PUBLICATION

Transactions with Broker/Dealers

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In conducting transactions with a broker/dealer, a party may be a customer, a secured or unsecured creditor, or simply a contractual counter-party. Given the recent volatility in the global financial markets, it is important for entities that engage in transactions with broker/dealers to understand the differing levels of protection afforded by their legal status in connection with a particular transaction.

Role as a Customer: As the customer of a broker/dealer, your account is insured by the Securities Investor Protection Corporation (SIPC) up to $500,000. SIPC insurance does not provide insurance to you or others from market losses, but instead provides customers of the brokerage firm the ability to reclaim their actual securities held at the broker/dealer. The protection afforded under the SIPC's rules does not extend to those who finance the operations of the broker/dealer. As such, parties who are engaged in repurchase or swap transactions and have broker/dealers as counterparties need to be aware of two things: (a) they will not be able to claim SIPC protection in the event of the broker/dealer's default, and (b) since they are not "customers" of the broker/dealer, they instead become general creditors of the broker/dealer in the event of default.

Role as a Secured Creditor: As counterparty in a repurchase transaction, the securities borrowed are used as collateral to secure the transaction. If you enter into such a transaction and the broker/dealer defaults on the obligation, the transaction is not covered by the SIPC, but you are treated as a secured creditor.

Role as a Contractual Counter-Party: A useful perspective to keep in mind with respect to broker/dealers as counterparties to a swap is that the counterparty is not actually the broker/dealer and all of its customer accounts, but instead is the broker/dealer and the revenue it derives from its accounts, minus its other liabilities. Swap collateral is quite valuable to broker/dealers, insofar as that collateral may be treated as an actual asset of the broker/dealer for regulatory purposes and leveraged and/or hypothecated. For these reasons, many broker/dealers have preferred to essentially provide cash flow for their firms through swap transactions, rather than lending clients funds that likely couldn't be counted on balance sheets as customer assets. In short, if you wish to use corporate financing tools to manage cash flow, you need to be aware that swap transactions are not substitutes for loans, and that they have risks very much dependent upon the financial solvency of their counterparty. Counterparty risks are among the many risks that corporate treasurers and others must keep in mind as they seek viable, economic financing alternatives.