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Evan R. Chesler

THE TREATMENT OF SECURITY OPTIONS IN SIPA LIQUIDATIONS: A CALL TO PUT ORDER IN THE LAW

*EVAN R. CHESLER**

I. INTRODUCTION

CONGRESS passed the Securities Investor Protection Act of 1970 (SIPA)[1] in an effort to provide protection for the customers of unsuccessful brokerage firms.[2] Under this legislation, the Securities Investor Protection Corporation (SIPC) was established[3] to finance the protection of customers of defunct brokers. It seemed that Wall Street had become early prey of the new consumerist age.

Yet, as often happens in the case of miracle cures, there are classes of casualties who escape the eye of the developer. Such appears to be the fate of the option writer unfortunate enough to be the customer of a broker liquidated under SIPA. It is the purpose of this Article to identify the nature of the "option problem," explore possible means of dealing with it, and suggest an effective solution.

II. BACKGROUND OF THE PROBLEM

A. *Nature of the Option Arrangement*

A prerequisite to understanding the option problem in the SIPA liquidation context is a familiarity with the option arrangement. There are two basic forms of options: "puts" and "calls." Although various combinations of these two forms can create other option varieties, for present purposes one need only be acquainted with the basic two and their simple combination, the "straddle."

An option is sold by a "writer," whose obligation under the option agreement is, in effect, guaranteed by an "endorser," usually the writer's stockbroker.[4] The option is purchased by the "holder," in whom the sole discretion to exercise resides.

The holder of a put has purchased (for a fee called the "premium") the right to sell (or "put") to the writer a certain quantity of a given

* Member of the New York Bar; J.D., 1975, New York University School of Law.

1. 15 U.S.C. §§ 78aaa-78*lll* (1970).

2. See SEC v. Alan F. Hughes, Inc., 461 F.2d 974, 977 (2d Cir. 1972).

For a general discussion of SIPA, see Sowards & Mofsky, The Securities Investor Protection Act of 1970, 26 Bus. Law. 1271 (1971); Note, The Securities Investor Protection Act of 1970: An Early Assessment, 73 Colum. L. Rev. 802 (1973); Note, The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection, 24 Vand. L. Rev. 586 (1971).

3. 15 U.S.C. § 78ccc (1970).

4. See note 10 infra.

security at a stated price (the "strike price") for a predetermined period of time. Similarly, the call holder has purchased the right, should he choose to exercise it, to buy (or "call") from the writer a quantity of shares of a particular security, again at a stated price for a fixed period.

Simple logic dictates that the put holder will only exercise his option if the market price of the security falls sufficiently below the strike price to make such a sale profitable (taking into account, of course, the premium which the holder originally paid for the option). By the same token, the call holder hopes that the market price will climb sufficiently above the strike price to justify calling the writer's stock. A quick profit could then be made by "buying" at the strike price and immediately selling on the open market. A more speculative holder might exercise the call and hold the stock for still greater market price increases.

The writer is often gambling that the market price of a security on which he has sold an option will not fluctuate in such a way as to trigger the option's exercise. If it does not, the writer has made a profit equal to the premium received, less relatively minor transactional costs. If the option is exercised, the writer is forced to pay more for shares than they are worth, or to sell shares at a price well below their current value.

However, the writer does not always hope for the expiration of the option without exercise by its holder. Thus, a writer may sell a straddle—a put and a call for the same quantity of shares at the same price. If both options, which are not necessarily sold to the same investor, are exercised, the writer will effectively be returned to *status quo ante*, but enriched by his experience as well as by the two premiums originally paid for the options. Moreover, the writer is often able to avoid the negative consequences of an option exercise by "hedging" his bet. That is, the writer may make other purchases or sales of the same security to offset any loss arising from the option's exercise.

A concrete example may clarify the point. The writer of a put, by the terms of which he agrees to buy 100 shares of X Corporation at $5.00 per share, may, at the time he writes the option, sell short 100 shares of X Corporation at or near $5.00 per share.[5] If the market

5. The term "selling short" essentially means to sell stock one does not then own. The purchaser, on the other side of such a transaction, receives his stock as in any other purchase. However, the short seller's broker obtains the shares for delivery to the purchaser by means of an inter-broker loan; that is, the short broker borrows the stock from another broker and delivers same to the purchaser's broker on the settlement date of the transaction.

price falls to $2.00, and the holder exercises his option, the writer will be forced to buy $200.00 worth of stock at $500.00. By virtue of his hedging, however, the writer is now able to cover his short position with the shares received from the holder, and thereby gain the release of the $500.00 in proceeds from the short sale. Disregarding commissions and the like, the writer has realized a net profit approximately equal to the premium paid by the holder for the option.[6]

The writer's ultimate position is also a function of what he initially contributed to the transaction. Margin account regulations require that the option writer deposit with his endorser/broker the funds or securities necessary to cover the option commitment.[7] Thus, for example, the writer of a call must deposit the shares on which he has sold an option. While exercise of the option will take these shares from the writer, depending on the price at which he originally purchased the shares, he may not actually lose money. Thus, if shares were purchased at $10.00 and a call was written at $15.00, the writer will clearly make a profit should the option be exercised. Of course, the shares may have traded at $20.00 at the time of the exercise, but this "loss" is more aptly deemed a "failure to realize additional profit."

Often, however, it is the writer's speculative ability which will determine the ultimate profitability of his option transactions. At the time an option is exercised there may be no more than a paper loss to the writer. His willingness to ride out the market's uneven seas could convert such a technical loss into a hard cash profit. Thus, the put writer may retain his depressed acquisition only to have it climb above the strike price. Similarly, the writer from whom an inflated stock was called—at a bargain to the holder—may survive to the day when he can buy back into the security with less than the proceeds received from the option's exercise. Alternatively, the call writer who bought an equal number of shares on the open market at the time he wrote the now exercised option[8] can sell and recover his "loss," or hold on for still greater profits.

One sells short for just the opposite reason that one "buys long." The short seller is gambling that the security's market price will fall, and that the shares which he (and his broker) owe to the lending broker can be purchased at the lower price and returned. The difference between the original proceeds of sale and the "buy in" price is the net profit realized by the short seller.

6. The call seller may also hedge. He might, for example, buy on the open market the same quantity of shares on which he has sold a call option. If the market price increases, and the call is therefore exercised, the option writer still has a profitable long position in the same security which he can then liquidate at the increased market price or hold on to for still more possible profit. For additional examples, see J.C. Francis, Investments: Analysis and Management 92-101 (1972).

7. See generally N.Y. Stock Exch. R. 431.

8. See note 6 supra.

Of course, it is absolutely essential to the success of these speculative hedging devices that the writer have the immediate use of the cash or securities received from the exercising holder. Since the endorser functions as a middleman between the principal parties to an option agreement, the writer must depend for his flexibility on his broker. Indeed, the holder also looks to the endorser, since the writer's identity is not known to him. It is the endorser who accepts the holder's stock or money and makes the appropriate exchange. And, should the writer somehow default on his obligations,[9] it is the endorser whose liability then attaches.[10] Plainly, there can be serious consequences for option writers and holders if the endorser goes into SIPA liquidation.[11]

B. *The General SIPC Framework*[12]

1. Creation and Pre-Liquidation Role

SIPC is a "membership corporation." Its membership is comprised of virtually all brokers registered under the federal securities laws and all members of national securities exchanges.[13]

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9. This is unlikely. See text accompanying note 7 supra.

10. The precise nature of the option endorser's potential liabilities is a most complex and as yet unresolved issue. On the one hand, the broker is known in option parlance as the "endorser." Certainly, this word is a term of art to lawyers and generally conjures up the image of a party who stands ready to make good the obligations of its principal. See L. Simpson, Suretyship 25 (1950). This notion of the endorser would support the view that brokers who endorse option contracts are secondary parties to the agreement between the writer and the holder. Investment industry practice also supports this view of the broker as guarantor and is the position that will be adopted throughout this article. Cf. H. Kook & Co. v. Scheinman, Hochstin & Trotta, Inc., 414 F.2d 93, 94, 99 (2d Cir. 1969); L.T. Alverson, How to Write Puts and Calls 117 (1968); J.C. Clendenin, Introduction to Investments 205-06 (4th ed. 1964); J.C. Francis, Investments: Analysis and Management 94 (1972); Franklin & Colberg, Puts and Calls: A Factual Survey, 13 J. Fin. 21 (1958).

On the other hand, a logical argument can be made that, despite the name "endorser," such a broker is a principal to a contractual arrangement between itself and the option holder. This view would seem to be supported by the language of the common option contract. The contract states essentially that the holder has the right to "call from" or "put to" the broker the securities involved and that the broker must "deliver to" the holder the securities or cash, as the case may be.

The theory that the endorser is primarily liable is further supported by the fact that the typical option account agreement between brokers and their option writer customers resembles an indemnification, wherein the customer agrees to hold his broker harmless for any expenses incurred by the latter in honoring options.

The "primary obligation" view has recently been adopted by at least one district court. See In re Weis Sec., Inc., 411 F. Supp. 195, 197-98 (S.D.N.Y. 1976).

11. See section II(C) infra.

12. For a more detailed discussion, see sources cited in note 2 supra.

13. 15 U.S.C. § 78ccc(a)(2) (1970). There are some exceptions set forth in the statute which are not relevant to the present treatment.

A principal tool for implementing the terms of the statute is the "SIPC Fund" into which each member pays an initial assessment and annual assessments, based upon a formula related to gross revenues from its securities business.[14] SIPC also has the authority to borrow needed additional funds from the SEC.[15] The statute provides for the SEC, in turn, to issue notes to the United States Treasury in order to obtain the funds required for loans to SIPC.[16] SIPC will advance money from this fund to a trustee appointed by the court to oversee the SIPA liquidation[17] to facilitate prompt payment of the "net equities" of the defunct broker's customers[18] up to $50,000 for each customer, with certain qualifications.[19]

SIPC enters a broker distress situation by first determining that a member "has failed or is in danger of failing to meet its obligations to customers" and that at least one of several additional situations exists.[20] Upon making such findings, SIPC is empowered to seek a judicial decree adjudicating the member's customers to be "in need of . . . protection."[21]

Once SIPC has made its application, the court to which it is made essentially takes on the role of a bankruptcy court.[22] If the application is granted, the court must then appoint a "disinterested" trustee.[23] The trustee is empowered to carry out the liquidation of the debtor's business pursuant to the statute.[24]

2. Liquidation Proceedings

The purposes of a SIPA liquidation are set forth in the statute:[25] (1) to return promptly "specifically identifiable property" to the debtor's customers, and to distribute to them the "single and separate fund" as well as funds advanced by SIPC; (2) to operate the debtor's business "in order to complete open contractual commitments of the debtor;" (3) to enforce rights of subrogation; and (4) to liquidate the debtor's business.

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14. Id. § 78ddd.
15. Id. § 78ddd(g).
16. Id. § 78ddd(h).
17. Id. § 78eee(b)(3).
18. See text accompanying notes 27-34 infra.
19. See 15 U.S.C. § 78fff(f)(1) (1970).
20. Id. §§ 78eee(a)(2), (b)(1)(A).
21. Id. § 78eee(a)(2).
22. Id. § 78eee(b)(2).
23. Id. § 78eee(b)(3).
24. The powers and duties of the trustee are set forth in id. § 78fff(b).
25. Id. § 78fff(a).

A proper treatment of the mechanics of a SIPA liquidation undoubtedly requires extensive discussion. However, since the liquidation process itself is somewhat tangential to the principal focus of this article, an abbreviated synopsis will be attempted.[26]

The trustee must determine and create the "single and separate fund." This fund, which is essentially comprised of all of the debtor's holdings from or for its customers' accounts—except "specifically identifiable property" held for "cash customers"[27]—is created for the benefit of the remaining customers who share in it ratably on the basis of their "net equities" as of the SIPA filing date.[28] These customers form a separate class of creditors and are given priority over most of the debtor's other creditors.[29]

Specifically identifiable property, which is taken out of this pro rata distribution scheme, may be loosely defined as fully paid for, segregated (either individually or in bulk) securities,[30] and securities held for customer margin accounts which are in excess of 140 per cent of any outstanding debit balance.[31] The trustee must promptly return to customers their specifically identifiable property.[32]

With respect to the single and separate fund, a necessary step in the calculation of the pro rata participation of customers is the determination of each customer's "net equity." To arrive at net equity the trustee must first give effect to "open contractual commitments"[33] and exclude reclaimable specifically identifiable property. He must also deduct the customer's indebtedness to the debtor, if any, "from the sum which would have been owing by the debtor to the customer had the debtor liquidated, . . . on the filing date, all other securities and contractual commitments of the customer . . . . "[34] In other words, the trustee must determine the net value of the customer's account on the filing date (excluding, of course, property which is immediately reclaimable by the customer) in order to set the degree of that customer's pro rata participation in the single and separate fund.

An element of the procedure by which net equity is calculated is the

26. For a more comprehensive treatment, see sources cited in note 2 supra.
27. This term is defined in 15 U.S.C. § 78fff(c)(2)(A)(iii) (1970).
28. Id. § 78fff(c)(2)(B).
29. Id.
30. Id. § 78fff(c)(2)(C).
31. Id. § 78fff(c)(2)(C)(iii); 17 C.F.R. § 240.15c3-3j (1976).
32. 15 U.S.C. §§ 78fff(a)(1)(A), (c)(2)(C) (1970).
33. See text accompanying notes 35-38 and 44-46 infra.
34. 15 U.S.C. § 78fff(c)(2)(A)(iv) (1970).

treatment of "open contractual commitments." As indicated above, such commitments are given effect in determining net equity, which in turn governs a customer's pro rata share of the fund.[35] The trustee is charged with the duty of completing commitments of the debtor which were made in the ordinary course of its business, and which were outstanding on the SIPA filing date.[36] The purpose is to avoid a "domino effect" which would result from the failure of a defunct broker to complete outstanding transactions with other brokers who were acting for their respective customers.[37] This provision was not intended to apply to commitments of the debtor to its own customers.[38]

In sum, if the trustee successfully complies with the letter of SIPA, the results should be: a prompt notification of the SIPA liquidation to all customers of the debtor,[39] the timely filing of claims by affected customers,[40] the determination of the securities and cash due each claiming customer (either as specifically identifiable property or as a claim against the single and separate fund, with any deficits to continue as claims against the "general estate"[41]) and the completion of appropriate payments.

It is in the context of this underlying procedure that the plight of option sellers and buyers, as well as the duties owed by the trustee to each group, must be viewed.

C. *The Option Problem in the Context of SIPA Liquidations*

1. In General

The general nature of the "option problem" is implicit in what has already been said.[42] The onset of a SIPA liquidation evidences the

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35. Payment of claims will be in full if there is sufficient capital in the fund to satisfy all customer claims. In the case of fund deficiency, customers become general creditors to the extent of the unpaid balances. Id. § 78fff(c)(2)(B). To the extent that SIPC advanced money to the trustee for the prompt payment of customer claims, the statute provides that SIPC is subrogated to the claims of such customers. Id. § 78fff(f)(1).

36. Id. § 78fff(d).

37. See H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. 9 (1970) [hereinafter cited as House Report]. See also SEC v. Alberdeen Sec. Co., 480 F.2d 1121, 1125 (3d Cir.), cert. denied, 414 U.S. 1111 (1973).

38. SEC v. Aberdeen Sec. Co., 480 F.2d 1121, 1125 (3d Cir.), cert. denied, 414 U.S. 1111 (1973).

39. See 15 U.S.C. § 78fff(e) (1970).

40. See id.

41. Id. § 78fff(c)(2)(B).

42. See text accompanying notes 9-11 supra.

death of the middleman who also functions as the option endorser. It is the former role which particularly gives rise to problems especially if, as noted earlier, the secondary nature of the endorser's liability,[43] assumed here throughout, means that a broker failure need not alter the writer-holder relationship.

The middleman role is peculiarly important because it exists as a bridge between two "blind" parties. That is, as is true of securities transactions in general, the parties on opposite sides of a transfer of ownership do not know one another's identity. Their respective brokers are the ones who meet "face to face" and execute their agency responsibilities almost as if they were principals.

The ordinary purchase and sale of stock is, of course, not seriously affected by the failure of an executing broker. This is because this type of transaction is executory for only a moment. To the extent that its incompleteness continues for any period, as during the five business days between trade date and settlement date,[44] or in the case of a "fail to deliver" situation,[45] the statute provides for the completion of such pendencies as "open contractual commitments."[46]

The option, with its inherent executory nature, is therefore a form of security transaction which is particularly liable to be affected by an intervening broker failure. In a way, it is a *potential* transaction, in which each principal stands poised, ready to complete his bargain with an unknown partner through the facilities of the broker/endorser. If that endorser closes its doors, the option arrangement necessarily avoids completion.

2. A Lack of Guidance

The basic notion of dealing with wholly or partially executory arrangements was not completely overlooked by SIPA's drafters. Indeed, the trustee is required to complete the debtor's open contractual commitments.[47] However, it is doubtful that this provision applies to options endorsed by the debtor[48] because the policy underlying the

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43. See note 10 supra.

44. See generally N.Y. Stock Exch. R. 64.

45. See id. 141, 152. This is where the selling broker lacks the physical stock and is unable to deliver it on the settlement date to the buying broker and, in effect, sends an IOU in place of the certificate(s).

46. 15 U.S.C. § 78fff(d) (1970); 17 C.F.R. § 240.206d-1 (1976).

47. 15 U.S.C. § 78fff(d) (1970).

48. The defunct broker is known as the "debtor" under the Act. Id. § 78eee(b)(4)(A).

open commitment provision is the desire to avoid a "domino effect" in which other brokers and their customers are caught in the repercussions of one broker's failure.[49] Since this policy primarily concerns *inter-broker* obligations,[50] it is apparent that the duties owed by a now defunct broker to its own customers do not come within this section of the statute.[51] The provision would seem similarly inapplicable to a contingent obligation of the debtor to the holder, such as its liability as an endorser which does not attach unless the option writer defaults.[52]

If, as asserted here, the option endorser's obligations are not the type which the trustee is required to complete, then SIPA offers no guidance for the handling of option arrangements.

3. Complicating Factors

The trustee's dilemma is further complicated by the unique character of the securities option. For example, its relatively brief life span makes the promptness of the trustee's actions quite important. If the debtor was a broker of substantial size, many options which were endorsed by the firm now in liquidation may be expiring each day without an opportunity for exercise.

The trustee's position is further aggravated by the volatility of the securities trading markets. The profitability of option exercise may come and go within a short period of time; and there may be few such instances during the life of any option.

Furthermore, the contingency of the option arrangement—both by definition and by virtue of the multiple and varied factors which go into option investment and exercise strategies—exacerbates any attempt by the trustee to anticipate the "normal" outcome of any such transaction.

Lastly, the trustee would appear to be faced with different degrees of duty owed to various classes of participants. Thus, a distinction should be drawn between customers of the debtor and non-customers. Certainly the primary purpose of SIPA is the protection of the

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49. See text accompanying note 37 supra.

50. See SEC v. Aberdeen Sec. Co., 480 F.2d 1121 (3d Cir.), cert. denied, 414 U.S. 1111 (1973).

51. See id.; In re Weis Sec., Inc., 411 F. Supp. 195, 204 (S.D.N.Y. 1976); In re Weis Sec., Inc., CCH Fed. Sec. L. Rep. ¶ 95,429, at 99,183 (S.D.N.Y. Jan. 19, 1976); 17 C.F.R. § 240.206d-1 (1976).

52. See note 10 supra for contrary opinion that the endorser's liability is primary.

former,[53] although the open commitment provision is an attempt to afford some protection to the latter.[54]

Superimposed on the customer/non-customer dichotomy is the holder/writer distinction. To the extent that the customer and the writer, as well as the non-customer and the holder, are the same persons, this last distinction would not necessarily further complicate matters. However, option related roles have a significance of their own, especially in the SIPA context. Accordingly, and again assuming the secondary nature of the debtor's liability, the trustee must also consider differing duties owed to the principals in each option arrangement. Here, the difference is more qualitative than quantitative. The debtor has promised the writer that it will take his place, should the writer default. The debtor has promised the holder that it will make good the writer's commitment, should that become necessary. And the debtor has promised both sides that it will function as middleman between them.

III. Possible Approaches

Having identified the problem, it remains to explore possible solutions. As noted earlier, little concrete guidance is afforded by the statute.[55] Accordingly, the trustee is left with a trial and error approach in an effort to do equity while fulfilling his statutory functions.[56] The following discussion will survey the alternatives available to him.

A. *The Policy of "No Policy"*

Perhaps the most obvious course open to the trustee is simply to take no action concerning options endorsed by the debtor and outstanding on the SIPA filing date. If the debtor's doors are shut, these options will expire without the opportunity to exercise them. At first glance, there may be some justification for this approach, given the absence of statutory guidance.

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53. See SEC v. Alan F. Hughes, Inc., 461 F.2d 974 (2d Cir. 1972); House Report, supra note 37, at 1-2.

54. See text accompanying notes 47-52 supra.

55. See section II(C)(2) supra.

56. It is also undoubtedly true that the SIPA trustee, as do other trustees, owes a fiduciary duty to the defunct broker's customers. See generally Overfield v. Pennroad Corp., 42 F. Supp. 586, 607-08 (E.D. Pa. 1941), rev'd in part on other grounds, 146 F.2d 889 (3d Cir. 1944); G.G. Bogert & G.T. Bogert, Law of Trusts 337-65 (5th ed. 1973).

However, the "no policy" route would have serious implications for writers and holders. Some writers might welcome a "hands off" stance by the trustee. The writer has received his premium from the holder, although his identity is unknown to the holder, and is now assured that the option will not be exercised.

Yet there are negative implications as well for writers. First, the writer is deprived of often desirable flexibility.[57] The stock necessary to cover short sales effected to hedge the option risk, or funds required to make purchases with the same intent, are kept from the writer's control. Furthermore, the writer is deprived of the opportunity to speculate further with the money or securities which he would otherwise have received from the exercising holder.

In addition, many writers stand to benefit from the exercise of their options. One scenario is that of the straddle writer who has had one side of his option exercised prior to the SIPA filing date. Assuming that the security's market price moves substantially in the other direction after the filing date, sparking an attempt to exercise the straddle's other half, the writer would be precluded from restoration to his original position which would have given him a profit approximately equal to the premiums originally received.

For the holder's part, the "no policy" approach brings only negative consequences. In simple terms, the holder has lost the ability to assert his rights. He has paid a premium for the opportunity to buy or sell stock, yet he no longer has access to the party (or parties) with whom he dealt.

Beyond the problems of writer and holder, the trustee might well fall victim to his own plan. While the precise nature and extent of the trustee's respective duties to writers and holders may be unclear,[58] some conclusions can be reached with substantial certainty. A principal intent of SIPA was to safeguard the customers of the debtor broker.[59] And, as alluded to above, the failure to honor options presented by holders may be less than beneficial to the debtor's writer-customers. Further, although the endorser's option liability is secondary to that of the writer, the latter's inability to meet his obligations (both because the debtor has closed its doors and because the writer's identity is ordinarily unknown to the holder) may lead to a default, thus giving rise to the debtor's duties as a guarantor.[60] If such

57. See text accompanying notes 5-6 supra.
58. See section II(C)(3) and note 10 supra.
59. House Report, supra note 37, at 1.
60. Of course, the lack of precedent makes such a conclusion questionable at best.

be the case, the trustee may succeed in doing nothing more than creating additional claims against the debtor's limited assets.[61]

B. *"Business as Usual"*

A second possible approach to the option problem is for the trustee to continue the debtor's business as it relates to the exercise of options which the debtor has endorsed for its customers. That is, upon the holder's presentation of the option and accompanying money or securities to the trustee, the latter would inform the writer of the exercise and pay out the requested stocks or funds against the writer's account. The trustee would then turn over to the writer that which he has received from the holder.

On its face, this seems an eminently reasonable course of action which gives to the writer and holder the benefit of their bargain. But a closer look reveals an abundance of problems. There would almost certainly be a delay in completing the exercise process. The delay may be caused by many factors, including the intervention of the trustee as middleman, the requirement of notice to the writer and the possible unavailability of the cash or securities due the holder.[62]

A more significant difficulty with this approach is the inordinate administrative burden which it places on the trustee. The trustee, in addition to the other duties imposed by SIPA, would, in effect, go into the brokerage business. This raises yet additional ominous prospects such as potential liability under the securities laws for poorly performed responsibilities, once they have been assumed.[63]

Related to the issue of an increased burden on the trustee is the possibility of even greater complication in the case of debtor shortages. For example, if the trustee attempts to complete option transactions, he may be faced with insufficient quantities of "called stock" in the bulk segregation accounts maintained by the debtor. Similarly, each payment of cash pursuant to the exercise of a put will decrease the total balance available for the satisfaction of customer claims.[64]

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61. If the obligation of the debtor broker were held to be primary, the trustee would appear to be under some statutory obligation to complete the transactions since they could thus be considered "open contractual commitments." See text accompanying notes 47-52 supra. Cf. In re Weis Sec., Inc., 411 F. Supp. 195, 203-04 (S.D.N.Y. 1976).

62. See 15 U.S.C. § 78fff(c)(2)(B) (1970).

63. E.g., liability under rule 10b-5, 17 C.F.R. § 240.10b-5 (1976). Exploration of this possibility is beyond the scope of the present treatment.

64. See text accompanying notes 14-19 and note 35 supra; In re Weis Sec., Inc., 411 F. Supp. 195, 203 (S.D.N.Y. 1976).

A further problem of the "business as usual" course is a possible inference to be drawn from the statute. An express purpose of SIPA liquidation proceedings is "to operate the business of the debtor in order to complete open contractual commitments of the debtor . . . ."[65] In light of this purpose, the trustee is vested with the right to operate the debtor's business in order to complete such commitments.[66] If, as is suggested here, an endorser's option obligation is secondary to that of the writer and, prior to any default by the writer, does not constitute an "open contractual commitment" in any strict sense,[67] then the trustee's right to carry on the option portion of the debtor's business is without support in the statute.

Lastly, there is the notion that the continuation of the debtor's business for the benefit of a limited class of customers—and, more significantly, for the benefit of non-customer holders—is fundamentally inequitable. The demise and liquidation of a brokerage firm will have an adverse impact on most, if not all, of its customers. Their plans must be altered and their expectations frustrated in the name of the greatest good for the greatest number.[68] Viewed in this light, it seems unfair to undertake extraordinary procedures designed to give one group primary consideration. Expeditious completion of the proceeding is the goal, and "special cases" only serve to forestall achievement of it.[69]

C. *Suspension of Option Activity*

A third possible prescription for the option problem is the suspension of all option activity for a relatively short time in order to give the trustee an opportunity to formulate a plan suited to the specific problems faced. The life of the suspended options could then be extended for an equal period of time. This approach has positive and negative features.

On the positive side, the suspension avoids the possibility of arguable due process deprivations, as when the trustee fundamentally affects the option arrangement without sufficient advance notice to the

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65. 15 U.S.C. § 78fff(a)(2) (1970).

66. Id. § 78fff(b)(1)(B).

67. See text accompanying notes 47-52 supra.

68. E.g., the "six month rule" embodied in 15 U.S.C. § 78fff(e) (1970) often leads to seemingly arbitrary results. This rule essentially provides that the failure of a customer (now claimant) to file a claim form with the trustee within six months of the first creditors' meeting precludes recovery on the claim. See, e.g., In re Weis Sec., Inc., 411 F. Supp. 194 (S.D.N.Y. 1975).

69. House Report, supra note 37, at 9-10.

writer.[70] That is, the writer should have notice of any plan devised by the trustee, hopefully in time to hedge his risk or pursue other compensatory maneuvers. Further, a suspension would provide time in which writers could arrange the transfer of option (and margin) accounts to viable brokers.[71] The more quickly this is done, the less likely it is that options presented to the debtor by holders will go unexercised.

However, the suspension plan is not without its drawbacks. An optioned security might trade at vastly different prices during the extended life period from those at which it traded during the suspension period. Such a situation would clearly have a significant impact on the nature of the bargain between writer and holder. One can foresee complaints of lost opportunities for profitable (or at least more profitable) option exercises, with consequent claims against writers and/or their endorsers.

Additionally, as mentioned earlier,[72] the endorser's liability is secondary to that of the writer or, at least, is here assumed to be so. Assuming that the writer stands ready to meet his obligations, under this scheme the endorser has intervened to profoundly change the writer's commitment as well as the holder's rights. In the absence of an express statutory amendment conferring authority to do so, the propriety of such a course is questionable. Thus, while procedural due process may be served by the suspension technique, substantative rights may be unjustifiably infringed.

D. *Liquidation of the Holder's Damages*

Yet another approach to the option problem is one actually adopted by a trustee in a SIPA proceeding.[73] This plan provides for the holder's presentation of an option to the trustee (or his agent) at the time he would normally exercise it. The trustee dates and time stamps the option, the market price of the security at that moment is noted, and the holder is given a claim against the debtor (endorser) for the difference between the market price and the strike (option) price. The

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70. See In re Weis Sec., Inc., 73 Civ. 2332 (S.D.N.Y. July 29, 1975), rev'd, 411 F. Supp. 195 (S.D.N.Y. 1976).

71. Transferee brokers would presumably assume the role of option endorser and, as is common, accept any debit cash balances and short security positions in the customer's account.

72. See note 10 supra.

73. Trustee Redington in the liquidation of Weis Securities, Inc. See In re Weis Sec., Inc., 411 F. Supp. 195, 198-99 (S.D.N.Y. 1976).

debtor then charges the writer's account in the same amount as the holder's claim.[74]

As is true of other proposals, this course initially commends itself as a reasonable means of dealing with a knotty problem. Again, however, there are unfortunate consequences for the principal parties to the option agreement.

This approach appears to unduly favor holders over writers.[75] Indeed, the holder is assured of a claim equal to the profit he could immediately have made at the moment of the actual exercise, while the writer gains nothing more than a charge to his account. It should be noted, however, that the holder's claim is merely that and not a guarantee of full and prompt payment. More importantly, the liquidation of the holder's damages may drastically alter the consequences of writing an option. For example, the writer of a straddle who would have a net gain equal to the premiums received if both his put and call were exercised (assuming the sort of market fluctuation that would trigger both exercises) may end up with far less. In place of profit, he will be charged twice—once with the difference between the call's strike price and the security's market price as of its "exercise," and a similar charge resulting from the presentation of the put. Moreover, because of the debtor's failure to collect or deliver securities in option transactions, the writer is deprived of the use of these receipts in the various hedging maneuvers which would otherwise be available to him. The plan's value is further diminished in that it is seemingly premised on a misconception of the debtor's role. That is, assuming that the debtor's option liability is only secondary in nature and, in the absence of the writer's default, does not attach, it might well be improper for the trustee to "give" a claim against the debtor to exercising holders.

It has been asserted that early notice to writers of this intended procedure—at or near the time of notice to holders—would go a long way toward ameliorating the plan's inequities.[76] However, this reasoning seems convincing only when it enables the timely transfer of accounts to functioning brokers. The "automatic charge" procedure would otherwise go into effect and, aside from writers with sufficient additional funds to hedge their risk, the failure to receive the holder's stock or money would still curtail their flexibility.[77]

74. Id. at 198.

75. This theory was rejected by Judge Wyatt. Id. at 202-03.

76. See text accompanying notes 70-71 supra.

77. Cf. In re Weis Sec., Inc., 411 F. Supp. 195, 203 (S.D.N.Y. 1976).

IV. Proposed Amendment to SIPA

The shortcomings of the various proposals explored above lead inevitably to the conclusion that the fault lies not in the trial and error efforts of any trustee, but in the underlying statute which offers no firm guidance. Accordingly, it is to SIPA that the reformer's attention should turn.

While there are undoubtedly endless possible statutory amendments there is much to be said for simplicity. This is particularly so in the case of a statute intended for the protection of "lay investors" whose abilities to master the ins and outs of SIPA as it now exists may be limited.[78]

The option problem may be diminished in severity by several fairly simple amendments to SIPA. First, section 78fff(e), which provides for prompt notice of a SIPA liquidation to all customers of the debtor, should be amended to require specific notification to option writing customers, in light of the unique problems they face. The promptness with which the trustee will be able to effect such notice will be increased if the statute is amended to require brokers to maintain on-going lists of all their option account activity.

In order to avoid delay in the liquidation process, timely notice must also be given to those who hold options endorsed by the debtor. Fairness, the policies underlying SIPA and notions of due process require no more than what is reasonable.[79] Accordingly, a public notice directed specifically to "holders of options endorsed by ---------," with perhaps a simultaneous notice to broker-dealers for relay to their option holder customers, would be appropriate. This procedure should be incorporated in section 78fff(e).

In addition to notice, some substantive rights must be afforded option writers. While timely notice may provide an opportunity to "hedge one's bets," the SIPA liquidation of an option endorser will still fundamentally alter the relationship between writer and holder. It is therefore suggested that SIPA be amended to provide for the release to a writer of the cash or securities deposited to cover an outstanding option[80] if the writer agrees to honor the option when notified of its

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78. Even a cursory review of the volume of appeals by dissatisfied customers of Weis Securities, Inc., contained in the court clerk's file is illustrative. See In re Weis Sec., Inc., 73 Civ. 2332 (S.D.N.Y.).

79. See, e.g., Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950).

80. Assuming, of course, that only "specifically identifiable property" is released, pursuant to present SIPA procedures. See section II(B)(2) supra.

presentation to the trustee. The statute must provide that the writer's breach of this obligation will create a liability to the trustee.

A further step in this direction would provide for the debtor's (trustee's) release from secondary liability on any option which is effectively "left to the parties" (*i.e.,* where the trustee steps out of the role of middleman, pursuant to the procedure suggested above). However, this variation of the basic scheme should first be carefully explored. It may afford the trustee too much protection, just as the lack of any statutory guidance affords him too little.

An alternative substantive procedure, and one that probably requires no statutory amendment other than one regarding timely notice, would be the trustee's expeditious handling of requests to transfer option accounts. If this approach were adopted, the amendment requiring that notice of the liquidation proceeding be sent should also require that the notice contain a recommendation that option accounts be transferred to other brokers. It may also be appropriate to inform writers that this is their only real alternative to some less attractive approach—thereby adopting the notion of waiver or estoppel to preclude subsequent complaints by non-transferring writers.

The only serious gap in such a plan would be the inevitable delays which are encountered in nearly every transfer of accounts between brokers.[81] Such delays are particularly onerous to the parties to an option agreement, since fluctuations in market price may make the profitability of exercise a fleeting thing. It may therefore be necessary to couple the transfer plan with a means of equitably handling options presented for exercise in the period before a transfer can reasonably be effected. The "suspension" approach suggested above[82] may serve this purpose.

V. CONCLUSION

SIPA represents a major step toward providing security market investors with a modicum of protection against the possibility of broker failure. However, as is true of many innovations, it does not provide, nor has it been applied so as to provide, adequate protection for all classes of investors.

In simple terms, SIPA's goal is to make each investor who has dealt with an unsuccessful broker as nearly whole as possible. Certainly, this is the objective concerning "traditional" customers—those who have a

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81. This may be particularly common where the transferor broker is defunct, since shortages of stock to deliver are likely to occur.

82. See section III(C) supra.

broker buy and sell stocks and bonds for their accounts. Presumably, the goal should be no less for investors who have chosen to engage in less traditional, although increasingly popular forms of security transactions. Such disparate degrees of protection are seemingly inconsistent with the fundamental policy of SIPA and should therefore be corrected.