When Securities Firms Fail:

An Inside Look at the Marlow Group Bankruptcy

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Following the U.S. financial meltdown that began in September 2008, stock markets around the world have experienced unprecedented volatility. While the impact of the crisis reverberated in many sectors, the financial services industry was particularly hard hit. Brokerage firms saw fee revenues fall as a result of reduced trading activity. Declining margin loans also put a squeeze on interest revenues.

In addition to shattering investor confidence, the credit crunch called investment firm practices into question. With media headlines predicting the failure of securities firms and other market intermediaries, investors have become worried about the safety of their investments.

What happens when a securities firm goes bankrupt? How can investors protect their money? If you have ever administered the bankruptcy of a securities firm, or represented anxious investors, you know there are no easy answers to these questions. Unravelling the affairs of a failed securities firm, and distributing its remaining assets, is fraught with legal and practical complexities.

Notably, however, the January 2006 case of *Ashley v. Marlow Group Private Portfolio Management Inc. (Marlow)* addressed some of these issues. By reviewing the outcomes of that case, insolvency and restructuring professionals can gain important insight into the full extent of Canada's investor protection laws. At the same time, you can begin to better understand the role of Part XII of the *Bankruptcy and Insolvency Act (BIA)* in securities firm bankruptcies.

To appreciate the importance of Part XII of the *BIA*, it helps to understand the legislative state of affairs prior to its enactment in 1997. Until that time, the administration of securities firm insolvencies was extremely time-consuming and uncertain.

In an effort to recover their shares, customers of bankrupt securities firms invariably raised trust claims, invoking centuries-old "tracing" concepts. As one U.S. court lamented (in *Slattery & Co.*), "probably no branch of bankruptcy administration presents more troublesome questions of law and administration than does the insolvency of a stock brokerage or investment concern."

Meanwhile, as those claims inched through the courts, the Receiver or trustee would have in its possession volatile securities, whose values could potentially diminish while the various customers battled to have their securities returned.

With the introduction of Part XII of the *BIA* in 1997, Parliament sought to oust all trust claims from securities firm bankruptcies and allow for the return of only "customer name securities."

The goal of this rule was to promote a simplified, and hopefully more equitable, distribution process. Since it can be difficult to trace the ownership of individual securities, Part XII mandates that only those securities registered in customers' names will be returned to customers. All other securities and cash would be put

into a general "customer pool", to be distributed pro rata to customers.

Enter the Marlow case. In March 2005, the Marlow Group of companies, which operated as securities dealers, investment dealers and investment advisors, was placed into receivership. Apparently, more than $3 million had vanished from clients' trust accounts, causing the Ontario Securities Commission to suspend the company's affairs. While investors scrambled to locate their missing money, the Ontario Court appointed our firm as Receiver. Our mandate was to identify and secure the Marlow Group's assets, quantify the losses and determine the most suitable basis on which to distribute the remaining funds.

Despite the fact that the Marlow case seemed a perfect fit for Part XII of the *BIA*, some investor groups challenged its application. One group claimed that certain securities, although not registered in its customers' names, were being held in trust and should, therefore, be returned. Another group, claiming Marlow wasn't yet technically bankrupt, tried to obtain last-minute name registration of its securities. Yet another argued that Marlow was not a securities firm at all, but merely an investment advisor, and that buying and selling securities for its customers was not its primary business activity.

To give these parties the opportunity to have their positions heard, the Receiver brought a motion for directions before the Court to determine whether the Marlow Group should become bankrupt and whether its bankruptcy should be administered in accordance with Part XII. The various parties brought cross-motions, setting out their respective positions.

In the end, though, the Court held that the Marlow Group of companies was to be assigned into bankruptcy. The Court also affirmed that the bankruptcy of those companies that were securities firms was to be administered in accordance with Part XII. In fact, the Judge went to great lengths to consider what comprises a "securities firm" and so falls under Part XII. Essentially, the definition includes "a person who carried on business of buying and selling securities to, from or for a customer, whether or not as a member of an exchange, as principal or agent..." The Marlow case acts as clear judicial affirmation that securities firm bankruptcies should be administered under Part XII.

The Court also considered the definition of what constitutes a "customer name security." Its finding was that, unless securities are registered in the name of the customer, or are in the process of being registered, they are not "customer name securities." As such, they do not need to be returned to customers. Notably, current practice is generally not to register securities in customers' names as an electronic system of registration of security interests is employed. In Marlow, most investments were purchased and held in the name of a Marlow entity and shares were notionally allocated to individual investors. Thus, even though Marlow held more shares of a particular investment than there were claims against those shares, they all fell into the customer pool fund for pro rata distribution to all customers.

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This raises interesting questions regarding the protection of investors' money. Legal and accounting professionals should pay particular heed. To prevent investor securities from falling into a general customer pool for distribution, advisors should try to have securities registered in their customers' names as soon as the securities are purchased.

There are also other steps that advisors should take in light of the Court's decision. For instance, to reduce the risk of fraud or misappropriation, investors should aim to deal with only credible institutions. Large banks and investment dealers are strictly regulated and may be more likely to have better controls over trust funds. Admittedly, the failure of major U.S. investment firms like Lehman Brothers and Merrill Lynch can negate this argument. However, Canadian investment firms tend to be more closely regulated than their American counterparts, which can provide domestic investors with more effective protection.

Similarly, the Canadian Investor Protection Fund (CIPF) also protects some of the cash and securities of eligible customers of investment dealers that are members of the Investment Industry Regulatory Organization of Canada. This was of little value, however, in the Marlow case. Only one of the Marlow corporate entities was a CIPF dealer member. While the investors of that company suffered minimal losses, investors of the non-insured entities were not as fortunate. From an investor protection standpoint, then, it's important for advisors to ensure that securities firms are registered with the CIPF in advance of making client investments.

Other protection strategies include working with more than one securities firm to diversify the risks of mismanagement and moving quickly to protect assets at the first sign of trouble. Sadly, by the time a trustee in bankruptcy or Receiver enters the picture — after the Ontario Securities Commission institutes proceedings — it's often too late.

Marlow investors recovered more than $0.70 on the dollar. In too many instances, losses cut much deeper. RS