedly disclaimed any acceptance of an implied obligation, from its liquidation of the Haupt firm and reimbursement of its customers, to guarantee all customer losses in the event of a member firm's insolvency. *Hearings on H.R. 6789, supra*, at 1139.

Another alternative is the liquidity requirement such as that suggested by the SEC's Special Study:

> It would seem desirable that broker-dealers . . . be required to maintain reserves of cash or Government obligations equal to a percentage of free credit balances. Although the question of percentage may be left for future determination, it would appear that a reserve requirement of about 15 percent would be feasible, would bear some relation to the requirements of Federal law for banks and would force broker-dealers to maintain themselves in a more liquid status than some do now.

1 SPECIAL STUDY, *supra* note 1, at 401.