THE SECURITIES INVESTOR PROTECTION CORPORATION: PAST, PRESENT, AND FUTURE

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THE SECURITIES INVESTOR PROTECTION CORPORATION: PAST, PRESENT, AND FUTURE

Wednesday, March 7, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:37 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, King, Royce, Pearce, Fitzpatrick, Hayworth, Hurt, Grimm, Stivers, Dold; Waters, Sherman, Maloney, Perlmutter, Donnelly, Peters, and Green.

Also present: Representative Cassidy.

Chairman GARRETT. Good morning. The Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order. Today's hearing is entitled, "The Securities Investor Protection Corporation: Past, Present, and Future." This hearing will now come to order, and I recognize myself for 4 minutes to give an opening statement.

Today's hearing is a broad oversight hearing on the Securities Investor Protection Corporation (SIPC.) It is not meant entirely to be focused solely on the particular aspects of SIPC's work. But to me, the failure of SIPC in relation to the Madoff liquidation is so fundamental relative to the protections that SIPC is supposed to provide to investors, and so antithetical to the goals that SIPC and Congress set out to achieve at the very beginning, that I would like to focus much of my time, and my thoughts, and my energy, and my comments on the circumstances surrounding that particular case.

I also think that it is worthwhile to hear today about SIPC's work in regard to the Lehman bankruptcy, and also to examine the long-awaited and recently-released report of SIPC's Modernization Task Force, as well. In going through that Task Force and looking at it, unfortunately, is that it is somewhat of a missed opportunity, if you will, to seriously study some of the shortcomings of SIPC exposed by the recent failures of the broker-dealers.

So let us return now to the failures of the Madoff firm. Once examined, the facts of that case—as we are all probably too familiar—the Madoff firm was regulated by both FINRA and the SEC. And it repeatedly received government stamps of approval that it was operating, basically, legally.

The firm proudly displayed the SIPC logo which, again, implies government backing, since SIPC is backed by the U.S. Treasury.

Madoff investors paid taxes to the IRS, the U.S. Government, for years. Again, another government agency saying that its investments and profits were, well, real.

Since around the same time that SIPC was enacted, investors no longer held stock certificates, so the only proof of ownership they have, or had, was a statement that they received from a government-regulated broker-dealer. So what does this mean? The Federal Government both provided a stamp of approval and relied upon that stamp of approval, and yet innocent private citizens now, as investors, are being held to a higher standard than them.

So instead of being provided protection by SIPC, as Congress did intend in order to increase confidence in investment and our markets, innocent investors, in this case, are being sued by the very same trustee chosen by SIPC. Now, am I the only one—when you go down that whole litany of facts here—to say that something is simply not right here.

An additional irony is that if the trustee is successful in suing individual investors, who will the money go to? It will largely go to pay off institutional investors. Now, this is the same class of investors that the trustee has repeatedly tried to sue because he believes that they should have known better. But they will be paid.

It is because of my concerns over these issues that I have introduced H.R. 757, the Equitable Treatment of Investors Act. This legislation would reaffirm and clarify key protections for ordinary investors that were put in place when Congress passed, and amended, the SIPC. In particular, the bill aims to shield innocent individual investors who have already been defrauded and financially devastated by the Madoff situation from further clawbacks by the SIPC trustee.

In addition, the bill clarifies that for purposes of SIPC protection, customers of registered brokers are legally entitled to rely on their broker's statements as evidence of what the broker owes them. Indeed, in a world where customers no longer hold the physical stock certificates, how can it be done any other way?

Finally, H.R. 757 would end an ongoing conflict of interest by having the SEC rather than SIPC select trustees for the SIPC liquidation. Now, several of my colleagues have already joined me in co-sponsoring this legislation, and I encourage my other colleagues to look at it and consider it, as well.

I look forward to today's testimony from our witnesses on all the panels that we have, and a hearty discussion on SIPC activities and roles in the past, in the present, and in the future.

With that, I yield back, and I yield to the gentlelady from New York for 3 minutes.

Mrs. MALONEY. Okay. thank you. Thank you, Mr. Chairman. I thank you for your deep concern on this issue, which is a major concern for many of us on this committee. And I welcome Senator Vitter. You honor us with your presence, and we look forward to your testimony.

As a representative of New York City, the financial industry is a very important part of our economy. The massive fraud that was put forth by Bernard Madoff is very personal to me, and it hurt many of my constituents, and certainly violated the trust of the public for the industry.

So it was a tremendous blow to many people on an individual basis, and to the industry at large. For my constituents, many of whom are victims of this fraud—from union workers who lost their pensions, to charities that lost their operating funds, to investors large and small who lost their life savings, literally lost their homes, lost absolutely everything—the experience has been absolutely devastating and they are devastated.

Even worse, the confidence of investors around the world, and the system of regulation and law enforcement of our financial markets, was visibility shaken by this scandal. Just yesterday, Mr. Stanford, another perpetrator of a Ponzi scheme who cheated his investors out of over $7 billion, was convicted on 13 out of 14 counts that he faced.

This should be some comfort for the people he defrauded, but we want to make sure that if this ever happens again, there are tools in place so that victims can be made whole and SIPC can do its job. I believe that markets run as much on confidence as they do on capital, and this is a serious blow to investors' confidence at a critical time.

We still see that many people are holding their money back from investing and going forward with our financial system. The reason we are here today is to look at the Securities Investor Protection Corporation, SIPC, and to shed light on the reform proposals that are out there, including several pieces of legislation that are pending before the House.

I know this committee is looking closely at the SIPC Modernization Task Force report, which was released at the end of last month, so this hearing is very timely. I know that my colleague, Mr. Ackerman, and the chairman, have put forward thoughtful bills. I am interested in seeing how their bills coincide, or reflect, go further or not as far as the SIPC Modernization Task Force report's recommendations.

And I look forward to working with them on these bills. I hope we can explore both of these legislative proposals, and hear from the witnesses what they believe is the better approach, or the right approach we should be taking. I look forward to the hearing. It is one that is very important to our country.

And I thank the chairman for calling this important hearing, and for his work on his legislation. I also compliment Mr. Ackerman for his hard work.

I yield back the balance of my time.

Chairman GARRETT. Okay. The gentlelady yields back.

The gentleman from New York is recognized now for 3 minutes.

Mr. KING. Thank you, Mr. Chairman. Thank you for calling today's hearing. It is very timely for the representatives from SIPC to come before the subcommittee. After several years, they finally produced the recommendations of their Modernization Task Force.

And this hearing and report come against the backdrop of the Madoff liquidation, which you have referenced and which Ms. Maloney has referenced. This was unearthed 3 years ago, and during the last 3 years that process, run by SIPC, has gone profoundly amok.

This is tragic, this is wrong. From my perspective, there are at least four takeaways from this liquidation. One, the trustee, Irving

Picard, is out of control. He interprets SIPC as he desires, not as intended by the courts, and on several occasions has been slapped down by the courts. He intimidates innocent victims, brings spurious clawback suits against them, maligning their reputations in the process, and leaking furiously to the media.

Even Chairwoman Mary Shapiro expressed surprise at the initiation of the baseless lawsuits. Just the other day, in an order dated March 5th, in the southern district of New York, Judge Rakoff, in the case *Irving H. Picard* v *Saul B. Katz et al.* made a finding: "The court remains skeptical that the trustee can ultimately rebut the defendant's showing of good faith, let alone impute bad faith to the defendants."

"More generally, the court is concerned that much of the evidence that the party's profit on summary judgment did not comport with the Federal rules of evidence. Conclusions are no substitute for facts, and too much of what the parties characterize as bombshells proved to be nothing but bombast." And that is what that lawsuit has been from beginning to end—bombast.

Two, the victims are being treated unfairly. Very few victims have received the statutory-mandated SIPC advances. The trustee has hatched an accounting mechanism that disregards real-world customer expectations and broker-dealer protocol, it is lawyer-intensive, and it has run up the fees of $300 million paid to Mr. McCarter—$300 million. He has an open piggybank here for himself. It is not an exaggeration to say the victims have been victimized twice: once by Bernie Madoff; and now by Irving Picard.

Three, the trustee is not being properly supervised. Where were the regulatory bodies tasked with oversight over the trustee, SIPC directly, and the SEC indirectly? Moreover, where is the statutory-mandated report on the liquidation required of the trustee? The trustee in the Lehman liquidation has completed and filed such a report. The broker-dealer failure is arguably much more complex and complicated than the Madoff debacle.

And four, this miscarriage of justice endured by the Madoff victims could happen to any investor whose broker deal fails for any reason. We need to restore some reason and some rationality to the unwinding of failed brokerage firms, and that is why I am proud to sponsor, with Chairman Garrett, H.R. 757, a proposal that enjoys bipartisan support.

Mr. Chairman, thank you for you leadership on H.R. 757, and thank you for holding this hearing. I look forward to hearing from the witnesses. I yield back.

Chairman GARRETT. And again, I thank the gentleman from New York. Thank you for your work on this legislation, as well, and for your leadership on this issue.

Mr. Green is recognized for 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I would like to thank my colleague and friend from Louisiana, my home State. While I represent Texas, I was born in Louisiana. It is an honor to have you with us today.

Mr. Chairman, I, too, am concerned about investor confidence. I think it is exceedingly important that investors understand that we desire to impose proper protection for their investments. As I weigh this issue of whether we are going to base our payments on account statements or actual net cash investments, my concern is the actual statements.

Because as you know, in the Madoff case his statements were misrepresentations and they were actually fraudulent in and of themselves. So that causes a degree of concern. I am eager to look at the legislation and make some decisions. My thoughts are rather ambivalent right now.

I do want the investors to be protected, and I stand for investor protection. I would like to peruse the legislation to ascertain how we manage these statements that are fraudulent, that themselves are misrepresentations. And we are talking about tax dollars, to a limited extent.

So for this reason, I thank you, and I look forward to hearing more so that I can come to a final conclusion.

Chairman GARRETT. And thank you. The gentleman yields back. Mr. Dold, for 2 minutes.

Mr. DOLD. Thank you, Mr. Chairman. I certainly appreciate you holding this hearing, and for your leadership. And I want to thank Senator Vitter for being here, as well, and the other witnesses.

We all have tremendous sympathy for all of the direct and indirect Madoff victims, and all other Ponzi scheme victims, as well. Which is why we are all here, to see how we can improve available protections in a balanced way, without creating unsustainable, unfair, and otherwise negative, unintended consequences.

The fundamental reality of the Madoff Ponzi scheme, and every other Ponzi scheme, is that money is stolen from many innocent people and there isn't enough money to make everyone whole. That is a difficult and complicated situation, and there aren't any perfect answers or perfect solutions.

People suffer in those circumstances, and we need to find the most balanced way to minimize the losses and the suffering among a large group of innocent victims. But all innocent victims aren't in the same position. Many innocent victims have great conflicts of interest with many other innocent victims.

Some victims ended up getting more money than they put in, in some cases, much more money than they put in. Their profits were, I would argue, all fake, were fraudulent, stolen by the Ponzi schemer from other innocent victims. Those other innocent victims received absolutely nothing, and instead lost everything. And their stolen money has gone to pay for those fraudulent profits to others.

What do we do in that situation? There is no perfect or even good answer. But historically, we recover the fake profits from the innocent victims who received them to partially repay the actual losses of other innocent victims. In that way, nobody gets to profit from the Ponzi scheme.

There might be a better way or a more fair way, or a less unfair way to handle this difficult situation, and I hope that we hear one today. And if no investor should profit from a Ponzi scheme, the Federal Government should also never profit from the Ponzi scheme. For decades, innocent people paid very real taxes on totally fake profits.

When the fraud is exposed, the IRS says that the innocent victims can only get refunds for the taxes paid during the last 5 years. So ironically, the Federal Government benefits more and more from a long-term Ponzi scheme the longer it continues. Why shouldn't the innocent investors be able to recover all the taxes that were wrongly paid on totally fake or fraudulent profits?

I have a number of other questions, and I see my time has expired. But I do hope we have an opportunity to ask them during the question-and-answer period. I certainly want to thank those who are coming here today to testify.

And again, Mr. Chairman, I thank you for your work.

Chairman GARRETT. Thank you. Thank you for your comments.

The gentlelady from California for the remaining time on her side, I believe?

Ms. WATERS. Thank you very much, Mr. Chairman, and thank you for holding this hearing on the Securities Investor Protection Corporation.

The past few years have been very challenging for SIPC. During the height of the financial crisis, the Corporation was forced to liquidate Lehman Brothers, one of the world's largest brokerage firms. Shortly thereafter, the Madoff Ponzi scheme was uncovered. In the years since Madoff, we have also seen the case of the Stanford Group Company and the failure of MF Global.

Following the liquidation of Lehman Brothers and the discovery of the Madoff Ponzi scheme in 2008, SIPC's board of directors created the SIPC Modernization Task Force to review whether any changes to the law or to SIPC's operations were needed. Today, we are considering the report published by this Task Force.

Their recommendations include both items that require an Act of Congress, and items that can be pursued administratively. I am interested to hear from the Corporation on the rationale behind these recommendations, as well as any areas where certain Task Force members may have alternatives to what was presented in the consensus report.

It is also important to know how we can increase investor understanding of SIPC, and make certain that investors realize that it does not offer the same protection as FDIC insurance. I am also interested in exploring how we can ensure the most equitable outcomes for investors who have put their savings into Madoff, Stanford, and MF Global.

I understand that Chairman Garrett and Representative Ackerman have legislation that would attempt to provide additional assistance to certain victims of the Madoff fraud. I am very curious to hear more about these bills, while also being mindful that Congress should be very careful in this area since any changes to how customer claims are calculated will inevitably make certain investors winners, and others losers.

Finally, I am very curious to hear more about SIPC's rationale for not paying out claims under the Stanford Group company fraud, a decision that the SEC has contested. The timing of this hearing is all the more apt in light of Allen Stanford's conviction yesterday on 13 counts related to his $7 billion Ponzi scheme.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman GARRETT. I thank the gentlelady. And that is an interesting point, the last one you raised there.

And we have one other member, Dr. Cassidy, who, without objection, would like to sit on the panel later on today, once we get into the panels. Without objection, it is so ordered.

So we will now go to our first panel, and we welcome a gentleman from the other side of the Capitol, a former House Member, Senator Vitter. I know you serve on the Senate Banking Committee, and I know also that coming from where you do down south, a number of your constituents were more than adversely affected by the—some maybe by the Madoff case, but more by the Stanford case, and that you have been a leader in trying to bring an equitable solution to that situation.

So we thank you to coming and joining us, and commenting. Senator?

STATEMENT OF THE HONORABLE DAVID VITTER, A UNITED STATES SENATOR FROM THE STATE OF LOUISIANA

Senator VITTER. Thank you very much, Chairman Garrett, Ranking Member Waters, and all of you, for the invitation. I really appreciate it. And even more importantly, thank you for your important work and partnership on all sorts of issues—this, as well as a lot of challenges that have confronted Louisiana—Hurricanes Katrina and Rita, and the BP oil disaster.

All of you have been wonderful and generous in terms of our working partnership. Thank you for that. And it is great to be back on the House side. I remain a House Member in spirit. I brought a healthy House skepticism to the Senate. In fact, I still don't drink from the water fountains over there, and that is not going to change any time soon.

So it is great to be here. I am here, of course, because this is a very important issue, and I have been particularly involved in the case you mentioned, the Stanford case. I will submit my full comments for the record, and I will summarize here. And because of that focus, of course, my comments are going to be very informed by the Stanford case in particular; although I certainly acknowledge the importance of many other cases and share all of your concerns, including, in particular, about the Madoff case.

I am very involved in the Stanford case because, unfortunately, there are thousands of victims nationwide and many of them—many retired oil and gas workers and executives—are in Louisiana. So I am talking personally to dozens and dozens of them. Like in the Madoff situation, many lost their entire life savings. Many have literally had to sell their homes, go back to work well after normal retirement, and things like that.

There are real victims who have been taken advantage of. In the Stanford case, as you know, SIPC has denied coverage completely. And that is the fundamental problem. SIPC has basically taken the position that these were valid CDs that were lowered in value, lost value, and we don't cover market losses.

I think that position is just flat-out wrong. And through the Stanford experience, I have come to the conclusion that there is a need for major SIPC reform. It isn't to change their coverage, it isn't to change the parameters of the statute. I am not here to argue that should be broadened.

Again, I think there is clearly coverage in the Stanford case under the present statute, and I don't propose that SIPC should cover market losses or every evil or bad situation under the sun. Rather, I think reform is needed in a different way and, in some ways, a much more fundamental way.

I have reached the conclusion that SIPC, if it were a true regulator, would—in the parlance that is used—be a situation of complete regulatory capture. I do not think SIPC is focused enough on following the law and executing the law. I think it is far too focused on serving the industry and its member companies, and looking after their interests.

And my experience in the Stanford in particular has led me to that unfortunate conclusion. First of all, let me talk briefly about why there is coverage. As was mentioned, Allen Stanford was found guilty just yesterday of 13 criminal counts. He was found guilty of basically fraud, stealing customer funds.

Instead of purchasing Stanford International Bank CDs, the Stanford Group company, which was a SIPC member, acquired control of its customer funds and the funds were stolen by Allen Stanford. The SEC and the courts have taken a position in litigation that the Stanford companies operated a Ponzi scheme. And, "A Ponzi scheme is, as a matter of law, insolvent from its inception."

So it is not a matter of real CDs losing value. It is a matter of a Ponzi scheme, a fraud, and Allen Stanford stealing those funds. There are several other precedents in law, and other cases, that back up this point of coverage. They are in my written testimony, so I won't go into it exhaustively.

But my first point is that there is coverage. Now, people can disagree about legal points, but what I have really been crestfallen about isn't simply that SIPC has disagreed, but the way they have acted again has led me to conclude that they are not primarily focused in the right spirit on executing the law and protecting people properly covered under the law. But they are really focused on protecting their fund and their member companies.

Let me give you some examples. The very first meeting I ever had with SIPC, the chairman was there, the top staff were there. The first concern mentioned about the Stanford case was the amount of money it would drain from the fund and the reaction of member companies to the need to replenish the fund through other assessments.

That was the first thing that came out of their mouths, quite frankly, before we talked about what is the right thing to do, what the law says. Later, after they had dug in their heels for months and months denying all coverage, after the SEC finally acted and did the right thing, they entered into settlement negotiations and were willing to settle, albeit for far less than 100 cents on the dollar.

So apparently, their view of the law changed if it was going to preserve more of their fund. When they couldn't reach a settlement, they went back to court and are presently, in my opinion, dragging their feet and prolonging court action as much as possible. This includes spending $200,000 of what is there for ultimate recovery by the victims on certain discovery. This includes, presently, asking for more prolonged discovery rather than getting to the heart of the issue in the legal proceeding.

You put all of that together, Mr. Chairman, and in my opinion, that is not a picture of an agency or an entity trying to meet its responsibility to covered victims under the law. It is more of a picture of what would be akin to an industry trade group or association, an active party litigant, if you will, just trying to preserve as much as they can of their resources and their fund.

I believe that is the fundamental problem, and that is the most fundamental need for reform. So, Mr. Chairman, again thank you for this hearing, and for calling attention to this important matter, including the Madoff case, including the Stanford case. I think this discussion will promote important reform.

I hope in the meantime, SIPC still does the right thing in the Stanford case and that it doesn't prolong the court activity and the litigation, and we get to that bottom line as quickly as possible for the good of all of the victims. And I really appreciate the invitation to be here, and all of your partnership, on this important issue and other important issues.

Thank you very much.

[The prepared statement of Senator Vitter can be found on page 225 of the appendix.]

Chairman GARRETT. Senator, I thank you for coming to join us today and speak on the first panel. I thank you also for your concern for your constituents, and other constituents around the country as well, with this matter. I appreciate also, and thank you for you work and leadership in the Senate on this matter.

As you see from the questions in the opening statements, I think we—it is a bipartisan concern on this issue, in general. And as you can see with the legislation, that we—that is here partly to be considered—you also see that it is a bipartisan initiative, as well.

There are still open questions as to the finality of some of these things, but I think we are going to try to do it in a bipartisan manner. I understand that we are already at the top of the hour, and I was told by staff that you have, as always for Senators, a commitment back on the other side of the Capitol.

So I would just say I appreciate your coming over, and I appreciate your accepting our invitation, and I look forward to working with you and the other side of the house, as well, on this issue.

Senator VITTER. Thank you very much.

Chairman GARRETT. Thank you, Senator.

Senator VITTER. I appreciate it.

Chairman GARRETT. With that, then, we will move on to panel two, and they can come to the table. At the table, we will have the president and CEO of what we have just been talking about, the Securities Investor Protection Corporation, Mr. Harbeck. And we also have Ms. Bowen, the acting chairman of the board of the Securities Investor Protection Corporation, as well.

I will let you get situated there. And welcome, again, to the committee hearing today. I appreciate both of you coming and joining us to talk about this very important topic. Your complete written testimony, of course, as always, will be made a part of the record. But we will recognize each of you, I understand, for opening statements for 5 minutes each.

Mr. Harbeck, we usually go from left to right.

STATEMENT OF STEPHEN P. HARBECK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE SECURITIES INVESTOR PROTECTION CORPORATION (SIPC)

Mr. HARBECK. If you wish, I will begin. Chairman Garrett, Ranking Member Waters, members of the subcommittee, thank you for this opportunity today. My name is Steve Harbeck, and I am the president and CEO of SIPC.

Since the collapse of Lehman Brothers Entities—as mentioned by Ranking Member Waters—in 2008, SIPC has been at the center of the financial crisis. I would like to give you an overview of what SIPC has done between 2008 and the present day.

First, the guiding principle SIPC has used in this period is the greatest good for the greatest number, consistent with the law. I would like to briefly highlight some of the matters in Madoff, Lehman, MF Global, and Stanford. The Madoff case is the largest Ponzi scheme in history. The people who have not received funds from SIPC are those people who have either received 100 percent of their investment back, or people who must repay a portion of what they received before receiving funds.

The courts have uniformly confirmed that SIPC's method of computing what is owed to customers is, in fact, correct, and in accordance with previous precedent. I am pleased to note that the GAO report that was just issued within the last day, indicates on page 31 that the driver of administrative expenses in the Madoff case is asset collection for those people who have not received 100 percent of their investment back.

The trustee has used the so-called "avoiding powers" wisely, judiciously, and effectively. The avoiding powers are precisely what makes the trustee's distribution in that case among innocent investors truly an equitable one. The Task Force on SIPC Modernization agreed, and Exhibit D to my written statement demonstrates, that SIPC doesn't benefit from the avoiding powers, but those people who are most damaged are the people who benefit.

The trustee has also adopted a hardship program to discontinue any avoidance suit that should be dropped, given the nature of a defendant's circumstances. It is very important to note that no customer money is used for administrative expenses, and there has been an incredible benefit to investors.

I first appeared before this body in January of 2009. And if I had told you then that the trustee would recover $9 billion to $10 billion for the Madoff investors, you would not have believed me. But that is already what has been accomplished to date. And the driver of the $300 million of administrative expenses is the recovery of that $9 billion.

Those who would expand the distributions to net winners in the Madoff game should recall that the distribution in a Ponzi scheme is a zero sum game, and the trustee's plan distributes benefits to those who have been most damaged by Mr. Madoff's theft.

If other victims, and they are victims, but people who are net winners, who have received 100 percent of their assets back, share in that fund, it is mathematically ineluctable that the people who are most damaged will suffer on a dollar-for-dollar basis.

Turning to Lehman, Lehman is the largest bankruptcy in history. And in the early days of Lehman, under SIPC's initiation of a liquidation proceeding, 110,000 customers received $92 billion in 10 days. The trustee in that case has been extremely successful in lawsuits. He has won $2.3 billion from Barclays Bank, and settled a suit for over $700 million with JP Morgan Chase.

And last week, the trustee scored a major victory in the Supreme Court of the United Kingdom that will benefit American investors directly. The impartial observer closest to the case, the bankruptcy judge, states that the case has been an extraordinary success and it is coming to a successful conclusion.

In the MF Global case, SIPC acted to protect investors and did so, demonstrating that we can act quickly and decisively. SIPC placed a fiduciary in charge of the firm less than 12 hours after being notified that customer protection was warranted. As I outline in my written statement, significant distributions to both commodity investors and securities investors have been made.

And that brings us to the most difficult subject, and that is the Stanford case. SIPC protects the custody function that brokerage firms perform. Let me say that again. SIPC protects the custody function that brokerage firms perform. The investors in the Stanford case, unlike the investors in the Madoff case, knowingly sent their money away from the brokerage firm to an offshore bank.

They were specifically told, in writing, that SIPC does not protect their investments. They each opened a bank account in a bank of Antigua, and they now see recision of that investment and to have SIPC pay the original purchase price of their investments using SIPC and, if necessary, taxpayer funds.

Simply put, Congress never intended, and the statute has never been held, to refund the purchase price of a bad investment. That is absolutely not what the law mandates. And while there were other legal reasons as well, that is why SIPC has not initiated a customer protection proceeding for the firm.

SIPC has acted to protect and benefit investors in those three cases, but SIPC's protections are not available to restore the purchase price of a bad investment on a CD issued in an overseas bank.

Mr. Chairman, if I could respond to one of your comments, at the beginning of the case you mentioned that institutional investors would receive most of the money in the Madoff case. This is a point made by Mr. Stein in his written communique, and I think we are failing to connect some dots here that very, very much need to be connected.

Mr. Stein mentions that a number of investors received zero in the Madoff case, and that is quite true. So there are thousands of investors who did not receive money. But then when you say 75 percent to 90 percent of the assets in Madoff are going to institutional investors, you must connect the dots by saying the thousands of people who did not receive anything are the people who own those institutions, and they will be satisfied by distributions to the institutions.

So I wanted to make that clear so that we realize that when the indirect claimants are not paid, they will receive their proportionate share of the distribution when the funds they owned receive a distribution from the trustee. And another point made in the written comments concerning SIPC's actions in this case is that the distribution was not prompt.

The trustee stands ready to make a $9 billion distribution as soon as he can. But the people who have initiated litigation to allow net winners to share in that money have delayed that distribution. And if you don't connect those dots, you don't get the complete picture.

SIPC has done a great deal. We have advanced $800 million for the investors in Madoff. And we think, in that sense, the process is coming to a sound conclusion. I would be pleased to take any other questions you have.

Thank you very much.

[The prepared statement of Mr. Harbeck can be found on page 172 of the appendix.]

Chairman GARRETT. I thank you for your statement.

Ms. Bowen is recognized for 5 minutes. And welcome to the panel.

STATEMENT OF SHARON Y. BOWEN, ACTING CHAIR, SECURITIES INVESTOR PROTECTION CORPORATION (SIPC)

Ms. BOWEN. Thank you.

Chairman GARRETT. Thank you.

Ms. BOWEN. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for the opportunity to appear before you today to discuss the important work of the Securities Investor Protection Corporation. My name is Sharon Bowen, and I am the acting Chair of SIPC. Because I also served as Vice Chair of the SIPC Modernization Task Force, I will focus on the four issues raised by that report.

SIPC was created in 1970. With some narrow exceptions, every registered broker or dealer is a member of SIPC. Membership in SIPC is automatic upon registration as a broker or a dealer. SIPC is not a government agency. Its policies are set by its seven-member board of directors, five of whom are appointed by the President and confirmed by the Senate.

SIPC administers a fund which is comprised of assessments paid by its members. The fund is used to support SIPC's mission of customer protection, and to finance SIPC's operations. Should the fund become inadequate for any purpose, SIPC may borrow against a $2.5 billion line of credit from the Treasury.

In its nearly 40-year history, SIPC has never drawn on that line of credit. Every customer of SIPC is protected up to $500,000 against loss or missing cash or securities deposited with the broker-dealer for that customer's account. Of the $500,000, up to $250,000 may be used to satisfy claims for cash only.

To date, SIPC has overseen the administration of 324 customer protection proceedings, which have involved the distribution, through 2010, of roughly $109 billion of assets for those customers. Of that sum, $108 billion has come from the debtors estate, and $1.1 billion has come from the SIPC fund.

Former SIPC chairman Orlan Johnson promised Congress at his confirmation hearing that he would form a Task Force to conduct the first comprehensive review of the Securities Investor Protection

Act and SIPC's operation since the amendments of 1978. The SIPC Modernization Task Force has completed its work, and the report and recommendations of the Task Force are attached.

The Task Force reached out to obtain broad input. It conducted a live forum in New York City to receive the personal views of individual investors. It held an Internet question-and-answer forum with investors, as well. A Web site was established to advise the public of the issues being considered and to solicit input from investors.

In particular, the Task Force reviewed issues raised by recent complex litigation. In some instances, the Task Force recommendations will require legislation, and others will require rule changes. And some of the recommendations can be implemented directly by SIPC.

We also considered areas where we decided there should be no change. Let me quickly cover some of the key recommendations. First, the Task Force concluded that SIPC should be amended to allow for inflation since 1980. In that year, the maximum was set at $500,000. In inflation adjustment dollars today, that level of protection would be $1.3 million. And the Task Force has concluded that sum should be used and should be adjusted for inflation periodically.

Second, the Task Force was presented with numerous cases where cash was being caught at a moment just before securities purchase or subsequent to a securities sale. And that was subject to a lower protection. Because these results are somewhat arbitrary, the Task Force has recommended that we eliminate the treatment of cash and securities.

Third, since smaller investors often have so much of their wealth in pension plans, the Task Force has recommended that we extend pass-through protection for pension plan participants that currently does not exist today.

Fourth, in what we believe was an unintentional consequence of an amendment to SIPA, some SIPC members actually had their assessments reduced. We recommend correcting this oversight.

Fifth, the Task Force recommended that SIPC assist in creating an international association of investor protection entities. While SIPC has a memorandum of understanding with a number of these organizations, the Lehman and MF Global cases show that international issues will only increase in the future.

And finally, the Task Force advocated that SIPC could change the developed programs to fully educate investors about SIPC protections and limitations on those protections.

These are a few of the recommendations. I would like to take the opportunity to thank the members of the Task Force for their work. And I would be happy to take any questions.

[The prepared statement of Ms. Bowen can be found on page 87 of the appendix.]

Chairman GARRETT. And I thank you for your testimony. I will now recognize myself to begin with just a couple of questions.

And maybe I will throw it out to Mr. Harbeck, but it sort of goes with the last comment that Ms. Bowen was making as far as educating the investors and the like. So Mr. Harbeck, you made a comment which was an interesting one with regard—and I will bring this all around—to the Stanford case; that in that case, there was actually written notice.

Your first comment was to the effect that the coverage and insurance, if you will, is—protection is for the securities that are held by the broker. And you—in that particular case, I think you made a comment just now saying that actually written notice was made to the investors that they were investing and the money was going, as you put it, offshore. Correct?

Mr. HARBECK. In the Stanford case, as a part of the investor package that each investor received from the Stanford International Bank in Antigua, the investors—most of whom never gave money to the SIPC member firm at all, but some did—when they gave their money to the brokerage firm, the money went to the Stanford International Bank in Antigua. And that bank issued a statement saying that the brokerage firm is not liable and that SIPC does not protect the investment.

Chairman GARRETT. Right. Okay. That is good to know, on that particular case. In all other cases, the average situation is, when the investor goes into the broker's office, there is the SIPC logo there. And the implication comes with that, as well. I remember when we met for the first time, I guess, the comment was made is that there is a perception that you were covered, or insured if you will, up to $500,000.

I remember you saying at that time no, not in all cases. And I think that is the message that you are delivering today, as well, from your testimony. No, you are not covered for $500,000 in all cases. So I guess a very seminal question here is, should we go back to the days of allowing, or requiring, that people actually have the stock certificate in their hand so that they can be guaranteed that this is actually what they have if, without that, you are not really sure what you have?

Mr. HARBECK. Congressman, that would solve the problem. That is just not going to happen. It is not the way the world works. Transactions are done instantaneously at this juncture. And to take physical possession of securities, I think is an impractical—

Chairman GARRETT. Right. I would agree with you. But if that is the case, that we can't really be sure of what I have in my hand as I used to in the old days, then I have to be guaranteed of something, assured of something. And in this case, the IRS was. Or in certain of these cases, the IRS is insured of something because they see the statement—I guess it is a 1099 or what have you—that goes to them saying this is what the dividends, or payments out.

So they are assured of it. I, as an investor, hypothetically—or an investor would say—I have the certificate, or I have the statement saying this. If the investor can't rely on the statement, what should he rely upon then?

Mr. HARBECK. One of the problems here, of course, is that the investors in Madoff gave discretion as to what to buy to Mr. Madoff.

Chairman GARRETT. In any case, if I can't rely on the statement, what should I be able to rely on?

Mr. HARBECK. In the overwhelming majority of instances, you can. But what you cannot rely on is that when you give discretion to someone to buy securities, and he backdates a statement and generates fictitious profits again and again, month after month after month, it is—

Chairman GARRETT. Yes, but the investor wouldn't know about the backdating. I only have a minute left already. As far as discretion—I am going to get right to the point on this one—the discretion right now, as far as the situation when you have a situation like this in the appointing of a trustee, that selection or the nomination of that process is by SIPC. Correct?

Mr. HARBECK. Correct.

Chairman GARRETT. Would it be a better process to take that step away from SIPC, and give it to a so-called neutral party, which would be the SEC? Let them make the nomination of it so you would avert any idea whatsoever, real or otherwise, of any conflict that SIPC would have? If not, why would that be bad?

Mr. HARBECK. I think SIPC has an extended body of knowledge concerning who has expertise on this, number one. And number two, that knowledge and expertise has to be applied on about an hour's notice. The MF Global case is a perfect example of that. I received—

Chairman GARRETT. So if we could set up something within SEC that they would: one, get the knowledge; and two, have a mechanism to be able to make these things quickly, could that address both of the situations?

Mr. HARBECK. I am not sure it could, but there is a further reason. And the further reason is that the people who are saying that these trustees are not comporting with the law are being unsuccessful in that position in courts. It would be different if these trustees were advancing positions in courts and the courts were saying no, you are incorrect.

But in Lehman and in Madoff, consistently, the trustee has upheld the law as Congress has written it. And the courts have said that is the case. So I don't think there is anything broken about the process. Experts are being put in place, and they are doing a good job.

Chairman GARRETT. My time has expired. I am always mindful of my colleagues. I guess the question is not necessarily whether they are breaking the law, but whether the intention of Congress is being fulfilled as far as how the trustees are managing the case. With that—

Mr. HARBECK. In 1978, Congressman, the Congress investigated that precise point, and chose to strengthen SIPC's ability to designate trustees.

Chairman GARRETT. Thank you.

The gentlelady from California is recognized.

Ms. WATERS. Thank you very much, Mr. Chairman. And let me thank our witnesses who have appeared here today to help us better understand some of the discussions about SIPC and these cases that have been mentioned here today that have played out in the press.

I want to understand. Can I get a summary of the areas where SIPC and SEC disagree about how to resolve, first, the Robert Allen Stanford case?

Mr. HARBECK. Certainly. The essential dispute is that the SEC's position is a change in the 40-year interpretation of the statute.

For the first time, the SEC is saying that SIPC should pay recision damages to people who are in physical possession of the security that they purchased.

That has never been the law, and it is not the law. And the reason that SIPC has not been involved for 2 years is because the SEC staff looked for instances where individuals left assets at the SIPC-member brokerage firm and did not receive those assets. There is no such investor.

The investors who lost money knowingly and willingly sent their money to an offshore bank. And saying that there is some vague connection between—it is not a vague connection. To say that there—you can just sort of smush everything together, and say therefore the brokerage firm must have had custody of the investor's assets is factually incorrect.

The fact is, the investors got what they paid for and they were defrauded. But SIPC does not pay that as a damage claim. These are victims, but they are not covered by the statutory program.

Ms. WATERS. I must say, Mr. Harbeck, you make a very good case. What is the current status of SEC's effort to force SIPC to initiate a claims procedure for Stanford's victims?

Mr. HARBECK. The SEC delivered a letter to SIPC on June 15th of last year. Our board examined the issue very, very carefully. The board did not take the staff's recommendation without hiring outside counsel to make sure that the staff recommendation not to start a liquidation proceeding under these circumstances comported with law.

We did attempt to resolve the problem. We were unsuccessful in resolving the problem with the SEC. And as a result, the SEC filed suit to compel SIPC to take action. But we have yet to have been presented with someone who left custody of their assets with the SIPC-member brokerage firm. And that is why we feel we must go forward with the lawsuit.

Ms. WATERS. Thank you very much. Let me just ask about the Madoff case. Can you discuss how clawbacks have been treated by SIPC as it relates to Madoff's fraud?

Mr. HARBECK. Yes, I would be happy to. Ever since Charles Ponzi enacted his own Ponzi scheme, there have been avoidance powers that allow a trustee to reach back to people who have already received assets out of the fraudulent scheme and bring them back into a common pool.

That is exactly what the trustee has done, and it is exactly what the Task Force has looked at with respect to that should continue under the Securities Investor Protection Act. And the Task Force concluded that if any bankruptcy trustee has that authority and right, then a SIPA trustee, under the Securities Investor Protection Act, should have that right.

And the reason is, the common pool is expanded and we don't let the luck of the draw, by getting out the day before or withdrawing profits and even your principal just before the collapse of the scheme gives you an advantage over people who are stuck. And so, the trustee has used those avoiding powers.

And by starting one particular lawsuit, he has brought back billions and billions of dollars into this estate for distribution to the people who need it the most.

Ms. WATERS. Mr. Chairman, I yield back.

Chairman GARRETT. The gentlelady yields back.

Mr. Dold is recognized.

Mr. DOLD. Thank you, Mr. Chairman.

Ms. Bowen, even though almost 11,000 indirect investors lost their money in the Madoff fraud, not one single indirect investor was invited to be on the Modernization Task Force. Why is that?

Ms. BOWEN. The Task Force actually was comprised of a broad group of people of expertise, including two lawyers who represent investors such as the ones that you have mentioned. So we felt that their voice was being heard at the table. In addition, we created a Web site and we had the Internet forum, if you will.

And we had a live presentation, where we had an open forum in New York City. I was there at that forum. Investors showed up, and they did speak to the Task Force. And we heard their words and we took their comments to heart.

Mr. DOLD. Mr. Harbeck, do you believe that President Nixon and Senator Muskie and the other supporters led the 1970 passage of SIPA to provide financial relief for all investors?

Mr. HARBECK. That is a statement of extraordinary breadth. The fact is, the statute, as originally drafted in 1970, was intended to protect the custody function performed by brokerage firms. And we have been following that mission for 40 years.

Mr. DOLD. Do you believe that it is fair and equitable to differentiate between direct and indirect investors?

Mr. HARBECK. The indirect investors that you are referring to are people to whom I was referring with respect to comments to Chairman Garrett. The trustee did not pay them, but the reason he did not pay them is he will pay the institution that they own, the feeder funds that they own.

So if five people own a feeder fund, they will each get whatever portion they get in terms of their ownership.

Mr. DOLD. And will that be considered a single entity? Because I know we are talking about each individual entity has certain abilities to receive resources back. Will that fund that has five individuals be counted as one, or will that be counted as five?

Mr. HARBECK. It would be counted as one. And 2-point—

Mr. DOLD. Do you think that is fair and equitable?

Mr. HARBECK. Yes I do, and here is why. There are two points on that. First of all, the Task Force considered that and considered the fact that small investors in pension funds might well be considered the small investors who are supposed to be protected by this statute.

But moreover, the big protection is not the advance from SIPC. The big protection is the share of customer property. And in the Madoff case, this is precisely what Trustee Picard is trying to expand using the avoiding powers. And those funds, if numbers hold, will receive 50 cents on the dollar, which was an unthinkable result, an unthinkably positive result, in 2008.

Mr. DOLD. I understand what you are talking about. But I think my concern is that the assumption is that these are going to be smaller investors. Could you not see a situation where a group actually were the large investors coming in, and would not be treated as one?

Mr. HARBECK. The size of the individual investor—

Mr. DOLD. Obviously varies.

Mr. HARBECK. —is not relevant. What is relevant is whether they had a direct relationship with the brokerage firm.

Mr. DOLD. Are you then taking—

Mr. HARBECK. And many of the indirect people had no direct investment.

Mr. DOLD. Are you then trying to pick winners and losers in terms of determining direct or indirect?

Mr. HARBECK. Absolutely not.

Mr. DOLD. You don't believe that there is any difference there?

Mr. HARBECK. No. No, if a large investor owns a share of a feeder fund, he will get a proportionate share.

Mr. DOLD. Capped at what, $500,000? Is that correct?

Mr. HARBECK. No, sir. The fund itself will get $500,000 plus its pro rata share of the fund. And the pro rata share of the fund is the lion's share of what any investor will receive.

Mr. DOLD. Mr. Harbeck, let me just move on then a little bit. How does the net equity, or the cash-in minus cash-out computation, protect all customers of a failed broker-dealer?

Mr. HARBECK. This is the methodology that has been used in every single case under the Securities Investor Protection Act dating back to the 1970s where fictional statements have been involved; S.J. Salmon in 1973, Adler Coleman in the 1990s, and many cases in between. The money-in, money-out methodology is not new to Madoff. It is historically what has always been used when brokers enter fictional transactions to benefit customers.

Mr. DOLD. Thank you. I realize my time has expired, Mr. Chairman. But I do—hopefully, we will have another round to talk about some clawbacks, which I think is important when we talk about some of these Ponzi schemes.

And I yield back.

Chairman GARRETT. The gentlelady from New York is recognized for 5 minutes.

Mrs. MALONEY. First, I would like to thank you for your testimony, and voice my support for the Task Force's recommendation that the $500,000 be raised, with inflation, to $1.3 million, and to provide pass-through protection to some indirect investors. I think that was a thoughtful recommendation, and I support it.

I would like to ask a question on H.R. 757. It is one of the bills that we are debating and is before this committee. And in that bill, the last statement would be used when determining a customer's eligible claim. As was stated, courts have recently ruled that this standard in a Ponzi scheme is not appropriate and that the standard that SIPC is using—net investment money in, money out—is more appropriate.

I do see that there could be some problems with this, and I ask you to comment on it. And one example that came in to me was, investors that most used—in this case, basically, the claim could be based on fraudulent information to begin with.

So if you are using the last statement, it could be based on fraudulent information and it could be a fraud in the first place. And for example, if you invested $1 million 10 years ago, and your statement says you now have a fictitious earning and that you now have

$10 million, you would be treated the same as someone who invested $10 million yesterday.

So the former has $9 million in fictitious earnings; the latter had no fictitious earnings. However, both are treated the same. So if the pot of money actually in the Ponzi scheme was $5 million, each would get $2.5 million. And that doesn't seem fair because it doesn't reflect the reality of what is behind that.

I ask you to comment on that, and other ideas of why you think your recommendation of money-in, money-out is better. And that, of course, is what the courts are saying. But I also would like to ask, how do you or Trustee Picard determine when it would be a hardship to claw back funds?

Mr. HARBECK. I would like to speak to your first issue first, if I may, Congresswoman. Exhibit D to my written testimony goes through examples of why the avoidance powers resolved the problems and actually do equity, and that H.R. 757, while well-intentioned, actually creates inequitable results.

Mrs. MALONEY. Thank you, we will read that. But for now, could you answer how do you and Trustee—or how does Trustee Picard determine when it would be a hardship to claw back funds?

Mr. HARBECK. The hardship program is one where anyone who has been sued under the avoiding powers can demonstrate financial hardship. And those are as unique as the number of individuals involved. And I think the trustee, first of all, made a decision not to sue certain of the people who received relatively small amounts, although they are, in absolute terms to me, somewhat sizeable.

He didn't sue everyone who received more than they put in. But when he did, he was more than willing to listen and apply a rule of reason—that is the only way you can really describe it—to a situation. It makes no sense to sue someone when they have no assets or they are extremely—

Mrs. MALONEY. And my time is almost up. Can you discuss the Task Force's recommendation to provide pass-through protection to indirect investors in certain ERISA-qualified plans but not investors in other funds?

Ms. BOWEN. Oh, sure. Making that determination, we thought at least with the ERISA plans that those trustees have a fiduciary obligation to those retirement funds. We also thought that the whole purpose of SIPC is to protect the small retail investor. And given how people invest money today, most people's savings are tied up, frankly, in their retirement accounts.

So we were attempting to address that by really limiting it to that circle of people, frankly, and not to extend it to large institutional investors.

Mrs. MALONEY. Okay, thank you. My time has expired.

Chairman GARRETT. Thank you. The gentlelady yields back.

Mr. Hurt is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. I want to thank you all for being here today as we try to understand and deal with these important issues. I had three things I wanted to cover, and maybe each of you could address it, as appropriate.

The first is, can you give us some concrete idea of what the financial solvency is of the fund? Especially with the pressures that you face in wanting to raise the maximum reimbursement or the maximum claim amount and, I hope, also considering the fact that you want to keep these assessments as low as possible.

The second question deals with the assessments themselves. How are you dealing with the fact that a lot of these broker-dealers are a part of smaller outfits, smaller firms? And how do you account for the pressures that they face as small businesspeople?

And then finally, just a general question. Are these reforms things that will require congressional action, or are these things that you all, from your standpoint, would prefer to be able to do from within?

Mr. HARBECK. Let me make an attempt to answer that. First of all, in terms of SIPC's financial solvency, prior to the start of the Lehman Brothers case, SIPC had $1.7 billion. Even after paying $800 million to Madoff investors and paying administrative expenses of $300 million to $400 million that have brought in $9 billion for the Madoff estate, because we, in effect, turned the spigot back on of assessments we now have a fund of $1.5 billion.

And that is adequate to perform the statutory functions that Congress has assigned—

Mr. HURT. Has anything been drawn down from the Treasury?

Mr. HARBECK. No. We have never used Treasury funds. But I hasten to add that if SIPC is to be tasked with some new and radically different level of protection for rescinding bad investments, as in the Stanford case, I would anticipate that the Treasury line of credit may or may not be sufficient and we would have to assess the industry.

To your second point about assessing the smaller independent members, I have met—and other SIPC staff members have met—with the National Association of Independent Broker-Dealers to brief them on these issues. And we understand the nature of the problem. They are currently being assessed at one-quarter of 1 percent of their net operating revenues.

Mr. HURT. And if I could just interrupt. Before, it was at $150 per member, $150 annually for each member. Is that right?

Mr. HARBECK. We assessed on net operating revenues through the 1990s. When we reached a target of $1 billion, we cut back to a very nominal sum. But with the onset of the Lehman and Madoff cases, with reestablished a higher target of $2.5 billion that we would like to have on hand.

Mr. HURT. So what does that mean? Is there a way to characterize that as it relates to the smaller firms?

Mr. HARBECK. Yes. If we were to continue—

Mr. HURT. In a cash number?

Mr. HARBECK. Oh, in a cash number? It is very difficult because, frankly, the large brokers—

Mr. HURT. Is it $500, $1,000?

Mr. HARBECK. Oh, it varies dramatically. And as Ms. Bowen has said, some of the very smallest brokers have now actually, inadvertently, had their assessments reduced to zero.

Mr. HURT. Okay. All right, go ahead.

Mr. HARBECK. But the basic point is that we will be assessing, if we continued at the current rate of one-quarter of 1 percent of net operating revenues, we would reach our target of $2.5 billion between the years 2015 and 2016.

Mr. HURT. And then the last question deals with congressional action. Are these things that you all are inviting congressional action, or are these things that you feel like you can handle in-house?

Mr. HARBECK. I think some of the things can be done in-house. But most changes concerning the limits of protection require congressional action. And when former Chairman Johnson issued the Task Force Report, he requested—and raised at the board meetings—that we do some empirical studies as to the effect on the industry and on investors before we go to Congress and ask for those changes.

Mr. HURT. Thank you. my time is about to expire.

Ms. Bowen, do you have anything to add to that?

Ms. BOWEN. The only other thing I would add with respect to the assessments is that obviously that number is determined based on litigation, when and if it happens, at the time. And so we can't predict, necessarily, if there is going to be another big failure tomorrow.

So the concept of assessments really depends on the likelihood of litigation, the outcome. Stanford, obviously, would definitely be a huge problem.

Mr. HURT. Thank you.

Chairman GARRETT. The gentleman yields back?

Mr. HURT. Thank you.

Chairman GARRETT. Mr. Green is recognized. I think you are next.

Mr. GREEN. Thank you, Mr. Chairman. I thank these witnesses for appearing, as well. And I do concur and believe that we should raise the amounts to investors that they may acquire if there is some scheme that is uncovered.

Now, let us focus specifically on Mr. Madoff. And I would like to speak to you, if I may, Mr. Harbeck. Sir, is it true that Mr. Madoff had, with malice aforethought, statements issued that were misrepresentations?

Mr. HARBECK. Absolutely.

Mr. GREEN. And is it true that these statements—and I am not sure that you have added them up, but if you did add them up, that they would total probably billions and billions more than you are capable of paying if you pay based upon the statements?

Mr. HARBECK. On a money-in, money-out basis, the customers of the Madoff brokerage firm deposited between $17 billion and $20 billion. The final statements totaled about $63 billion. He had on hand virtually nothing.

Mr. GREEN. Before going on, let me make it very clear that I really am in sympathy with people who have been defrauded. This is a dastardly deed perpetrated by a criminal mind, without question. The question, however, becomes how do you compensate these victims?

And this is why I have said my thoughts are somewhat ambivalent. Because I am trying to do equity. I want to make sure that people can have some confidence in capital markets and confidence that when they go to these brokers, they are going to get some degree of equity.

Just address it, please, given the wide chasm between the statements and the money-in, money-out methodology.

Mr. HARBECK. The difficult answer, but the correct answer which the courts came to, is that to base the payments on the last statement is to allow the fraudulent actor—the dastardly criminal who you correctly characterized—the final say as to who wins and who loses.

And further, if you go by the last statement, the unintended consequence of that is you make Ponzi scheme participation a good thing. You make it profitable. So in one of the comments that I made to one of the bills, it was to create a dialogue between a fraudulent salesman and someone who was questioning, "Well, if this is a fraud, will I get money back?"

And the answer was, "Don't worry about that. SIPC will pay for it even if it goes down, even if it's fraudulent." So it is a difficult question. But the courts that considered it—the trial court, the bankruptcy court and the 2nd Circuit Court of Appeals—came to the conclusion—and these are not my words, these are the words of the four judges who have considered this—that it would be absurd to let the thief determine who wins and who loses.

And consequently, you can't use the last statement.

Mr. GREEN. Now, I concur with the chairman with reference to the statement. And to this extent, I want the person receiving a statement, the investor, to have some belief in that statement and to rely on that statement. Is there any means by which we can use technology, or somehow cross-reference, or give that person receiving the statement the opportunity to—as an aside, are all or most of these persons sophisticated investors?

Mr. HARBECK. We make the assumption that they are not.

Mr. GREEN. Okay. Now, they are not sophisticated investors. How can we, perhaps with technology or some other means, give them a greater degree of confidence in that statement? Because the chairman makes a good point. I have my statement, I am relying on my statement. To a certain extent, there are other entities that rely on the statement.

How can we strengthen the statement?

Mr. HARBECK. I think you have put your finger on it. I think technology is the answer. In this case, Bernard Madoff, acting as an investment advisor, used his own firm as the custodian of the securities supposedly held for his clients. If you divorce the custody function from the investment advisor function, as is done by most investment advisors, then the problem solves itself.

Then the brokerage firm with custody has the securities. It is a check on the system. And I think the SEC has located that as one of the problems in the Madoff case.

Mr. GREEN. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And I thank you.

The gentleman from New Mexico is recognized for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Ms. Bowen, as I am reading through Senator Vitter's testimony, he alleges that SIPC is dragging its feet on solving the cases. Do you have a rebuttal to his testimony?

Ms. BOWEN. Obviously, I think you are referring to the Stanford case.

Mr. PEARCE. He is talking also, saying—he says you are dragging your feet on the Madoff case also.

Ms. BOWEN. I would say, just given the outcome with the Madoff case, that we haven't been dragging our feet, and we have been maximizing the return to the investing public. With respect to Stanford, it is a really complicated issue. We decided that we did not have the authority to change the law, to change the statute.

And our reading of the statute is such that we felt we had to go to court. I believe the court has decided to be as expeditious as possible in reaching a resolution. And actually, we will follow the law.

Mr. PEARCE. Does the SEC agree with your position, or does the SEC oppose your position?

Ms. BOWEN. It opposes our position as to whether or not they are—

Mr. PEARCE. So they feel like it is not required to change any law?

Ms. BOWEN. I believe—again, I haven't really read their filings. But I believe they think that there is, there may be a customer who is entitled to recovery. We don't see a customer at a broker-dealer.

Mr. PEARCE. Do you all get involved at all in the notifications up front that investors are worried about their investment? Are you all notified at all? You just come in later as the insurers?

Mr. HARBECK. First of all, we are not a regulator in any way, shape, or form. And unlike the FDIC—one of the questions earlier concerned the FDIC. We are not an insurer, and that is not in our name. We do come in—and you are correct—only after the firm has failed.

Mr. PEARCE. So are you involved in the MF Global case at all?

Mr. HARBECK. Yes, sir. I was notified at 5:20 a.m. on Halloween day that MF Global's customers were in need of protection. And one of the gentleman in this room, who is on the legal staff of SIPC, was in court and had a trustee appointed that afternoon.

Mr. PEARCE. Who notified you at 5:20 a.m.?

Mr. HARBECK. A member of the trading and market staff of the Securities and Exchange Commission.

Mr. PEARCE. Do you remember the name?

Mr. HARBECK. Yes. His name was Mike Macchiaroli.

Mr. PEARCE. You received the SEC's e-mail at 7:29 on October 31st, and that e-mail set forth the basis that they thought that a settlement was going to be reached? Is that correct?

Mr. HARBECK. I think you are conflating two cases, sir. Oh, a settlement in the MF Global case.

Mr. PEARCE. Okay.

Mr. HARBECK. Yes, yes. At 7:29 on October 31st of last year, that was a written confirmation that MF Global had failed and was in need of protection.

Mr. PEARCE. Okay.

Mr. HARBECK. Subsequent to my—the 5:20 call from the Securities and Exchange Commission, Mr. Macchiaroli in New York, we put an attorney on a plane that day. And that day, we took over the firm and placed a trustee in position.

I think that demonstrates that we don't drag our feet. We had no idea whether we had billions of dollars worth of exposure in that situation, and we did it because that was the right thing to do.

Mr. PEARCE. You are discussing, in another circumstance, about the professionals that you all contacted. Who are the professionals that you all contacted? Can you get us a list of that, and what were their positions?

Mr. HARBECK. We contacted attorneys from Weil, Gotshal & Manges, we contacted attorneys from several other law firms, the name of which escapes me. Several of them had conflicts of interest. And we felt that, as it turned out that MF Global was the 8th largest bankruptcy of any kind in history, it would be a poor time to put in someone who had no previous experience in this case.

Mr. PEARCE. Let me get one question in before my time is up. I am sorry to interrupt, but you talked about going and getting settlements from—say people had received a payment, they had cashed in their account. And you go back, and you are not going to let them succeed just because they got paid out the day before the bankruptcy.

Do you ever go after the personal assets of the people, the principles, involved in these decisions? In other words, Mr. Corzine?

Mr. HARBECK. Since no lawsuit has been started against Mr. Corzine, I would rather speak to either past cases or—

Mr. PEARCE. That was an example.

Mr. HARBECK. —or theoretically.

Mr. PEARCE. You do go after—

Mr. HARBECK. We go—the SIPC trustees are financed by SIPC to take every—we think it is a good lesson for people who steal money to be held accountable for it. And we will finance litigation to do that, and take those people down to their last cent.

Mr. PEARCE. All right. Thank you, Mr. Chairman. I appreciate it.

Mr. HARBECK. Thank you.

Chairman GARRETT. Mr. Royce? You are recognized.

Mr. ROYCE. Thank you, Mr. Chairman. I guess what has caught our attention, among other things, is the report of the Office of Inspector General Office of Audits, where they have some very pointed things to say about the oversight. They say, "We found that significant criticism and concern have been expressed about the amount of trustee fees awarded in the two largest liquidations in SIPC's history, Lehman and Madoff."

And here is what they say about that. We will have a comparison up on the board in terms of the way Lehman, in the U.K., has been handled versus the U.S. up there. But here is the observation from the report: "For the Lehman liquidation, SIPC's trustee fee chart combined both the trustees and the council's time, and the hourly rate ranged from $437 to $527 an hour."

"Moreover, the fees paid to date for both the Lehman and Madoff liquidations are a mere fraction of the amounts that will be eventually sought." The fees paid to date I think are in the order of $600 million. And I guess my question is the same question that the Office of Inspector General is getting to, and that is, do you believe the $600 million-plus in legal fees is reasonable?

Mr. HARBECK. Yes, sir, I do.

Mr. ROYCE. Then let me ask you, if this is reasonable, what would you deem reasonable for a completed Lehman liquidation?

Because as they point out, again, "It is a mere fraction of the amounts that will eventually be sought. Significant work relating to customer claims with pending litigation remains to be done."

Now, this is after 3-plus years. And, of course, they point out that they would like additional oversight, that they would like SIPC to negotiate with outside court-appointed trustees more vigorously to retain a reduction in these fees. So they have a little different take on this than you do.

What do you think the final cost will be?

Mr. HARBECK. The cost estimation for the Madoff case in the administrative expenses is $1 billion. To date, I believe somewhere in the vicinity of $400 million has been expended of legal fees. Two important things to note. One, not one penny of that came from customers, or diminished customer assets. SIPC paid for it all.

So SIPC paid for the litigation, which the GAO report which was issued yesterday, or today, indicates brought in billions and billions of dollars in the Madoff case. Customers haven't been diminished in any way, shape or form by that.

Mr. ROYCE. I understand.

Mr. HARBECK. As to the Lehman Brothers case, this is the largest bankruptcy of any kind in history. And what I would refer you to in terms of the person closest to the facts on the legal fees is Bankruptcy Judge Peck in New York.

And I have included in my written statement his comments at the Chapter 11 confirmation hearings, where he says the case is coming to an unbelievably successful conclusion and that he congratulates all of the professionals involved. So my God, the hourly rates these people charge are staggering. Everybody knows that.

But in that one instance, and I am familiar with that, the SIPA trustee did an outstanding job, and I think the fees are reasonable.

Mr. ROYCE. But one of the unique situations here is that we can compare and contrast with the situation in the U.K. And in terms of return of customer assets, you have a situation in the U.K. where of the $21.8 billion of client assets, $20 billion was returned. In terms of settlements with foreign affiliates, in terms of the U.K., you have a situation where they have settled with U.S. affiliates, with Lehman Hong Kong, with affiliates around the world.

That process hasn't gotten under way here. In terms of general unsecured estate, in the U.K., they have resolved the majority of its unsecured claims, whereas in the United States, they have yet to review unsecured claims. But most importantly is the fees.

Look at the difference, and you look at the timeframe—3-plus years versus what has occurred in the U.K.—and it truly grabs one's attention in terms of the cost, but also the criticism of the Office of Inspector General brought to the process about the oversight and the way in which we are conducting this.

And especially the way in which you are down to two firms doing some pretty major work. or one firm handling MF Global and Lehman simultaneously. Reportedly, in the financial press, that is causing some backlog in terms of the ability to push this through. If I get your response.

Mr. HARBECK. [Off mike.].

Mr. ROYCE. Yes.

Mr. HARBECK. If I could respond, actually, the fact that the trustee in the Lehman Brothers case and the MF Global case has leveraged their work incredibly well. The Lehman Brothers trustee just won a case for American investors over Lehman Brothers, Inc. Europe before the Supreme Court of the United Kingdom last week.

And the exact same issue arises in the MF Global case. This is an example of picking a veteran staff and a veteran trustee who knows what they are doing and does it well.

Mr. ROYCE. I will close with this. Reportedly, part of the problem in terms of making progress is that you have people pulled off of one case to work on the other case because you have one firm. But my time has expired.

Mr. HARBECK. I can speak to that. I asked that exact same question on the morning of October 31st to make sure that the trustee staff would not affect either case. I was assured that it would not, and our supervision of the case indicates that it has not.

Chairman GARRETT. Thank you.

The gentleman from Colorado?

Mr. PERLMUTTER. [Off mike.]

Chairman GARRETT. And then you will—would like to come back to you? Sure.

Then, the gentlelady from New York.

Dr. HAYWORTH. Thank you, Mr. Chairman. If we can just leave that slide up for a moment, Mr. Harbeck or Ms. Bowen, I am intrigued by the difference between the two columns.

To what do you attribute—is there a matter of the laws being different in the U.K., or they—

Mr. HARBECK. It is apples and artichokes. They are just not comparable. The size and scope of the operations aren't comparable, the laws are different, the administration of bankruptcies are different. The fact that they both have the name Lehman Brothers is the reason they are both on the same chart.

Dr. HAYWORTH. Understood. Is there something that we can use from the U.K.—although two different entities, obviously the Lehman Brothers applies to two different entities. But is there something we can take home from that as legislators in terms of our approach to these kinds of problems?

Mr. HARBECK. Let us think about Lehman Brothers and MF Global, and the Dodd-Frank Act. I think the 8th largest bankruptcy in history was not a Dodd-Frank event. And that is a good thing. So the fact is, I think the system works. It is an expensive system. Bankruptcy is an expensive process in financial institutions.

But by and large, the system is working in the United States. Again, the Lehman Brothers Holding bankruptcy judge comments on this case really do strike home for those of us who have been living with that situation for several years.

Dr. HAYWORTH. In terms of Madoff, I have met a couple of folks who have been directly affected by the Madoff situation. Is there any shred of hope we can offer people who trusted their Madoff accounts, and—

Mr. HARBECK. One thing that the trustee has run across when he has sued financial institutions—saying that those financial institutions knew, or should have known, of Madoff's problems—he has been running into a defense that he does not stand in the shoes of all of the individual customers.

I think he does. Under the law, some courts have held to the contrary. If we get some clarity on that, then SIPC could use its funds to prosecute lawsuits against entities that should be held financially responsible. And that would benefit customers at no expense to them.

So if the courts do not see it our way, perhaps legislation to give the trustee an overruling of an old, old case called *Kaplan* v *Marine Midland* would be a tool in the trustee's quiver that he could use to benefit investors.

Dr. HAYWORTH. Okay.

Ms. Bowen, any—

Ms. BOWEN. No, nothing to add to that. No.

Dr. HAYWORTH. Thank you.

Mr. Chairman, I yield back.

Chairman GARRETT. If the gentlelady will yield to me, just a couple of quick points.

On the point that Mr. Royce and Dr. Hayworth were raising as far as the two entities, the United Kingdom and the United States. If you convert these to dollars, are the size of the assets of the book of these companies apples and artichokes? What are the relative sizes?

Mr. HARBECK. I think the answer to your question is, the overwhelming majority of assets were in the United States. For example, SIPC—the trustee—transferred $92 billion in the first week. And the wind-down of the other assets, the non-liquid assets, is being conducted in the Chapter 11 proceeding of Lehman Brothers Holding.

Chairman GARRETT. I understand that.

Mr. HARBECK. Not the liquidation of the SIPC-member firm.

Chairman GARRETT. Yes, but—

Mr. HARBECK. But I think the American entity is larger by a factor. I don't know the factor sitting here, no.

Chairman GARRETT. All right. And as long as we have the time, part of your position is that SIPC has done such a tremendous job—your point of saying, well, $9 trillion now, I guess, at about a cost of a billion dollars in fees in this particular case, ballpark figures. But—

Mr. HARBECK. That is projected out into the future, sure.

Chairman GARRETT. Right.

Mr. HARBECK. Yes.

Chairman GARRETT. But out of that $9 billion, isn't the bulk of that just through one case? It is a very great case—the Jeff Picower matter—there was net equity in that case, if I—my understanding, on Madoff's books, basically saying, hey, you really owe this money back to us, meaning Madoff from Picower.

So 99 percent of that net equity in the book was from the Picower case. And that was around, a little over $7 billion. Is that right?

Mr. HARBECK. The overwhelming majority of it was, absolutely.

Chairman GARRETT. So—

Mr. HARBECK. But the trustee is not done yet, sir.

Chairman GARRETT. Right. But when you—yes, you add $200 million on top of that, I guess, from the kids of the Picower family, which is all good, but to come and say, we spent a billion bucks—which, as you agree, is amazing fees, $500 or so an hour—that is good work if you can get it.

I used to be an attorney. I billed out, I guess, a tenth of that or so, or a little more than that. But, yes, out of the $9 billion when you came here, first I thought that is great. But $7 billion-plus of that is one case, and the other—so a little over a billion dollars comes from all the rest.

So I guess you really have to put that into perspective as to exactly what the trustee has accomplished. But for that case, you would be spending $1 billion to get about $2 billion.

Mr. HARBECK. And the answer to your point is, we are not done yet. The trustee—

Chairman GARRETT. I guess that is part of the—

Mr. HARBECK. The trustee hopes to get back 100 cents on the dollar. Will he do that? I don't know.

Chairman GARRETT. And that is the concern.

Mr. HARBECK. But if you say—I think if you said to anyone from any source that you were going to get back $9 billion—

Chairman GARRETT. Right. We keep going back to that. Yes, but we never knew the Picowers were out there, and the negative equity out there the one individual had. But when you say they are not done yet—and there is the rub, or there is the concern, is that they are not done yet—there are probably not that many more Picowers, if I am saying the names correctly, out there anymore.

So the rest are going to be the smaller ones. The rest are going to be people that we are concerned about in this panel—or some of us concerned on this panel—of going back to those people who, as Mr. Green was saying and shares with me the concern, all they did was rely upon what was sent to them.

And to your comment that it makes Ponzi schemes a good thing, only if there is the intention, or knowing that it is a Ponzi scheme. But I am going over my time.

If the gentleman from Colorado is not ready yet, then Mr. Stivers is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

My first question is for—I think it is probably for Mr. Harbeck, although maybe both of you can answer this one. What would the impact on the SIPC fund be if every indirect investor expected to receive SIPA coverage?

Mr. HARBECK. At the start of the Madoff case, we made an effort to tell every person who thought they even remotely were damaged by the Madoff case to file a claim. Thousands of people did so who didn't even know that they were invested in Madoff.

Some of the people who have testified in front of this body bought a feeder fund that bought a feeder fund that bought a feeder fund that bought Madoff, and said that they were an indirect investor. So that is like throwing a ping pong ball into a bunch of mouse traps loaded with ping pong balls.

I couldn't possibly tell you what the cost would be because the cost would be capped at the net equity of $17 billion, assuming that they were all owed by feeder funds. But the relationship between broker and customer, that is the one part about this that isn't rocket science.

Did you open an account? Yes? Okay. If you didn't open an account, you are not going to be a customer.

Mr. STIVERS. Ms. Bowen, do you have anything to add to that?

Ms. BOWEN. No, I don't.

Mr. STIVERS. Do either of you think that SIPC has a responsibility to warn customers about possible signs of fraud, or conduct that might indicate fraud?

Mr. HARBECK. Whether we have an obligation to do so or not, it is a good thing to do. Ms. Bowen has recommended, and championed on the Task Force, an investor education program. I have been doing what I would call "dog and pony shows" with members of the North American Securities Administrators Association on fraud.

And I have, in the back of my mind, a program that I want to use at Walter Reed Hospital. Because you would be surprised at the fact that people will steal money from amputees. And I have seen enough different kinds of these schemes.

I have been doing this for 35 years, and I have seen enough of these things to put together a program where we could say these are some red flags that you should have. And actually, I enjoy doing that.

Mr. STIVERS. Great.

Ms. BOWEN. I would add to that, too, that with the Task Force, we did have some securities regulators who were part of our Task Force. And we talked about—

Mr. STIVERS. Was that the SEC or FINRA? Or who was that?

Ms. BOWEN. Mr. Borg is here from Alabama.

Mr. STIVERS. Oh, some State regulators. Sorry. Thank you, great.

Ms. BOWEN. Yes, State regulators. And so we talked about having forums maybe throughout the country, to get the word out. And also, frankly, if there is a way for us to work with the SEC and FINRA to maybe change the language that is in the broker's statement; although we know, frankly, that may not solve the problem in terms of education.

And then I think, following the Task Force, to recommend that we have a person dedicated to investor education who would work with us to get the word out much more effectively.

Mr. STIVERS. Great. Do either of you think that SIPC should be empowered to conduct spot audits to ensure that cash and securities are really in the custody of broker-dealers?

Mr. HARBECK. The one-word answer is no, but I would really like to explain why.

Mr. STIVERS. You have 1 minute and 6 seconds.

Mr. HARBECK. There are five levels of review of that issue. The internal auditor of the brokerage firm, let us assume he is corrupt. The outside auditor, let us assume that auditor is either corrupt or incompetent. A State audit, a self-regulatory organization audit, and the SEC. If you added SIPC as a sixth, SIPC would have to hire the experts who are already doing it.

And I am not sure that we—

Mr. STIVERS. Can I do a quick follow up on that? Like in Madoff's case, he was not covered by FINRA so he wouldn't have had an

SRO. He would have only had an SEC, and they actually do it once every 10 years for firms of his size?

Mr. HARBECK. I don't believe you are correct, sir.

Mr. STIVERS. Okay.

Mr. HARBECK. I believe he was—every brokerage firm is a member of a self-regulatory organization. It is required.

Mr. STIVERS. Okay.

Mr. HARBECK. So, yes, FINRA did not find this, nor did the SEC.

Mr. STIVERS. I yield back the balance of my time, Mr. Chairman. Thank you.

Chairman GARRETT. The gentleman yields back.

The gentleman from Colorado is ready and recognized.

Mr. PERLMUTTER. Thanks, Mr. Chairman, and thanks to the panel.

I guess let us just sort of—and I know you have broken it down into two categories. You have the situation where it is a fraud from the outset, or more or less a fraud. It is insolvent is a result of just being a fraud, and then it is insolvent as a result of things falling apart. It wasn't a sham to begin with.

So let us deal with the fraud one first—the Madoff, the Stanford, the Peters or Peder, whatever they are called. In Colorado, we had a number of investors who invested in "company A" that invested in "company B" that then invested in Madoff or Stanford or some other Ponzi artist.

As I am looking at the recommendations of the Task Force, those—everybody calls them indirect investors—are sort of out of luck, based on the law today, the SIPC law today, or the Task Force recommendations, except for those that might be pension plans. Am I right? Wrong?

Ms. BOWEN. No, that—

Mr. PERLMUTTER. And I am asking both of you, so—

Ms. BOWEN. No, that is correct. That is the recommendation.

Mr. HARBECK. Sir, if I could elaborate, though. The indirect investors will share—and I believe in my written comments I speak to this specifically because I know this is of particular concern to you. If you take a look at exhibit B to my written comments, it is a letter that I wrote to you and to Congressman Ackerman to make sure that when we settle with one of those feeder funds on a preference or a fraudulent transfer, that the money flows directly through to the indirect holders.

Mr. PERLMUTTER. Okay. But I guess I am just trying, from a policy standpoint, to understand why the pensioners—and they are obviously a sympathetic group. I think the firefighters lost some money, or their pension initially was in the Madoff mess.

So why—the pensioners, I guess I am happy if they get it. But I would like to see others, indirect investors, be entitled to some recovery directly from the fund. What is the policy distinction you all make?

Ms. BOWEN. I think one of the things we considered is the fact that, with the pension plans that we suggested with the pass-through, there is already a level of fiduciary obligation under ERISA, so we felt that level of protection, if you will, gave us some comfort.

If we are talking about people who may invest in a hedge fund, for example, we wouldn't be privy to what their arrangement is in terms of, they may have invested in a huge fund in Connecticut.

Mr. PERLMUTTER. And I guess what I am saying—and Mr. Harbeck, I understand your sort of black-and-white position that you know who has opened an account with Madoff—you can go back, so-and-so, so-and-so, and so-and-so. But the reality of how the system works these days is that you are going to have—or at least in that instance, and I think in many you have—a number of different investors who invest in "company A" who then conglomerate into "company B," and then "company B" invests with the Madoff—with the broker-dealer.

So I understand your wanting to have a black-and-white line there, but that is not how it works. And the guys who are really getting clobbered are the little investors back here in the indirect investors.

Mr. HARBECK. Again, if you focus on the common pool of assets known statutorily as "customer property," that is where the lion's share of any customer's assets are typically restored, not the advances from SIPC. So typically, the person who is an indirect holder will not be clobbered because the entity that has the account will get, typically—not in Madoff, granted, but typically—will get a large share of its assets.

Because typically—and here I find myself reluctantly, very reluctantly, defending the SEC—they usually find these things at a point where the amount of missing assets is small. And that means that the common pool of assets is in the 95 percent, 98 percent range.

In Madoff, there was an egregious failure that proves that rule. So ordinarily, the entity would receive a substantial portion. There have only been, prior to Madoff, somewhere in the vicinity of 350 customers—entities, or any kind—whose claims were not 100 percent satisfied; individuals, entities, whatever.

And the total amount that those claimants did not receive—again, this is prior to Madoff—was somewhere in the vicinity of only $47 million. So I am not sure that pounding the Madoff issue is the reality for most people who get caught in one of these unfortunate situations.

Mr. PERLMUTTER. Thank you.

And, Mr. Chairman, if I could ask unanimous consent to insert into the record a letter dated March 2, 2012, from the Agile Funds Investor Committee?

Chairman GARRETT. Without objection, it is so ordered.

Mr. PERLMUTTER. Thank you. I yield—

Chairman GARRETT. The gentleman yields back.

Dr. Cassidy?

Dr. CASSIDY. I want to first thank the chairman and the ranking member for allowing me to ask questions.

Mr. Harbeck, I am not a securities attorney. I am a doctor, so your knowledge greatly exceeds mine, and if I say something stupid, it won't be the first time, and it won't be the last, so please forgive me.

That said, let me first ask, was there a settlement offered by SIPC to the SEC on behalf of the Stanford victims?

Mr. HARBECK. Yes, there were settlement discussions.

Dr. CASSIDY. And was one offered?

Mr. HARBECK. We made an offer. But I would hasten to add that I won't go into the details on that because—

Dr. CASSIDY. That is fine. But the fact that you offered, even though you categorically deny the rationale for it in your testimony, gives me a little bit of pause regarding your testimony.

Secondly, let me ask you this. It seems as if you have two objections to SIPC expanding coverage: one, that SIPC does not cover losses of an investment; and two, the custody issue. So let me take the first. You quoted a court case earlier, in your reply to Mr. Green—clearly, you are an attorney, you defer to court—do you disagree with the Fifth Circuit Court, which found that a Ponzi scheme is, as of a matter of law, insolvent from the inception? That the value is fictitious; there is no value to lose because the value is not there at its inception. Do you disagree with the 5th Circuit?

Mr. HARBECK. The fact that it is insolvent from the initial moment does not detract from the fact that the instrument received by the Stanford people was a real certificate of deposit issued by a real bank in a real country that is in a real receivership—

Dr. CASSIDY. It is a piece of paper, I will agree with that. But whether or not the value is real or fictitious seems to be the point. And the fact that it is insolvent at inception suggests that the value is fictitious. I would just make that point, and you can hash that out in court. But I—

Mr. HARBECK. The other thing I would like to say is that this matter is in litigation.

Dr. CASSIDY. I understand that. But on the other hand, I think—

Mr. HARBECK. And I—

Dr. CASSIDY. —your—

Mr. HARBECK. —am constrained by that.

Dr. CASSIDY. Your testimony, written and spoken, really went after this case as if it were in case. And I think it is important on behalf of the victims to make the counterargument, if you will. So if the first point is that, indeed, the value is fictitious and there may not have been value to lose, let us move to the second, regarding custody.

Again, knowing that you are an attorney and that you have previously quoted court cases in reply to Mr. Green, you spoke earlier about how you would have to fold in these different entities in the Stanford Financial Group to, if you will, give the Stanford victims standing.

And yet there is a U.S. District Court for North Texas that says that the Stanford International Bank and Stanford Financial should be collapsed together; that, indeed, they should be folded and it is, again, a fiction to pretend that they are different.

Now that effect—and my understanding, again I am a gastroenterologist, what do I know, although I feel like I am kind of in the sweet right now—that would not give them standing as a customer?

Mr. HARBECK. For a wide variety of legal reasons, the answer is no.

Dr. CASSIDY. Okay.

Mr. HARBECK. Among other things, the independence of the entity in Aruba has been recognized in several other countries, separate, who have not turned over assets to the receiver in Texas.

Dr. CASSIDY. Let me just point out, though, that the Stanford Group company was a broker-dealer registered with the commission, and it is a big member. That both that, and the Stanford International Bank, Ltd. were wholly owned and directed by Stanford. That the Stanford Financial Group was a brand name, under which SGC, SIBL, and others operated, to give credibility to SIBL.

And that domestic clients purchasing Stanford International Bank limited CDs dealt substantially, if not exclusively, with Stanford Group company brokers. And that some SGCs—if you will, account holders—received consolidated statements from SGC regarding their Stanford International Bank loan investment.

I could go on, but I think I am making the point. It does seem as if there is a case for them to be folded together, as the North Texas District Court suggests. This would be the one to do so. Let me just kind of go on for a couple of other things because I am almost out of time, I apologize.

I have to admit, you give the hypothetical of, we have a salesman who says go ahead and invest in the Ponzi scheme and you will be covered. And I have to say that there isn't a victim yet who I learned would have invested in this Ponzi scheme should they have known it was a Ponzi scheme.

Now, I will just frankly dispute that. And the idea that somehow, don't worry, you give your $500,000 to us and we will cover it on the backside—forget the fact that you have lost the investment value over the period of time it is with them—I will just make that point.

But one last thing. Since there was a settlement offer, and since there has been discussion as to the amount of money it would cost for such a settlement, can you give us the cash figure that SIPC thought would be involved in such a settlement?

Mr. HARBECK. No, sir, I will not.

Dr. CASSIDY. I appreciate that.

Mr. HARBECK. That is a matter in litigation.

Dr. CASSIDY. But I will presume, because you are fiduciary agents, it would not have been one that would have broken the bank. And I think that point needs to be made.

You have been generous with your time. I yield back, thank you.

Chairman GARRETT. I thank the gentleman.

All Members have had the opportunity to ask questions, but a couple of members have asked for follow-up questions. So what we thought we would do is just split 5 minutes on either side, to split however the Members want to on either side.

And, oops. I reclaim that whole statement, and we will start with the gentleman from California for his 5 minutes.

Mr. SHERMAN. Last, and probably in this case least, what is the financial position of SIPC, and how is that affected by how you determine whether the Madoff investor, when pooled, is eligible for one $500,000 limit, or several?

Mr. HARBECK. We didn't take SIPC's financial situation into consideration in the slightest in making those determinations. Those determinations are made by the law.

Mr. SHERMAN. No, I am asking a financial question. I am not asking for a legal defense. What is your financial position, assuming your position on the Madoff claims is upheld by the courts, as I am sure you think it will be?

Mr. HARBECK. Our financial position would be that we have already paid all of the customers who are entitled to protection. We have paid—

Mr. SHERMAN. So what is the net worth of SIPC right now?

Mr. HARBECK. One-point-five billion dollars.

Mr. SHERMAN. And that is after paying all of the Madoff claims?

Mr. HARBECK. Correct.

Mr. SHERMAN. And if you were to lose on the arguments that have been raised for Madoff, how far underwater would you be?

Mr. HARBECK. Which arguments, sir? There are several.

Mr. SHERMAN. The argument that each participant in a pool is a separate investor.

Mr. HARBECK. I will preface this by saying we have never lost that issue.

Mr. SHERMAN. Right.

Mr. HARBECK. And I believe the outside is $17 billion because that would—I assume that all of—

Mr. SHERMAN. That would be the full—

Mr. HARBECK. —everybody would get paid 100 cents on the dollar.

Mr. SHERMAN. Okay. Do you have different rates for, in effect, what is insurance, based upon whether the securities are being held in one of the generally accepted depository houses, or whether the member of SIPC just says, "Hey, I have a safe in the back room?"

Mr. HARBECK. First of all, since it is almost all done electronically now, almost all securities positions are held at a common facility, such as the Depository Trust Corporation, or something like that. But we have tried—and many members have proffered the fact—that our kind of brokerage firm poses less risk.

And every time a group of brokers says that, I can come up with an example of large—

Mr. SHERMAN. So you charge the same amount for everybody.

Mr. HARBECK. We charge the same amount for everybody. It doesn't work for—

Mr. SHERMAN. What portion of your members do the, "We have our own safe" approach, rather than using one of the established depository—

Mr. HARBECK. I don't think it is possible to go back to the days, in the 1960s, where—

Mr. SHERMAN. Madoff did it.

Mr. HARBECK. Oh, I see your point.

Mr. SHERMAN. Yes.

Mr. HARBECK. I—

Mr. SHERMAN. If Madoff had had all his securities in—

Mr. HARBECK. No. Many brokerage firms—self-custody positions. But in turn, the positions should be reflected at the Depository Trust Company, DTC. And in Madoff's case, if any examiner had bothered to check between the positions shown on Madoff's records and what was in DTC, they would have dropped dead on the spot.

Mr. SHERMAN. If anybody had bothered to notice that he had an audit letter from a one-person CPA firm on a $17 billion balance sheet, that would have been caught, too.

But I yield back.

Chairman GARRETT. The gentleman yields back, and seeing no one else coming in at the last mimute, we will then just close with 5 minutes, if there are 5 minutes of questions on either side to be split up.

I will begin with the gentlelady from New York, then Mr. Pearce, and then Mr. Stivers.

Mr. PEARCE. Thank you, Mr. Chairman.

You have brought almost 1,000 clawback suits. How many of those were against institutional investors?

Mr. HARBECK. I don't know the answer to your question of percentage. It was done strictly—

Mr. PEARCE. Do you ever bring clawbacks against hedge funds, or the big guys?

Mr. HARBECK. Oh, absolutely. And, in fact, if I could speak to your question and simultaneously to a point made by the chairman, many of the clawback suits are in sums in the hundreds of millions of dollars that have been settled.

Mr. PEARCE. The one speculation is that the trustee has said that 75 percent of the property is going to be distributed to institutional investors in the Madoff case. What happens to all the little guys?

Mr. HARBECK. That statement was made by, I believe, Mr. Stein in his written statement. The trustee is going to distribute the money pro rata to each customer.

Mr. PEARCE. No. I said, what happens to the little guys?

Mr. HARBECK. If there is a claimant who is, regardless of the nature of—

Mr. PEARCE. So the big guys get protected, and the lawyers get 500 bucks an hour, and we spend about a billion bucks.

Mr. HARBECK. No, sir. Everyone gets the same pro rata share.

Mr. PEARCE. If you give 75 percent to the big guys, it looks like the little guys are going to be left out. I suspect I have used my minute there, Mr. Chairman.

Mr. HARBECK. No, sir. I would like to respond, if I may.

Chairman GARRETT. Let me—

Mr. HARBECK. Every customer—

Mr. PEARCE. The chairman owns the time, sir.

Chairman GARRETT. Yes. Let me go to the gentlelady from New York for a bit of—do you have any other questions?

Then Mr. Stivers is—

Mr. STIVERS. Thank you. I have one quick follow up. Because when I was talking to Mr. Harbeck about the Madoff portion, I believe Mr. Madoff had two sides of his business. He had a broker-dealer side and an investment advisor side. And most of the problems were in the investment advisor side.

But that is the side that is not regulated by FINRA. You indicated that his entire business was regulated by FINRA, or at least gave that impression. And I just wanted to make sure everybody in the room and everybody who might see this understands that the investment advisor side was not regulated by FINRA, and that is where most of the losses were.

Is that correct?

Mr. HARBECK. No, sir. Because the—

Mr. STIVERS. Okay.

Mr. HARBECK. —custody of the assets would have been at the brokerage firm, and that should have been discovered.

Mr. STIVERS. The brokerage firm had the custody of the assets, but it may or may not have had the custody of the assets.

Mr. HARBECK. It did not. That is the entire problem.

Mr. STIVERS. But that is the point. It may or may not have, in the first place—

Mr. HARBECK. But FINRA—

Mr. STIVERS. There was no requirement that the investment advisor firm keep all of its assets at that broker-dealer firm, was there?

Mr. HARBECK. No, but they did.

Mr. STIVERS. Okay, but there was no requirement. So therefore they could say they are—we have them somewhere else. And FINRA doesn't—you have to—there is too much coordination requiring, and FINRA doesn't have the ability to look at everything. So they are looking at the broker-dealer side of the business, and maybe they missed some stuff.

But the whole point is, there is not really an SRO on all of the Madoff business, is there?

Mr. HARBECK. No.

Mr. STIVERS. Thank you.

Mr. HARBECK. Okay.

Mr. STIVERS. I yield back my time.

Chairman GARRETT. Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman.

When the individual investor makes an investment through an institution, and that institution benefits from the common pool of assets, does the institution that benefits from the common pool of assets receive instructions as to how it is to distribute the funds to the individual investor?

Mr. HARBECK. That is done by contract between the individual investor and the fund. But in response to Congressman Perlmutter's concerns, when we have settled—when the trustee, rather, has settled with a fund, perhaps on a fraudulent transfer of preference, thus allowing the fund to share in the pool, one of the things that we, the trustee, has done is, as part of the settlement, get an agreement from the fund that the money flows straight through to the individual investors.

Mr. GREEN. Thank you.

I yield back, Mr. Chairman.

Mr. PERLMUTTER. Thank you. And sort of going back to the preference-fraudulent transfer piece of all this, the question is, let us say I put $100 in. I get to a fraud. I get 50 bucks back, so I have still lost 50 bucks. Somebody else puts $100 in, and they get nothing back because they are the last guys in the game.

The question is, I am out $50, but I got $50 more than the other guy who got robbed. So the question is, should we all get robbed equally? And I think that is where this clawback stuff comes in, and the policy behind the clawback. As we do these preferences, as say Tremont settles with the trustee, recovers all sorts of money, goes to Tremont.

When I am looking at your letter—and I thank you for your letter of September 11th, actually, or September 30th—how will all of these investors from Colorado know that they are going to get treated proportionately as to Tremont's share?

Mr. HARBECK. We don't.

Mr. PERLMUTTER. In terms of the preferential or fraudulent transfer of recoveries—

Mr. HARBECK. The way it works is, Tremont would have returned a preference of fraudulent transfer to the trustee, thus enabling them—freeing up, if you will—the entire amount of their valid claim. In the settlement of that preference, the trustee said that he would only enter into the settlement if Tremont or the other entities similarly situated would agree that regardless of any contractual commitments between the individual investors and the fund that they would pass the money straight through.

You have demonstrated one of the hard problems of what happens when somebody pulls out of the fund itself, not out of the Madoff case. And all of that has to be done at the level where the books and records are for that particular fund.

Mr. PERLMUTTER. Okay, thank you.

Chairman GARRETT. The gentlewoman from California?

Ms. WATERS. Thank you very much.

Ms. Bowen, I see that you have described to us your work with the Task Force. And I am looking at recommendation number three—"protect participants in pension funds on a pass-through basis." And I happen to have a communication here from Colorado, from one of our constituents.

Let me just read it to you: "My name is Peter J. Leveton. I live in Lakewood, Colorado, a Denver suburb in Congressman Ed Perlmutter's 7th District. I am an indirect investor victim of the Bernard L. Madoff Investment Securities, LLC ('Madoff' or 'BLMIS') Ponzi scheme, and a Co-Chairman of the Agile Funds Investor Committee of the Agile Group, LLC, Boulder, Colorado ('Agile' or 'Agile Group'). In December 2008, Agile had 205 investors and managed three primary hedge funds. The Group and its funds are currently in liquidation."

Now listen to this: "A large portion of Agile's funds under management were invested by Agile in the Rye Select Broad Market Prime Fund (the 'Prime Fund') managed by Tremont Group Holdings, Inc. ('Tremont' or 'Tremont Group'), and invested by Tremont with Madoff/BLMIS. Tremont is a subsidiary of Oppenheimer Funds, itself a subsidiary of Massachusetts Mutual Life Insurance Company."

I am trying to read this so I can get it all in very fast. Is this what you are referring to when you are rejecting the idea of pass-through to all who would claim that they should be considered for protection?

Ms. BOWEN. Yes. You mean outside of the pension, we would say other indirects would not be entitled? There would not be any direct customer relationship, in that case?

Ms. WATERS. What moves me about this is, he goes on to say, "Many of us placed a lifetime of savings in what we believed were safe investments but which were ultimately invested with BLMIS, often without our knowledge."

"Many of us are now devastated, financially and psychologically."

"Many of us have sold or are trying to sell our homes just to obtain money to live on without becoming wards of the state."

"Many of us in our 60s, 70s and 80s have been retired but have had to, or are attempting to, go back to work," and on and on and on.

The pension funds where you have the protection, they are more sophisticated. And, of course, they should have a lot more knowledge about investments.

But these people, who appear to have invested in some small entities who were managed by other entities that were managed by other entities, had no idea this was going on. So do you feel that they have no right to some kind of protection?

Ms. BOWEN. I do empathize with them. They obviously have recourse against the funds in this instance. But SIPC was not really created to reimburse victims such as those, who unfortunately suffered because they put money in the wrong place. It is really unfortunate, but that is not what we were entitled to do.

Ms. WATERS. All right. Given that, I understand exactly what you are saying. But for those who are members of SIPC, are they advised or told, or any regulation or rule, about who they represent and how many they represent and who these people are? What is the responsibility of SIPC to the members who are covered?

Mr. HARBECK. I am not certain I know what you mean, unless you are talking about the Agile to Rye to Tremont situation, something like that.

Ms. WATERS. Yes, I am talking about this situation.

Mr. HARBECK. The fact of the matter is, there would be no way for SIPC to know those relationships.

Ms. WATERS. I know, and that is my question. In your Task Force review, did you consider this aspect of it? That you have your members who don't—SIPC would not know the relationship of the members that are protected to all of these other entities that are involved with them.

Ms. BOWEN. Yes.

Ms. WATERS. Was that considered?

Ms. BOWEN. It was considered by the Task Force. And we did hear from investors such as the one that you mentioned. We also, with some of our participants on the Task Force, particularly the State securities regulator—it was rightly pointed out that there are Ponzi schemes and frauds that occur throughout their State all the time. And those folks are not entitled to SIPC protection because it is not a broker-dealer.

So unfortunately, we do have really bad people who are taking money from other people. But that is not really what SIPC is supposed to be protecting.

Ms. WATERS. So SIPC has no responsibility in this whatsoever in terms of educating?

Ms. BOWEN. Yes.

Ms. WATERS. The kinds of forms that you are talking about—

Ms. BOWEN. Yes. No, and that is something we did spend a lot of time talking about. Because there is a misperception as to what

SIPC is and what SIPC is not. And so one of the recommendations is that we work with the SEC, with FINRA, and with the State regulatory agencies to try to broaden the educational pool; to, in fact, hire someone whose job is to work with these entities to better get the word out to the investing public as to what it is that SIPC does protect as well as what it does not protect.

Ms. WATERS. Does the broker-dealer have any responsibility to tell them that?

Mr. HARBECK. The only responsibility is to display the symbol. We, at one point many, many years ago, tried to expand the investor education levels by the SEC. And we were not met with very enthusiastic results.

Ms. WATERS. So you need some congressional help.

Mr. HARBECK. Let us see what we can do on our own first, and then we will try. Thank you.

Ms. WATERS. Thank you.

Chairman GARRETT. I thank the gentlelady.

I thank the panel for your testimony, and for answering the questions today. Thank you.

Ms. BOWEN. Thank you.

Chairman GARRETT. The panel is dismissed.

Mr. HARBECK. Thank you, sir.

Chairman GARRETT. And then we, following that, move on to our third and final panel for the day. And as you are getting ready, we have four members of the panel: Joe Borg, director, Alabama Securities Commission; Steven Caruso, partner, Maddox Hargett & Caruso; Ira Hammerman, senior managing director and general counsel, Securities Industry and Financial Markets Association; and Ron Stein, president, Network for Investor Actions and Protection.

I assume that gave you all enough time, as I read that, to get your papers organized. I thank the members of the panel for coming forward today, and we look forward to your statements. As you know, your complete written statement will be made a part of the record, and you will now be recognized for 5 minutes.

Mr. Borg?

STATEMENT OF JOSEPH P. BORG, DIRECTOR, ALABAMA SECURITIES COMMISSION

Mr. BORG. Good morning, Mr. Chairman, Ranking Member Waters, and members of the subcommittee. Thank you for the invitation. I am honored to be back before the subcommittee in these hearings.

I am Joe Borg, the State securities regulator for the State of Alabama. Our office has administrative, civil, and criminal authority under the Securities Act. And in addition to the examinations of audits of broker-dealers and investment advisors, we do quite a bit of investigation on Ponzi, pyramids, illegal blind pools, offshore and tax scams, fraudulent private placements under Reg D, oil and gas and everything.

I have filed my written testimony with the committee, and I will briefly go over some of the points in that. And I will try and skip over some of the points that were discussed in the earlier panel. Direct equity investments, retirement plans, mutual funds, and similar investment vehicles have become the primary method by which Americans save for their future, accumulate wealth, and plan for a secure retirement.

Financial fraud in any form threatens the future security and well-being of our citizens, destroys the hopes and dreams of families, and destroys what should be the golden years of our life-experienced seniors. As I previously testified back in September, the Task Force was charged to look at 12 particular areas.

And out of that, we have a report covering 15 specific recommendations. The Task Force was split into two working groups. My particular subgroup covered recommendations 1 through 4, 14, and 15. So I will briefly talk about those particular points.

The $1.3 million reflects my original opinion of an increase to $1 million, plus an adjustment for indexing to inflation. Americans are looking to the markets and investments to secure their long-term future goals. The days of realizing the American dream of a secure future by saving only in a bank account or a certificate of deposit are long gone, especially with current rates below 40 basis points.

Interestingly enough, in meeting with the Federal banking authorities, they had concerns about SIPC diverging from the historical relationship between FDIC and SIPC protection levels. In my opinion, the historical tie between SIPC and FDIC levels have contributed to the lack of understanding of the differences of FDIC and SIPC coverage.

The insurance of FDIC to bank accounts, and the coverage non-insurance of SIPC to securities, is fundamentally different both in statutory application and practical application, at least under existing law. The reality is that my future security in retirement is not going to come from my savings and checking account, but from my investment accounts.

Recommendation number two had to do with eliminating the distinction for cash and securities. This outdates—it is meaningless in today's markets. Consider that money market accounts were relatively small in 1978. Now, they are $2.7 trillion. Brokerage cash sweeps into money market accounts or bank accounts overnight and back and forth, with substantial investor cash routinely held in brokerage accounts.

Those funds deserve the full amount of SIPC protection. This distinction has caused inconsistent court decisions, investor confusion, and, in some cases, lost customer funds. Interestingly enough, the Canadian counterpart to SIPC did away with the distinction back in 1998.

Again, banking authorities express concerns that SIPC will offer greater protection against cash losses than FDIC. This is an artificial connection. And again, maintaining parity does not benefit investors. The recommendation allows the realities of today's markets to determine the actual and appropriate need for the benefit of all investors.

Recommendation three had to do with the pension funds on a pass-through basis. There are a lot of Americans whose investments are not, right now, covered by SIPC protection. They should not be discriminated against because they have some generally small accounts, they are part of a defined benefit, defined contribution, or a deferred profit sharing plan.

The recommendations made comports with the trusted fiduciary provisions under ERISA. And we also took into consideration certain pension plans and employee benefit plans have been covered by FDIC and NCUA on a pass-through basis since 1978. On minimum assessments, according to the staff at SIPC, 25 percent of the membership paid a flat $150, based on net operating revenues.

After Dodd-Frank, the 0.2 percent of gross revenues, many of the same members are actually going to pay less than $150. I think this has to do with accounting issues. If members are utilizing SIPC in marketing materials and benefiting from the SIPC program, they should pay some minimum amount.

I personally thought the thousand was a little low, but the general consensus was a thousand would be reasonable in the current environment. The Task Force also discussed whether mutual fund dealers and assessments on mutual fund reserves should be included.

SIPC currently exempts mutual fund revenues. Representatives of the mutual fund industry made a case that there was no significant history of losses to investors. I did not agree with the majority of the Task Force not to assess mutual fund revenues because the mutual fund industry utilizes the SIPC logo, touts specific coverage, and billions of dollars of mutual fund shares are held in street name.

However, the fact is there is a history of minimal losses, and that was persuasive to the majority of the Task Force. And I respect the decision. Concerning international relations, it is a global economy. Geographical boundaries have no meaning. Cross-border effects of a failure like a Lehman or an MF Global have local, national, and international implications.

The resolution depends on the respective national jurisdictions. That just doesn't work. The Task Force recommendation encourages SIPC to elevate the program in taking the lead in developing a new international association. I think investor education has already been covered.

I proposed a suggestion with regard to adding information into brokerage accounts. The Task Force considered that recommendation, but were unable to determine the costs. The issue is left with a SIPC board. The invitation also asked for views on pending legislation. I will try and cover that very quickly.

The purpose of fraud is simple; deprive honest people of their funds to benefit the crooks. Look, in a perfect world, we want anyone so injured to get back what they lost. The question is, is it the actual investment that was stolen and distributed as profits to other victims, less the amount taken by the crook, or what was promised—that is, the representations of potential profit.

Our office investigates numerous Ponzi pyramids and other scams. I currently have 48 defendants awaiting trial for various forms of survey fraud right now, mostly Ponzis and pyramids and that type. In the past year, we have convicted 16. The problem is also the same: limited assets to distribute.

And while the intent of H.R. 757 is noble, I think it is not equitable, and it confirms an unequal benefit to some victims over others. And unfortunately, earlier investors may benefit at the expense of later investments, and may receive distributions in excess.

So with a limited amount of assets to distribute, we must find a way to treat every investor equitably by first attempting to make everyone whole on their initial investment. That is the amount invested minus amount received equals actual cash lost. Unless there is an endless supply of funds to pay promised returns, it becomes impossible from assets available to cover all promises.

The fundamental problem with the last-statement approach is that when thievery is involved, the statements will match the fraudulent misrepresentations, historical or otherwise, regardless of reasonableness, market conditions, or reality. And H.R. 757 attempts to fix a terrible problem.

I have a suggestion with part of it. During the September 23, 2010, hearings, Professor Coffee and I—and I will give most of the credit for this to Coffee, it was his idea—here is a signage to consider the creation of a de minimis exception instructing a specific trustee not to bring a suit against persons whose withdrawals exceeded their investment by a set amount, a given amount.

This would give peace of mind to many, but would not impede the trustee in his pursuit of the very large net winners. Another possible exemption is giving early investors credit for the imputed interest on their investments. Such amounts should not be regarded as fictitious profits.

Congress could immunize some minimum amount of rate of return from the concept of fictitious profits. I don't know what that rate would be: 5 percent; 7 percent; 2 percent; or adjusted to some sort of standardized index. But whatever the basis is used, it should maintain equitable balance between the victims of a Ponzi scheme.

H.R. 1987 contains similar concepts to H.R. 757. My commentary would be the same. I would say, again, there is no real profits in a Ponzi scheme, and payments to early investors are proceeds of a crime, unbeknownst to both the earlier and later investors.

For a second, let me discuss indirect—

Chairman GARRETT. Before we do that, since you are 4 minutes over time, let us allow the other members of the panel to testify, and we will come back to that thought.

Mr. BORG. That would be fine, sir.

[The prepared statement of Mr. Borg can be found on page 58 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Caruso?

STATEMENT OF STEVEN B. CARUSO, PARTNER, MADDOX HARGETT & CARUSO, P.C.

Mr. CARUSO. Thank you, Mr. Chairman, and Ranking Member Waters. My name is Steven Caruso. I am with the law firm of Maddox Hargett & Caruso in New York City. And as you may recall from our last appearance before this committee, our representation is of investors; people who have been defrauded, whether it is through some of the examples that we have discussed today—what I am going to call the "trifecta of criminality," the Madoffs, the Stanfords, the MF Globals—but we see this every day.

And in serving on the SIPC Task Force, one of the overriding considerations is, what are we going to do the next time one of these blows up? We have already today discussed the finances of SIPC. And if the Stanford case alone goes against the SIPC fund, that fund is gone. That fund is gone, the Federal Government backup of the SIPC fund is gone, and I would submit to you that investor confidence in our entire capital market system is going to be gone.

So one of the primary things I think that needs to be looked at is, how do we pay for what needs to be done? And clearly, there are victims of Madoff, there are victims of Stanford. But the time, I would suggest, has come for this committee to consider requiring brokers and investment advisors to have insurance.

It is too easy today to become a stock broker, it is too easy to become a registered investment advisor. But none of those folks are required to have insurance. So when we are entrusting them with millions of dollars, in some cases hundreds of millions of dollars, there is no requirement for any insurance whatsoever.

And I think that as part of any legislation, insurance is something that needs to be considered. There is no free lunch in this world, and asking for insurance when we have to have insurance to drive a car, when we have to have insurance to rent an apartment, I think when we have a fiduciary who is out there as an investment advisor and an investment professional, requiring insurance will go a long way towards helping potential victims.

I will yield back the rest of my time, given Commissioner Borg running over. And I thank you for the opportunity to appear here today.

[The prepared statement of Mr. Caruso can be found on page 160 of the appendix.]

Chairman GARRETT. There you go. Thank you, Mr. Caruso.

Mr. Hammerman, please?

STATEMENT OF IRA HAMMERMAN, SENIOR MANAGING DIRECTOR AND GENERAL COUNSEL, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. HAMMERMAN. Thank you for the opportunity to testify as a member of the SIPC Modernization Task Force. I am appearing here today in my individual capacity, and not speaking on behalf of my fellow Task Force members.

I would like to highlight some of the important pro-investor changes recommended by the Task Force, namely expanding and increasing the protection available to customers in three important ways.

First, when a brokerage is liquidate and the customer property marshaled by the trustee is inadequate to return all customer fund and securities, SIPC makes advances from its own funds to assure the return of the customer's property. For over 30 years, these advances have been capped at $500,000 per customer. The Task Force recommends increasing the maximum advance to $1.3 million to adjust the limit to reflect inflation since 1980.

Second, SIPA currently distinguishes between claims for cash and securities, setting a lower $250,000 limit on claims for cash entrusted to the broker-dealer. The Task Force recommends eliminating this distinction, which has been a subject of controversy and unproductive litigation.

And third, the Task Force recommends a limited pass-through of SIPC protection to make individual pension plan participants eligible for advances with respect to their share of the plan's accounts at a failed broker-dealer.

While I support these recommendations, I wish to note that they were made without any real consideration of their cost. This cost will be funded by the members of SIPC and, ultimately, by the investing public. Before implementing these recommendations, I suggest Congress obtain a reasonable estimate of the cost of that expanded protection, and consider whether these costs would be justified by the increased investor confidence.

I am disappointed by the Task Force's failure to take action with respect to several critical areas previously identified by SIFMA. It is essential to ensure consistency between SIPA and the SEC's rules that determine the property a broker is required to reserve or segregate for its customers.

Inconsistencies between the two may result in an insolvant brokerage holding an inadequate customer property to satisfy all the customers' claims for the property entrusted to it. To take just one example, discrepancies in the treatment of the proprietary accounts of broker-dealers may result in a multi-billion dollar shortfall in the property available for distributions to customers of Lehman Brothers, as we have heard earlier today.

The current discrepancies were briefly addressed by the Task Force's report, which recommended further study. The Task Force missed an opportunity to recommend a solution to a problem that is only going to become more urgent as the SEC promulgates rules for the protection of securities-based swap customers.

Although the Dodd-Frank Act addressed the treatment of these customers in a liquidation under the bankruptcy code, it did not address their status under SIPA, where their status is highly uncertain. If they are not protected as customers under SIPA, securities-based swap customer protection rules may be futile.

On the other hand, if they are protected as customers under SIPA, regular securities customers may be exposed to risks arising out of the swap business. The SEC should be authorized to make rules under SIPA so that it can promulgate harmonious rules addressing both the requirements for brokers to set aside property for customers, and also the distribution of that property in a liquidation.

The SEC should consider tailoring the customer protection and distributive schemes so that customers with simple securities accounts are not unduly exposed to the risks of newer and more complex types of transactions. Finally, to the question of fraud committed by a broker-dealer, I would like to note, as intended by Congress, SIPC's funds are available only to replace missing customer property that was in the custody of a failed broker-dealer.

I share in the sympathy with, and outrage on behalf of, the many innocent victims of massive fraud by the likes of Madoff and Stanford. Financial fraud undermines confidence in our markets and our regulatory system. However, SIPA is not intended to protect investors against losses on their investments, only against losses of their investments in the event of a broker-dealer failure.

Investors who lose money because of a decline in the value of the securities are not protected by SIPA against such losses, whether the decline is due to market forces or even due to fraud.

In conclusion. SIFMA appreciates the opportunity to participate in the work of the Task Force, and is committed to working constructively to modernize SIPA to better protect investors, and thereby increase confidence in the final markets. We look forward to continuing to work with the subcommittee on these important investor protection issues. Thank you.

[The prepared statement of Mr. Hammerman can be found on page 165 of the appendix.]

Chairman GARRETT. Thank you, Mr. Hammerman.

Mr. Stein?

STATEMENT OF RON STEIN, CFP, PRESIDENT, THE NETWORK FOR INVESTOR ACTION AND PROTECTION (NIAP)

Mr. STEIN. Thank you, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Ron Stein, and I am president of the Network for Investor Action and Protection, NIAP, a national nonprofit organization comprised of small investors dedicated to improving our Nation's investor protection regime.

I am also a registered investment advisor, certified financial planner, and a member of the financial services community. NIAP's primary constituents are individual, noninstitutional investors who are often the least equipped to deal with the fallout arising from Madoff-like catastrophes, but include an increasing number of regular investors concerned about protecting their assets.

To supplement my written testimony, which goes into great detail about the Madoff liquidation and the urgent need for H.R. 757, I wish to emphasize the following points. First, a majority of the Madoff victims have not and will not receive any of the SIPC advance guaranteed by Congress under the SIPA statute due to the misguided and inequitable methodology adopted by SIPC and the trustee, which minimizes investor protection and the amount that SIPC needs to pay to defrauded investors.

Despite assertions to the contrary, the payment of SIPC advances has nothing to do with investor-to-investor fairness or parity, nor does it reduce the amount of a customer fund available for distribution to customers. SIPC advances come from the SIPC fund, not from the customer property.

Over 3 years into the fraud, it appears as though the Madoff liquidation has protected SIPC and enriched the trustee and the trustee's law firm at the expense of the customers. The trustee has acknowledged in court filings that his method for calculating net equity has saved SIPC over a billion dollars, money that should be paid to the victims.

At the same time, the cost of the liquidation has exceeded $450 million, and this committee has been told to expect that an additional billion dollars will be spent before the process is complete. Ironically, it would have cost approximately the same amount to pay each Madoff victim the full measure of SIPC advances guaranteed by Congress when it enacted SIPA.

SIPC and its trustee have fashioned a net equity methodology which consciously ignores reasonable customer expectations as reflected in customer account statements, destroys the certainty Congress intended under SIPA law, and virtually ensures that no rational investor can have confidence in our capital markets or in the protections that SIPC promises but fails to deliver.

These core principles of basic investor protections were the fundamental reasons—indeed, the stated purpose—of enacting SIPA, despite an explicit congressional prohibition to the contrary. And in the Madoff liquidation, the trustee has been given carte blanche to create whatever definition he wants of net equity, including the one which favors SIPC over customers.

As a result, customers can never be sure until long after the fact what protections they have if their brokerage firm fails. Moreover, in light of the clawback cases the trustee has brought, no investor will be able to safely withdraw funds from their brokerage account for fear that years later, some SIPC trustee will sue to recover those monies under the rationale that it was other people's money.

Victims who have lost everything are now forced to defend against lawsuits that treat them as thieves, and victimizes them yet a second time. How can investors be asked to rely on a system which leaves wide open whether, and to what extent, SIPC will provide coverage, and which investors remain subject to clawback in perpetuity, even though they withdrew funds from their own accounts, in good faith, under the reasonable assumption that it was their own money.

Simply put, as of now, no investor can have confidence in the validity of their statements. Enactment of H.R. 757 is a crucial step in restoring sanity to the SIPA process. It will make clear that account statements which reflect positions in real securities will be honored in the event of a brokerage firm failure.

It will end the use of clawbacks against innocent victims. And it will end the cozy relationship between SIPC and their short list of trustees. I also commend Congressman Ackerman for his legislation which, among other things, would aid indirect investors who are often just as damaged, both financially and emotionally, from an event like Madoff.

Thank you for allowing me to testify. I would now be pleased to respond to any questions. Thank you.

[The prepared statement of Mr. Stein can be found on page 211 of the appendix.]

Chairman GARRETT. Thank you. I thank the panel. I recognize myself, since—I was going to say because—I will begin on this point. We are all in agreement that there is an untold number of victims who are out there.

But some of the beginning comments from this panel just lead me to a different set of—and I don't use the word lightly—"victims." That is, the conversations with regard to what happens as far as the fees, if you will, or the costs to the broker-dealers because of the money that is being paid out now and trying to build up the fund going forward, and what have you.

It is interesting to hear, first of all, as far as the previous figure, about $150. And that may actually be less, in certain circumstances. But we have also heard from certain broker-dealers that the assessment figure could be substantially higher. And these are, usually, still the smaller guys who did absolutely nothing wrong in this situation and did nothing wrong in any other situations.

But you might say, from their perspective and ours, as well, perhaps, that they are now being penalized for the errors of others. So I guess I will throw that out to Mr. Caruso, because I believe you were talking about the idea of mandating insurance. Is this a different, another class, of "victims" that we have to consider because of the ills and the bad behavior of others?

Mr. CARUSO. Chairman Garrett, one of the ways I would respond to your question is, I have never had a car accident in 35 years of driving. And yet through my insurance coverage, I am certainly paying for the ills of others. Again, looking at our financial system, somebody is going to need to focus on how we finance what we are discussing in this hearing and in similar hearings.

Whether we provide restitution, the money is not endless. Although I guess in this City, sometimes people think it is endless. But if you look at the SIPC fund, there is not enough money to accomplish, I would submit, what needs to be accomplished. The Madoff investors are victims because quite honestly, the government let them down.

The SEC did not pick up on what was going on. I think they deserve to be treated differently than the Stanford investors or the ML Global investors. But clearly, where the government is at fault, and allowed certain things to go on longer than they clearly should have, those people are indeed being victimized twice.

Chairman GARRETT. Thank you.

Along another note, the whole panel was here, obviously, all day listening to the previous panel. Mr. Stein, you heard Mr. Harbeck discuss several reasons why—three or four reasons why—he had concerns with, or opposed H.R. 757. Would you like to run down some of those, his position versus whether he is correct in his oppositions?

Mr. STEIN. I think Mr. Harbeck has a slightly different worldview than we do at NIAP. I think what we have all clearly heard from Mr. Harbeck today is that the SIPC fund, instead of perhaps saying, how can we help, says, how can we not help. I think, in Mr. Harbeck's worldview, there is equitability in denying SIPC protection for 75 percent of the victims, of the innocent victims of a fraud.

I think, in Mr. Harbeck's worldview, suing a thousand innocent victims on a clawback claim is an equitable solution. I think in Mr. Harbeck's world, making sure that close to 90 percent of the recoveries of customer property go to the highest, most wealthy institutions and institutional investors is equitable.

I think what Mr. Harbeck is missing is the point that there are basically two pots from which to provide restitution for victims or benefits to victims. You have the SIPC fund, which has a responsibility to pay victims based upon their final account statements, or the reasonable expectations of those final account statements.

And I would say that is a very, very core principle underlying the creation of SIPA, and that is step one. Step two is finding and seeking some equitable solution to dealing with the distribution of money from the recovery of customer property. But to focus on customer property, we believe is a red herring.

Second of all, Mr. Harbeck seems to feel that in some way, paying SIPC benefits in a Ponzi scheme empowers the fraudsters; it legitimizes the fraudsters. I would suggest to you that the only thing that legitimizes the fraudster is the failure of the regulatory apparatus to catch the fraudster.

And to say that the protection of—that giving funds to a customer or a victim of a fraud in a situation like this enables the fraudster is akin to saying a fire truck and a fireman putting out a fire that was caused by an arsonist in some way legitimizes the arsonist. It is an absolute absurd twisting of the concept.

At the core, we are talking about protecting customers. We are protecting small customers, people who are at the core of our financial system. And it doesn't sound to me like Mr. Harbeck has really addressed those core principles. Because that, in fact, is what is needed for Madoff victims now.

Chairman GARRETT. Thank you. And I have a few more questions.

But Mr. Hurt? Thank you, Mr. Stein.

Mr. HURT. Just following up with Mr. Stein, what I thought I heard Mr. Harbeck talking about, though, was that, in his opinion, the SIPC was not designed financially, in a fiscal way, to be able to address all of the inequities that could possibly occur. And that with respect to the Stanford case, if you follow the rules as he interprets them, it was not designed to do that.

Now, if Congress or SIPC wants to expand that authority, then suddenly you are going to have to build a different model and there is going to have to be more capital involved. I think what he said was you would end up having to draw down on the equity line with the Treasury in order to be able to guarantee that.

I think that is what he was saying. Can you talk about it in terms of that? Because I think that is what he was saying.

Mr. STEIN. Yes. Let me speak to that briefly, Congressman. I think, first of all, we are in great sympathy with a vast majority of the victims of the Stanford fraud. The vast majority of them had no knowledge that they were investing in something that was not going to be protected, that they were investing through a broker-dealer that was not going to property manage their funds.

They are truly victims. And what I think is important for SIPC to do in a situation like this is to address the situation in a way that says, what can we do to help, and what do we need to do in the future to prevent these sorts of calamities from happening again? And frankly, that is something that requires all parts of the regulatory apparatus to work together.

The fact of the matter is, Mr. Harbeck was correct. There were major failures of regulatory oversight that allowed the Stanford fraud to continue. And that is something that we have to pay very, very significant attention to. That said, I think we also have to find a way to think about how we can help the Stanford victims rather than do them further damage.

Mr. HURT. Another question that I would like to address, or have addressed, is a question that I asked the previous panel. And that is, when you look at the broker-dealers that are paying for this protection for the public—which I think everybody understands and agrees is appropriate—at some point, it seems to me, you have to be concerned about how much you are asking those to contribute.

Because at the end of the day, that comes out of their bottom line. It makes them either more profitable or less profitable, allows them to stay in business and provide that protection.

But it is something that I am aware of because as I travel across my district, I hear from people in every line of work who say, "You know, these little fees, they sound good when you are talking about them in a committee meeting in Washington. But once they all pile up on us, they have a devastating effect on our ability to be competitive."

And I was wondering if maybe each of you could just speak to that topic. What is the appropriate level of assessment, and does that assessment take into account the size and relative risk that perhaps each dealer-broker exposes the fund to?

Mr. STEIN. I think Mr. Caruso has spoken well to that issue. But the fact that for the better part of the last 20 years, every member of SIPC has been charged a paltry $150 per year, that ultimately led to the potential trauma that is now being experienced by the SIPC fund is beyond comprehension.

And by the way, the SIPC fund as its presently constituted has more than sufficient assets to pay off the advances to all the Madoff victims, just as a point to be made. But you get to a very important point. And that is, why were the members of SIPC resistant to increasing SIPC fees for the last 20 years, when this committee and other committees recommended an an increase to the SIPC assessment over the last 20 years?

We would have a SIPC fund that would have multiples of billions of dollars, more than capable of paying for the Stanford and the Madoff and, potentially, even some of the MF Global situation had there been a proper assessment on the SIPC members.

Now, the second part of this that Mr. Caruso alluded to is the process of underwriting. If you are going to take on a SIPC member who increases by their very practice the level of risk, it is important that we find some method to increase the cost for that individual. A high-risk driver should be charged a higher rate than a low-risk driver.

An investment advisor that has custody of their own assets should probably be charged a different rate than one that doesn't. So to get to the ultimate part of it, I think we have to find an assessment level that is consistent with the risk, and also begin the process of bringing in the private sector to improve the extent of—

Mr. HURT. Thank you, Mr. Stein. My time has expired, but I don't know if, without objection, there are others who could add to that point. Go ahead.

Mr. HAMMERMAN. Thank you, Congressman. I just wanted to echo the concern raised by your question. There are approximately 5,000 different broker-dealers, many of whom are small business operators. Which is why, in my oral statement, I indicated that while as a Task Force member I agreed with the notion of increasing the level of protection to the $1.3 million, one piece that we as a Task Force just did not really analyze is the cost.

What will these costs ultimately require for all the broker-dealers, from the smallest firms up to the largest? So I just think that is a relevant question, and part of the data analysis that should occur.

Mr. HURT. Mr. Caruso?

Mr. CARUSO. Thank you, Congressman. Obviously, we don't have access to the member assessments from SIPC as far as who is paid what over the past number of years. But looking just a few years ago, realize Citigroup global markets, Smith Barney, Merrill Lynch, Morgan Stanley—those firms paid a total of $150 apiece.

So does the system have to be changed? Certainly. You can't have a firm of that size, with thousands of brokers, paying $150. To come down here today, the shuttle cost me $800. Now, at $150 a year, I would have paid my SIPC dues for almost 6 years.

That is insanity, and that is what is at the core of the problem today, and why I would suggest that the SIPC fund, with just one more catastrophe, will not be viable any longer on its own or with the Treasury backstop.

Mr. HURT. Mr. Borg? Thank you.

Mr. BORG. The question of assessments really depends on what the focus of the fund is to do. If it is going to be limited to where it is now, or at least under the current interpretation, that is going to be one assessment. If you are going to expand it to cover potential losses on statements that may be inflated—especially 20 years' worth of Bernie Madoff—that is going to be a completely different assessment.

I think the committee, the Task Force, when looking at this, made recommendations not knowing what those costs would be. So we took what was the current law—the Dodd-Frank 0.02, quarter of 1 percent on revenues—and said that is what the law is now. And what we only did was say, look, it is ridiculous to have $150.

At least have some minimum. But I think it is incumbent upon Congress to decide where the parameters are. And I think a lot is going to depend on this SEC versus SIPC lawsuit. Because, quite honestly, if the SIPC is required to pay the Stanford or the account stated on account statements, then I would submit to you I have about $4 billion or $5 billion worth of Reg D 506s sold through broker-dealers on oil and gas deals and medical facilities that also would be required to pay.

What my concern is on the bills is not what you are trying to accomplish. It is that they only cover certain Americans in certain situations. Everybody is entitled to equal protection of the law. If you are going to cover Stanford—which, in essence, is going to cover an overseas bank, basically turning SIPC into FDIC insurance for an overseas bank—what about one of my cases? Mallory is a now-defunct broker-dealer.

I put them all in jail. There are not assets. But I have probably $600 million worth of account statements and folks who invested in U.S. projects that were fraudulent. There is no SIPC coverage for that. I can't give them their money back. Lets cover it for all Americans. But at that point, you have to look at what that universe is.

You cannot parcel the universe and say just Stanford or just Madoff—cover everybody, or decide not to cover anybody. Or try and find some level of protection that everybody can participate in.

Mr. HURT. Thank you, Mr. Chairman.

Chairman GARRETT. Sure.

Just on that last line, I am sorry, I wasn't familiar with that case. So that was not a securities case. That was—

Mr. BORG. Most of—

Chairman GARRETT. That last—they were—

Mr. BORG. Sorry, Mr. Chairman. Yes, Mallory was a broker-dealer out of California. It was FINRA-registered. However, they specialized in the private placements under Regulation 506, which is exempt from State securities jurisdiction, except for enforcement. There is no gatekeeper function. And what we discovered was that out of southern California, they were running an operation where they would do multiple 506s; 72 percent to 75 percent of all the money went to the company—salaries, bonuses, salesmen.

There was never any money for projects. They would open up a little project, and there was no chance it would ever succeed because there was no money to fund it. And this was a primary fraud. We see the same thing with captive broker-dealers in the oil and gas industry, where an oil and gas developer will set up a broker-dealer and sell only oil and gas placements.

DBSI out of Idaho was a real estate pool.

Chairman GARRETT. And that would not come under the SIPC, then?

Mr. BORG. No, because it is all fraudulent statements with false profits. It is identical to the Stanford situation.

Chairman GARRETT. Yes.

Mr. BORG. But if the case turns out that it is covered, then I think all those have to be covered, as well.

Chairman GARRETT. Yes.

I have a couple of other particular questions. But I guess Ms. Bowen actually raised some of that point before as to there are other classes, there are other activities of fraud that are out there—and we are trying to address where this fraud should be covered, right?

And I appreciate that. Part of the problem in this particular area is, where you were, clearly, in Madoff—which is the more infamous one where you are looking in that situation: one, it was covered; and two, there was an expectation of coverage.

Now we get into the two issues that we have in that particular case. Obviously, the one that the gentleman from Colorado picks up on the most is the feeder fund situation, and what was the expectation in that situation as far as the unlearned, the average investor on that situation.

And the other is the situation about the various pools of funds that are available for recovery. And to those separate points, Mr. Borg, you raised the point, I guess, in your opening comment. Just a side line on this is how mutual funds are treated under this.

The fact that they have the logo there, so to speak—although I guess most people really don't see that, since you are dealing with a lot of this online nowadays—your position was, and I will look at the rest of the panel, what the solution is, dealing with mutual funds.

The exemption is appropriate? Or is the exemption similarly removing of that logo, and say since they are not going to—

Mr. BORG. Mr. Chairman, I disagreed with the rest of the Task Force members on this point. I thought mutual funds, because they do: one, use the logo; and two, because money is going back and forth in brokerage accounts and there are all these mutual funds that are being held in a street name for that matter—all those shares that back up the mutual funds—

Chairman GARRETT. Sure.

Mr. BORG. —I just thought they should not be an exemption. I don't know what that kind of money would bring in, but that is a huge industry.

Chairman GARRETT. Does anybody else want to—since we know you were on that—just find where the rest of the panel is?

Mr. CARUSO. The only thing I would offer, Mr. Chairman, is, when we explored that issue as part of the Task Force, one of the things we looked at was how often do mutual funds fail. Yes, they all use the SIPC logo, but they don't pay anything for it. And the counterargument from the Investment Company Institute—the trade association for mutual funds—was, none of our members ever fail.

As Commissioner Borg indicated, mutual funds are a huge business in today's day and age, and they are part of the securities industry. But historically, they have been carved out.

Chairman GARRETT. Right.

Mr. CARUSO. Revenues from mutual funds. And I think given the current financial position in the environment, it is something that needs to be revisited.

Chairman GARRETT. Right. Anybody else?

Mr. HAMMERMAN. The only thing I would add, Mr. Chairman, is that many mutual fund complexes have broker-dealers as part of the complex. That is how they sell the mutual funds. So there would be SIPC coverage and assessment at that level.

Chairman GARRETT. Okay. The magnitude of those funds is still de minimis, based upon the current configuration.

Mr. Stein?

Mr. STEIN. I would agree exactly with what Mr. Hammerman just said on that.

Chairman GARRETT. Yes, yes. And also, I am down here, and since I can give myself as much time as I want—but I am mindful of your time—SIPC says what with regard to the payment methods? Cash-in, cash-out, right, when you are dealing in that equity calculation?

Do you want to just spend a moment on the appropriateness of that? And then to bifurcate that issue—and the rest of the panel, I will throw it out to you, as well—to bifurcate that issue to the fact that you can bifurcate that as far as whether you have one pool or two, right? The advances, or the other assets—back?

And your comment would be in general, should there be a distinction when you are dealing with both pools?

Mr. STEIN. Sure.

Chairman GARRETT. Okay.

Mr. STEIN. Sure. Sure, let me get to that.

Chairman GARRETT. Okay.

Mr. STEIN. All right. So when Congress passed SIPA law in 1970, at the same time that it was moving away from the use of physical securities that you referred to earlier today, it was doing so at the same time it was making an agreement with the American public of offering a degree of assurance that what was going to be replacing that physical security had to be meaningful.

It was intended to be modeled on the kinds of assurances that were provided by the Federal Deposit Insurance Corporation (FDIC). In fact, the original legislation was essentially a cut-and-paste from the original FDIC legislation. But the upshot, it was trying to protect the small investor and create a state of certainty, so that an investor knew that when we were dealing with something that was on an account statement, it was a true and honest and legitimate reflection of what they owned. Congress made this recommendation amidst a background of failed brokers, of Ponzi schemes, of thefts. The circumstances all existed, that we are talking about today, in various forms.

And Congress still said, we are creating a SIPC fund. This fund is going to protect the net equity based on understood-to-mean final account statement. So that an investor knew, when they looked at their statement, that they owned something. And it was necessary. Because after all, we were looking at protecting the smaller investor.

Richard Nixon's statement, when he signed that legislation, was a profoundly powerful one. And what it does tell us, very clearly, is that investors who are in their later years, who are now living on their retirement funds, cannot afford to think that their protections are being reduced by the amount of money that they pull out of those funds.

That the profits that their hard-earned savings have made on those funds in those accounts, whether it is at a bank or a financial institution, have to be protected. And that worse still, somewhere down the road, no trustee can come in 20 years hence and say no, you have to give that money back.

That is precisely what is going on now. So the SIPC fund itself has to be based upon reasonable expectations of final account statements. And frankly, if the statements are outrageous or wrong, then we really have to get to whether or not a person receiving those statements was willfully turning a blind eye.

The courts have the ability to say no, you are getting 40 percent return—maybe you don't get that protection. But when we come to the issue of the recovery of customer property—and I think that is where so much of the time has been spent—maybe there is a different standard.

The trustee has had the flexibility to apply a different standard and a reasonable standard. And that standard could incorporate the time value of money, it could find some way to equitably determine what the fair distribution would be of the recoveries of those monies.

But it should not eliminate the use of final account statement and reasonable expectations on the core of this protection, which is the SIPC fund. So customer property has an opportunity to have all kinds of equitable, ratable methodologies applied to it to come up with a good solution based upon what the trustee sees at that particular time.

The fund, however, that belongs to SIPC, the SIPC fund, is inviolate. It cannot be modified or changed. It is what the customer has to be relying upon for their protection.

Chairman GARRETT. The rest of the panel?

Mr. CARUSO. The only thing I would add, Chairman Garrett, is the one thing that has been clear from today's hearing is that how you stop this problem is you don't allow people to prepare their own account statements. If Madoff had not prepared his own account statements on one side of his floor, none of this would have happened.

So, a very simple solution, if we want to keep this from happening again, is that I cannot prepare my own statements. That solves the problem.

Chairman GARRETT. Mr. Borg?

Mr. BORG. In my office, investment advisors are looked at once every 3 years on a rotating cycle. We use a risk assessment. If they have custody and control, they go way to the top of the list and they are looked at a lot sooner and a lot quicker.

If they are strictly financial advisors that just give advice, and they have no custody, no control—no physical custody of the property—then they go to the bottom of the list. Because there is a clearing firm or someone else out there. The comment was made, and we try and encourage at least the investment advisors under our jurisdiction—Madoff would have been under the SEC jurisdiction—to get a clearing firm.

Again, I agree. A lot of the problems with these Ponzi schemes, if they are going through either a brokerage, or usually an IA, can be eliminated by actually having a dual or triple control. Because now you have three entities that have to conspire to make it all work.

Chairman GARRETT. Unless, of course, you control all three entities, and, as in the Madoff situation, where—

Mr. BORG. In that case, I would consider that as a unitary control because Mr. Madoff actually had control over both ends of his business. There has to be a Chinese wall between the two. Even where there are clearing firms that self-clear, we look at the controls between the two. Usually it is an outside auditor or an outside advisor, or some other third party that has to certify that they have looked at those systems and those systems are intact.

Chairman GARRETT. Have you ever had the case where you have a situation like that? Where there is collusion, and it doesn't solve the problem, as Mr. Caruso suggests?

Mr. BORG. I have not seen—yes, one time that I can think of. In fact, it gets tied up with that Mallory case because there was a separate organization called Capital Guardian which handled the trust accounts.

Chairman GARRETT. Okay.

Mr. BORG. In other words, if you had an IRA and there was collusion between the two. There was joint ownership, but it was so cleverly disguised it took us a little while to find it.

Chairman GARRETT. Find it, yes.

Mr. BORG. But it didn't last 20 years.

Chairman GARRETT. Yes. That is because you had good folks over there digging into it on a regular basis—

Mr. BORG. Thank you, Mr. Chairman. I appreciate that.

Chairman GARRETT. Sure.

If Mr. Hurt does not have any other questions at this time, I will dismiss the panel, and thank you all very much for your testimony today. And without objection, I will put into the record a statement from the Financial Services Institute, and also from the Bond Dealers of America (BDA). Without objection, it is so ordered. And again, I very much appreciate this entire panel for your information and discussion today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

Thank you. The hearing is adjourned.

[Whereupon, at 12:42 p.m., the hearing was adjourned.]

A P P E N D I X

March 7, 2012

TESTIMONY OF
JOSEPH P. BORG

Director, Alabama Securities Commission

before the

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES

United States House of Representatives

March 7, 2012

Chairman Garrett, Ranking Member Waters and Members of the Subcommittee:

Thank you for the invitation and opportunity to participate in your hearing focusing on the Securities Investor Protection Act (SIPA) and the Securities Investor Protection Corporation (SIPC). I am Joseph Borg, Director of the Alabama Securities Commission and today I appear in my capacity as Director of the Alabama Securities Commission (ASC). While I served as a member of the SIPC Modernization Task Force, I am not a spokesperson for the Task Force or for SIPC.

As the state securities regulator for the State of Alabama, our office has administrative, civil and criminal authority under the Alabama Securities Act, and, specifically, with respect to investor fraud. ASC investigates Ponzi and pyramid schemes, illegal blind pools, fraudulent private placement offerings under Regulation D and other scams which have led to numerous enforcement cases and criminal prosecutions.

The majority of U.S. households now invest in capital markets in one form or another, whether through direct equity investments, retirement plans, mutual funds or similar investment vehicles (up from 1 in 18 in 1978—the year of the last significant amendments to SIPA). These investments by "Main Street" investors have become the primary method by which Americans save for their future, accumulate wealth and plan for a secure retirement. Financial fraud therefore has a profound impact and threatens the future of a great number of working families.

Beginning June 10, 2010, the SIPC Modernization Task Force conducted a series of meetings (including industry and government agencies) and telephone discussions, as well as document reviews and research, which resulted in the Task Force presenting its "Report and Recommendations of the SIPC Modernization Task Force" to the SIPC Board of Directors in late fall of 2011.

As I previously testified[1] in hearings held by this Committee on September 23, 2010, the Task Force focused on 12 main areas:

1. Adequacy of the SIPC Fund
2. Audit Responsibilities
3. Avoidance Actions
4. Corporate Governance
5. Customer Definition
6. Customer Name Securities
7. Customer Property
8. Direct Payment
9. Fictitious Securities
10. International Relations
11. Investor Education
12. Levels of Protection

The published "Report and Recommendations" covers 15 recommendations encompassing the 12 general areas mentioned above. As a member of Subgroup #1,[2] I shall discuss the recommendations primarily examined by our subgroup, namely Recommendations 1 through 4, 14 and 15.

[1] Testimony of Joseph Borg before the Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, September 23, 2010. [Copy attached as Appendix "A"].

[2] The Task force was split into two subgroups with specific areas of review.

RECOMMENDATION NO.1: INCREASE MAXIMUM PROTECTION TO \$1.3 MILLION and INDEX THE LEVEL OF PROTECTION TO INFLATION

I strongly supported an increase in the levels of protection and I stand by my previous testimony before this committee:

> "...It is my belief that the level of protection with regard to the SIPC Fund should be increased from $500 thousand to $1 million. It is clear that in today's society, Americans are heavily invested in the markets and that a large portion of their retirement savings consist of securities investments in addition to savings in banks. Further, the $1 million level of protection would match SIPC's Canadian counterpart, the Canadian Investor Protection Fund (CIPF), which is currently at the $1 million (CAN). Secondly, I believe that the levels of protection should be indexed to inflation. Part of the public's concern with SIPC is the lack of adjustments over the years to the levels of protection, and indexing to inflation would allow some measure of increased protection going forward."[3]

The recommendation of $1.3 million reflects my original opinion of an increase to $1 million plus an adjustment for indexing to inflation in recognition that Americans increasingly look to the markets and investments to secure their long term future goals. Congress has recognized the importance of "Main Street" investors in our markets and has consistently introduced legislation to further encourage small investors to continue investing in start-up companies, existing small businesses, and our markets. If we continue to encourage investments, we must recognize that the standards of the 1970s and 1980s can no longer apply in today's economic environment. The days of realizing the American dream of a secure future by saving only in a bank account or a certificate of deposit are long gone, especially with current rates generally below 40 basis points.

During the deliberations of the Task Force and after discussions with various government agencies, it became clear that concerns existed with regard to this recommendation; specifically, diverging from the historical relationship between FDIC and SIPC protection levels. Part of the

[3] Testimony of Joseph Borg before the Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, September 23, 2010.

concerns are evident in recent SIPC matters and can be traced in part to a lack of understanding of the differences of FDIC and SIPC coverage. This public perception stems partly from the historical notion of maintaining parity. **The insurance of FDIC to bank accounts and the coverage (non insurance) of SIPC to securities is fundamentally different both in statutory application and practical application** under existing law.

RECOMMENDATION NO. 2: ELIMINATE THE DISTINCTION IN THE LEVELS OF PROTECTION FOR CASH AND SECURITIES

The distinction of cash vs. securities in brokerage accounts is meaningless in today's markets. For example, money market accounts were relatively small in 1978—certainly not the \$2.7 trillion[4] now held by investors. In addition, brokerage cash 'sweeps' into money markets or bank accounts overnight with the result that substantial investor cash is routinely held in brokerage accounts (which funds deserve the full amount of SIPC protection). Further, this distinction has caused inconsistent court decisions, investor confusion and in some cases loss of customer funds[5]. This was an issue I discussed in my previous testimony before this Committee on September 23, 2010:

> "...A major issue is the treatment of claims based on a securities position which never actually existed. The Task Force is aware of the conflicts between decisions from the Second and Sixth Circuit Courts of Appeals in this area. I believe that the problem which stems from SIPA's distinction between cash and securities (currently \$250,000.00 cash limit) could be eliminated by ending the disparate protection between claims for cash and claims for securities. For example, a person selling their securities portfolio and receiving a check in excess of the maximum SIPC advance for cash claim where the brokerage firm failed before the check was cashed, would be limited to the cash limitation. Therefore the current law may, in some cases, result in unintended and inequitable results. I would also note that the Canadian Investor Protection Fund (CIPF) eliminated a distinction between claims for cash and claims for securities in 1998. In a

[4] Presentation of Investment Company Institute ("ICI") to the SIPC Task Force.
[5] See examples set forth in the Task Force recommendations.

> discussion with SIPC staff, it appears that a change in favor of eliminating the cash vs. securities distinction would not alter the risk models used by SIPC...."[6]

Again, as with the increase of protection in RECOMMENDATION NO. 1, there was significant discussion of the concerns by banking authorities that the SIPC will offer greater protection against cash losses than the FDIC. The artificial "connection" between FDIC and SIPC levels of protection is meaningless in today's economic society and maintaining 'parity' does not benefit investors. Rather than trying to maintain the lowest level of parity, we should allow the realities of today's markets to determine the actual and appropriate need for the benefit of all investors.

RECOMMENDATION NO. 3 PROTECT PARTICIPANTS IN PENSION FUNDS ON A PASS-THROUGH BASIS

Many Americans have their retirement accounts as part of a 'fund' or 'plan'. These investors should be able to avail themselves of SIPC protection and not be discriminated against because their generally small accounts are part of an overall defined benefit, defined contribution or deferred profit sharing plan. This recommendation comports with the trust and fiduciary provision under the Employee Retirement Income Security Act of 1974 ("ERISA").

My testimony at this Committee's September 23, 2010 hearing included the following:

> "....The Task Force has had initial discussions with regard to indirect investors. It is my opinion that certain retirement plans are appropriate for customer eligibility. I am unsure with respect to the hedge fund arena due to the nature of hedge fund investing, including lack of transparency, lack of oversight and higher risk strategies. However, this matter is on the agenda for further discussion with the Task Force. The Task Force is also aware that certain pension plans and employee benefit plans have been covered by FDIC and NCUA on a pass-through basis since 1978. The limitation is that each beneficiary could only receive the "present vested and ascertainable interest of each beneficiary". Issues concerning deferred compensation plans and non-bank covered pension funds are issues for Task Force discussion. It appears to me that pension plans and employee benefit plans

[6] Testimony of Joseph Borg before the Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, September 23, 2010.

matching those covered by FDIA and FCUA would be appropriate for protection under SIPA."[7]

The Task Force recognizes that SIPC staff will need to review and implement specific mechanisms and procedures (claim filing, documentation, etc). SIPC accounting may also need to determine if the SIPC Fund target should be adjusted. The Task Force asked the SIPC staff if the costs would have been material based on a historical review. In response, SIPC staff advised that had this recommendation been previously implemented, the effect on the SIPC Fund would not have been material.

RECOMMENDATION NO.4 AMEND THE MINIMUM ASSESSMENT TO THE GREATER OF 1) $1,000.00; OR 2) THE AMOUNT SET BY SIPC BYLAW NOT TO EXCEED 0.02% OF THE MEMBER'S GROSS REVENUES FROM THE SECURITIES BUSINESS.

SIPC staff reported to the Task Force that 25% of the SIPC membership paid a flat $150.00 based on net operating revenues. After Dodd-Frank, based on 0.02% of gross revenues, many of the same members would pay less than $150.00, and in some cases, $0. If members are utilizing SIPC in marketing materials and benefitting from the SIPC program, they should pay a minimum amount. Similarly, considering the size of the industry and the touting of SIPC coverage in advertising, a reasonable minimum assessment should be required. While I personally thought $1,000.00 was low, the general consensus was that $1,000.00 would be a reasonable amount in the current environment.

Another area discussed by the Task Force involved whether Mutual Fund Dealers and Assessments on Mutual Fund Revenues should be included. Representatives from the mutual fund industry appeared and made a case that there is no significant history of losses to investors

[7] Testimony of Joseph Borg before the Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, September 23, 2010.

on mutual funds and that structural differences between retail broker dealers and mutual fund distribution do not warrant such assessments. I did not agree with the majority of the Task Force not to assess mutual fund revenues on the theory that the mutual fund industry utilizes the SIPC logo, touts the SIPC coverage and billions of dollars of mutual fund shares are held in street name.[8] However, the fact that there is a history of minimal losses was persuasive to the majority of the Task Force. Further, SIPA §78ddd (c)(3)(C) currently exempts "...revenues received by a broker or dealer in connection with distribution of shares of a registered open end investment company... ."

RECOMMENDATION NO 14 INTERNATIONAL RELATIONS: SIPC TO ASSIST IN THE CREATION OF AN INTERNATIONAL ASSOCIATION

In today's "global" economy, geographical boundaries have little meaning. The cross-border effects of a failure of a multi-national business (Lehman, MF Global) have local, national and international implications. While the financial sectors have transcended political and geographical boundaries, the mechanisms for resolution when a major failure occurs are still rooted in the laws of the respective national jurisdiction. This 'sorting out' of laws, rules, regulations and procedures incurs substantial expenditure of time and resources. The creation of an international forum specifically dedicated to resolution of a failed entity should be seriously considered. The Task Force recognized that an international association will take time to develop, but beginning with a forum for discussion of international securities investor protection initiatives may provide the basis for future dispute resolution. In past years, I have served as the States' representative through NASAA[9] to the International Organization of Securities Commissions ("IOSCO") and between 2004 to 2009 as a U.S. Delegate in an expert capacity to

[8] Members of ICI manage assets of $12.33 trillion with 90 million shareholders according to ICI.

the United Nations Committee on International Trade and Law (UNCITRAL). That experience convinced me that the establishment of direct contacts and combining efforts specifically targeted to develop methods for coordination of a cost effective, transparent and efficient claims process would be a substantial benefit to investors. The Task Force recommendation encourages SIPC to continue its Memorandum of Understanding Program but to now elevate this program to a new level in taking the lead in the development of an International Association of like entities.

RECOMMENDATION NO 15 SIPC TO CONTINUE INVESTOR EDUCATION EFFORTS

As one of the Task Force members who participated in both of the SIPC public forums and answered telephone questions from the public, it was painfully evident that many investors consider FDIC and SIPC to be virtually identical, that is, insurance against theft, loss and fraud. I stand by my testimony at this Committee's September 23, 2010 hearing:

> "...It is clear that there is a general public misconception that SIPC is some type of insurance, akin to FDIC insurance for banks. It is also clear in SIPC's application of the law that SIPA was not intended to be insurance for fraud, but only for replacing cash, as well as securities missing from customer accounts not connected to the actual value of investment into the securities purchased or believed to have been purchased, and not based on a risk of loss fundamental. If Congressional intent is to change SIPC into FDIC type insurance-based protection, then the parameters of the level of funding would change. The misconception has been historically exacerbated by references to FDIC as a comparison and by the broker-dealer community who tout the SIPC protection levels. Education initiatives to correct the misconception have proven to be inadequate. Therefore, I would suggest that to seriously educate investors with an understanding as to what levels of protection are available and the true nature of SIPC protection, a constant and systemic notification (education) effort will be required. I would suggest that every brokerage account statement that is sent to investors include a page or a section that clearly underscores what SIPC is and is not. I would also suggest that it include examples which change every quarter so that the public can see what to expect or not to expect from SIPC. The fact of the matter is that television advertisements, public presentations and newspaper reports are one-shot efforts that will not overturn a history of belief and

[9] NASAA (International Securities Administrators Association) is a voluntary association whose membership consists of 67 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

> expectation. I would also not recommend an insert into the account statements as they have a tendency to be discarded, instead, every account statement would have a portion of a page dedicated to SIPC coverage. It may take several years of constant message delivery to reverse the current tide of misconception. This is not to say that elimination of other types of investor education is desirable. However, for true education, the repetitive nature of account statement receipt should assist in disseminating correct information of the purpose and role of SIPC. I am also aware that SIPC does not have the power or authority to require this type of account statement inclusion and the matter would have to be implemented through the SEC and FINRA...."

The Task Force considered the recommendations above but were unable to determine the costs to the industry and the potential effectiveness of these efforts. The issue is left with the SIPC Board for further study. The Task force did, however, unanimously recommend that a dedicated investor education employee be hired to enhance existing efforts and develop new initiatives.

VIEWS ON PENDING LEGISLATION:

The Committee's invitation further requested any views on pending legislation, specifically the following:

H.R. 757 "EQUITABLE TREATMENT OF INVESTORS ACT"

H.R. 1987 "PONZI SCHEME INVESTOR PROTECTION ACT OF 2011"

H.R. 4002 "IMPROVING SIPC ACT OF 2012"

H.R. 757

When a fraud occurs, the purpose of the fraudster is simple....deprive honest people of their funds to benefit the crook..... In essence, stealing with paper and pen (now computers and technology) rather than at gunpoint or through a burglary. In a perfect world we would want anyone so injured to get back what they lost. The question is then, what should they get back? Is it what they put in, that is, the actual investment that was stolen and distributed as 'profits' to other victims (less the amount taken by the crook) or what was promised, that is, the representations or promises of potential profit?[10] Our office has been faced with numerous ponzi, pyramid and other scams that affect our citizens. The Alabama Securities Commission currently has 48 defendants awaiting trial for various forms of securities fraud. So far in this past year we have convicted 16 individuals for fraud upon our investors. The problem is always the same—limited assets to distribute. While the intent of HR 757 is noble, it is not equitable and therefore confers an unequal benefit to some victims over other victims, all of whom are innocent and all of whom relied on the con artist. The investor rule then becomes: be the first in on a ponzi scheme, always take out your profit to guarantee the money can't be touched and save all your account statements. The goal is to be an early investor at the expense of later investors.

In one case[11] prosecuted by my office, fictitious account statements were issued indicating substantial profits from options trading. In fact, what trading did occur consistently lost money. What little assets remained were proportionately distributed based on the actual cash invested. Had our office distributed assets based on the account statements, and not considered the payouts already received, the vast majority of the later investors would have received nothing.

In a Ponzi scheme, early investors may receive distributions in excess of their initial investment but their ever increasing account statements show substantial amounts the victims believe to be in existence. With a limited amount of assets to distribute, we must treat every investor equitably by first attempting to make everyone whole on their initial investment (amount invested—amount received=actual cash lost). Rarely is there ever enough money to

[10] For example, in *Alabama Securities Commission vs. Greater Ministries International Church* the promise was "Double your money in 17 months". Over 20,000 victims invested with losses of over $500 million. Account statements were sent quarterly for nine (9) years. Likewise, *In the matter of MN Partners*, the promise of a $300.00 investment that would return $1,800 as month for life tax free after 5 years, resulted in over 18,000 victim investor accounts.

[11] *ASC v. Wealth Builders International* and *Networker 2000*.

accomplish this task. In my 18 years of experience only once were we able to return 100 cents on the dollar of actual investments (not promised returns). Unless there is an endless supply of funds to pay 'promised' returns, it becomes difficult if not impossible from assets available to cover all promises or expectations without a 'bailout' from someone else, whether it be the federal government or increased costs to the industry (with costs passed on to other investors).

The fundamental problem with the 'last statement' approach is that when thievery is involved the statements will match the fraudulent representations made (historical or otherwise) regardless of reasonableness, market conditions or reality. Fraudulent representations of "double your money" or 20% returns and statements to match are commonplace.

While H.R. 757 attempts to fix a terrible problem for many, it creates a problem for many others. I concur with a suggestion made by Prof. John Coffee at the September 23, 2010 Committee hearing in his discussion of "Net Winners" and "New Losers" in a ponzi scheme on a possible compromise solution:

> ".....One can certainly understand the desire to protect the smaller Net Winner, who withdrew only a small amount in excess of his or her cash investment in the Ponzi scheme. Most likely, the SIPC trustee would not sue the smaller Net Winners, but a *de minimus* exception could be created, instructing a SIPC trustee not to bring suit against persons whose withdrawals exceeded their investment by a given amount (say, $500,000). This would give peace of mind to many, but it would not impede the trustee in his pursuit of the larger Net Winners......
>
> Another more limited exemption may also be justified. It can be argued that early investors in a Ponzi scheme should be given credit for the imputed interest on their investments, and such amounts should not be regarded as "fictitious profits." To illustrate, assume that two investors both invest $1 million in a Ponzi scheme, and both withdraw $2 million. But Investor A invested his $1 million ten years ago, while Investor B invested his $1 million only last year. Thus, Investor A made a profit of $1 million (the $2 million withdrawn minus a $1 million initial investment) over ten years (or a 10% annual rate of return), while Investor B made the same $1 million profit in one year (or a 100% rate of return).
>
> These two investors look very different once we recognize the time value of money. From such a perspective, Investor A's real rate of return was only 10% per annum. In this light, Congress could immunize some minimum annual rate of return from the concept of "fictitious profits." This could be done either in the Bankruptcy Code or (less desirably) in SIPA. Thus, Section 8A(f)[12] could instead

[12] Prof. Coffee's reference is to H.R. 5032 (2011), now H.R. 1987 (2012).

> instruct the SIPC trustee not to seek to the recovery of profits from any investor in a Ponzi scheme without first subtracting a credit against these profits equal to a defined interest rate (say, 10%) times the principal amount invested each year. On this basis, Investor A would not have received "fictitious profits," while Investor B would have. For the sake of simplicity, I am not considering the compounding of interest in this hypothetical.
>
> This distinction rests on a real economic difference between these two investors, subtracting a credit against these profits equal to a defined interest rate (say, 10%) times the principal amount invested each year. On this basis, Investor A would not have received "fictitious profits," while Investor B would have."[13]

Perhaps HR 757 should be revisited and drafters may wish to consider revisions reflecting a basis as described by Prof Coffee in order to maintain equitable balance among the victims of a ponzi scheme.

HR 1987:

To the extent that HR 1987 contains similar concepts as HR 757, the same commentary would apply. HR 1987 also seeks to limit the trustee of a Ponzi scheme on recovery of funds from investors who have received funds from later investors (clawback). The net effect is subordinating the claims of later investors, the 'net losers' under Prof. Coffee's terminology, to the interests of the 'net winners'. Reducing the pool of assets injures the later investors to a greater degree. When faced with a ponzi scheme situation, all the assets, including the transfers stolen from later investors and given to earlier investors should be pooled to benefit all investors without preferential treatment. There are no real 'profits' in a ponzi scheme and payments to earlier investors are proceeds of a crime unbeknownst to both the earlier and later investors. All victims are equal, and unlike George Orwell's Animal Farm, some victims should not be more equal than other victims[14].

[13] Testimony of Prof John Coffee Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, United States House of Representatives September 23, 2010.

I note that HR 1987 Section 8 (A) (h) would apply the law retroactively with a threshold of $1,000,000,000. Our experience in prosecuting these schemes confirms that even a small ponzi scheme can wipe out investors life savings and destroy the hopes and dreams of entire families. Such a threshold is artificial and is not fair to all investors. Only those investors in 'large' frauds get the benefit of the law and smaller frauds essentially don't count. The devastating effect on families occurs regardless of the size of the scheme. If Congress is considering retroactive application, why not retroactively apply the law to all ponzi schemes affecting all American investors, perhaps retroactive to March of 2000[15]?

With regard to 'indirect investors', while the Task Force discussed the concept of coverage for indirect investors, the Task Force chose to limit the discussion to similarities in existing law (see discussion of RECOMMENDATION NO 3 above). Considering the large body of law on limitations on claims against third parties (such as limitations on class actions and recent decisions not allowing derivative claims, etc.) and considering that investors who dealt with 'feeder' funds placed reliance in the feeder funds and not the brokerage entity, pass through liability to SIPC may not be appropriate. The 'feeder fund' is the client of the failed entity. The investors in the 'feeder fund' have claims against that 'feeder fund' for any violation of duty of care, failure of due diligence, etc. However, one provision of H.R. 1987 proposes a maximum amount for indirect ponzi scheme investors which may have merit prospectively if fully researched and developed. Coverage for "indirect investors" is feasible if clear rules are in place including transfer of potential claims similar to subrogation on insurance, up front disclosures by feeder funds to the brokerage entity of its clients, disclosure by the feeder fund to its investors of the pass through coupled with transparency as to fees charged for the service, and clear disclosure as to what actual services the feeder fund is doing for its fee.

[14] Orwell, George, Animal Farm (1945) " … all animals are equal but some animals are more equal than others …"

HR 4002

This Bill is specifically directed to the unfortunate situation created by the massive Stanford fraud. The matter is in litigation and will apparently be decided by the courts. Depending on a final court decision, the one-time payments being proposed may be correct, may be subject to recapture or may be determined to be inappropriately paid.

The pending issue is whether SIPC has the statutory power to reimburse the investors/victims in the alleged Stanford Ponzi scheme since it appears they did not lose money in a failed brokerage firm. Investors lost as they purchased CDs from an offshore "bank" instead of an FDIC insured institution[16]. The bank issuing the CDs was chartered, domiciled, regulated and audited in Antigua. Investors purchased the CDs for the interest rates being paid which were substantially higher than rates paid by U.S. regulated banks.

The potential result of the pending action may have wide ranging effects. If in fact a foreign (non - U.S. regulated) bank can sell CDs (or similar products) through a brokerage then it makes sense for anyone contemplating the purchase of a CD to find an offshore bank (through a brokerage) paying substantially higher than any U.S. Bank, therefore knowing that **if** a loss occurs by fraud they will be covered by SIPC at a possibly higher rate than currently offered by the FDIC. In such a case, why would anyone invest in a U. S. bank CD at substantially lower interest rates for the same or a lesser guarantee of coverage? At this point SIPC becomes the virtual equivalent of FDIC coverage for non U.S. regulated banks. If Congress has not yet sought the opinion of the federal and state banking regulators on this issue, I suggest that such a request be made.

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[15] Beginning of the first major crash of the century, commonly referred to as the "tech wreck".

[16] Based on information available, including comments by SIPC and its Trustee, it does not appear that investors placed funds in the Stanford brokerage unit and that the brokerage failed to purchase the Certificates of Deposit. If the brokerage unit had failed to transfer funds to the bank's accounts either in the U.S. or directly to Antigua for the CD purchase then clearly, SIPC coverage would be in effect.

Let me be clear, as a state securities regulator, I always look for ways to have investor losses covered when legally possible. If the current litigation between the U.S. Securities and Exchange Commission and SIPC determines that coverage is available for a foreign bank CD fraud, then we should expect that all similar cases of securities fraud should also be covered, not just foreign bank CDs. For example, the Alabama Securities Commission has investigated the matter of Mallory Investments[17], a defunct registered broker-dealer who sold millions of dollars of fraudulent Regulation D 506 private placement offerings to investors. Similar frauds exist through brokerages and investors in those cases should be covered as well if the decision in SEC vs. SIPC requires coverage in a situation even more remotely removed from a brokerage than the private placement offerings.[18]

At this time, it appears that the more prudent course would be to allow the judicial system to finalize the issue so Congress can consider the result and act accordingly to support, modify or overturn the Court's action through appropriate legislation.

Improvements to SIPA and SIPC can and should be made but must be made for the benefit of all investors equally.

Thank you for the honor to once again submit testimony on these critical issues.

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[17] To date, ASC has criminally convicted 5 individuals from California connected with the Mallory fraud. Other cases such as DBSI, MedCap and others may also become eligible for coverage.

[18] During the period 1996-1999, the Alabama Securities Commission was the lead state investigating the micro-cap frauds of the time, including such firms as Stratton Oakmont, Duke & Co., Biltmore Securities, etc. (Testimony of Joseph Borg, "Fraud in the Micro-Cap Markets and Penny Stock Fraud", before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, September 22, 1997). We proffered the idea that the SEC, SIPC and Congress consider the issue of SIPC coverage for brokerage fraud in the micro-cap area. The idea was rejected.

APPENDIX A to Testimony of Joseph P. Borg before the Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (March 7, 2012)

TESTIMONY OF

JOSEPH P. BORG

Director, Alabama Securities Commission

before the

**COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES**

United States House of Representatives

September 23, 2010

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee:

I am Joseph Borg, Director of the Alabama Securities Commission and I welcome the opportunity to participate in your hearing focusing on the Securities Investor Protection Act (SIPA) and the Securities Investor Protection Corporation (SIPC). Today I appear as a member of the SIPC Modernization Task Force and in my capacity as Director of the Alabama Securities Commission (ASC). Our office has administrative, civil and criminal authority under the Alabama Securities Act and specifically with respect to investor fraud, ASC investigates Ponzi and pyramid schemes, illegal blind pools, fraudulent private placement offerings under Regulation D and other scams which have led to numerous enforcement cases and criminal prosecutions in this arena.

With about 55% of US households now investing in our capital markets, up from 1 in 18 in 1978 (the year of the last significant amendments to SIPA), financial fraud has a profound impact on a great number of working families.

With regard to SIPC, I was invited to participate on its Modernization Task Force in late May of 2010. Since that time, we have had a series of telephone conferences, three in-person meetings discussing various issues related to SIPA and SIPC, as well as dedicated website access to exchange information and ideas. I would like to take a few minutes and advise you of my position with regard to certain "modernization" issues which I have either proffered or have supported. These views do not necessarily reflect those of SIPC or of the Task Force. The Task Force discussions are concentrating on twelve particular areas as follows:

1. Adequacy of the SIPC Fund,
2. Audit Responsibilities,
3. Avoidance Actions,
4. Corporate Governance,
5. Customer Definition,
6. Customer Name Securities,
7. Customer Property,
8. Direct Payment,
9. Fictitious Securities,
10. International Relations,
11. Investor Education, and
12. Levels of Protection.

In order to move the process along in an efficient manner, the Task Force has been subdivided into two groups. Later, the subgroups will join together for discussions on the various subjects for final recommendations. I would like to take a moment to commend the SIPC staff for prompt responses to my specific requests for information, data, reports and source materials in order for the Task Force to become adequately informed in certain areas. My particular areas of concern are as follows:

1. Levels of Protection. It is my belief that the level of protection with regard to the SIPC Fund should be increased from $500 thousand to $1 million. It is clear that in today's society, Americans are heavily invested in the markets and that a large portion of their retirement savings consist of securities investments in addition to savings in banks. Further, the $1 million level of protection would match SIPC's Canadian counterpart, the Canadian Investor Protection Fund (CIPF), which is currently at the $1 million (CAN). Secondly, I believe that the levels of protection should be indexed to inflation. Part of the public's concern with SIPC is the lack of adjustments over the years to the levels of protection, and indexing to inflation would allow some measure of increased protection going forward.
2. Fictitious Securities. A major issue is the treatment of claims based on a securities position which never actually existed. The Task Force is aware of the conflicts between decisions from the Second[1] and Sixth Circuit Courts of Appeals[2] in this area. I believe that the problem which stems from SIPA's distinction between cash and securities (currently $250,000.00 cash limit) could be eliminated by ending the disparate protection between claims for cash and claims for securities.[3] For example, a person selling their securities portfolio and receiving a check in excess of the maximum SIPC advance for cash claim where the brokerage firm failed before the

[1] *In Re: New Times Securities Services, Inc.*, 371 F.3rd 68 (2nd Cir. 2004)
[2] *Plumbers & Steamfitters Local No. 490 Severance and Retirement Fund v. Appleton (In Re: First Ohio Securities Co.*, No. 93-3313, 1994 US App. LEXIS 31347) (6th Cir. Nov. 1, 1994)
[3] If Subsection (a)(1) of SIPA § 78fff-3 is deleted, the disparity would no longer exist.

check was cashed, would be limited to the cash limitation.[4] Therefore the current law may, in some cases, result in unintended and inequitable results. I would also note that the Canadian Investor Protection Fund (CIPF) eliminated a distinction between claims for cash and claims for securities in 1998. In a discussion with SIPC staff, it appears that a change in favor of eliminating the cash vs. securities distinction would not alter the risk models used by SIPC[5].

With respect to increasing the limit to $1 million and eliminating the cash vs. securities distinction, the banking industry and/or banking regulators could be expected to oppose such a change as there has been an apparent historical progression of matching levels of FDIC protection to SIPC limits even though the operation of FDIC insurance is completely different to the operation of SIPC as a securities replacement vehicle. Certainly discussions with the Securities & Exchange Commission (SEC), Treasury, Federal Reserve Board and views of the industry (SIFMA) and other authorities would be appropriate.

3. Increase the Line of Credit from Treasury. Considering the explosive growth of the markets and investor participation therein since the enactment of SIPA and the expected continuation of growth in the securities markets, a change in coverage to $1 million cash or securities and indexed to inflation may require an increase in the line of credit from Treasury. The Task Force has requested the staff of SIPC to review the effect of protections at the $1 million level. It is my personal feeling that a line of credit of $5 billion matched with reserves of $5 billion would be appropriate going forward. At the current level of assessments, it will take a number of years to reach those levels. However, I believe those levels to be realistic and planning for them should begin now.
4. Assessments. Prior to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), assessments by SIPC had a floor of $150.00 with a maximum of .25% of revenues. The SIPC staff has also informed the Task Force that there are some SIPC members under the new Dodd-Frank Act who now pay zero assessments.[6] It is my belief, as well as other members of the Task

[4] Investors do not routinely accumulate cash with a broker and an investor's position is only "caught" in a cash position when the brokerage firm fails.
[5] It is my understanding that the sufficiency of the SIPC Fund Analysis is premised upon paying each claim up to the maximum limit for securities.
[6] Due to deductions for expenses, etc., in some cases, certain broker-dealers, based on net operating revenues, now pay zero due to elimination of any floor for assessments.

Force, that there should be a minimum assessment of some amount. I believe that minimum amount should be at least $1,000.00 and preferably in the range of $2,000.00 to $2,500.00. Based on information from the SIPC staff, SIPC receives about 80% of the assessment revenue from the larger firms and at current levels it will take approximately 5 years for the fund to reach the current target of $2.5 billion. I was surprised to learn that in computing assessments that revenues on mutual funds are not included. I am of the opinion that since all investors benefit from SIPC protection, that revenues on mutual funds should be included for assessment purposes as well.

Regardless of the target level that the Task Force recommends or what target level of funding for SIPC is finally adopted, any time that a target level is reached, there should be another determination of whether assessments are adequate based on the current level of investors assets in the market and whether new targets should then be considered. Also, it appears to me that the current arrangement with the Treasury for a line of credit, which is a term loan, should actually be a revolving loan in order to ensure continuity and flexibility in the ability of SIPC to protect investors where and when needed.

5. Investor Education Efforts. It is clear that there is a general public misconception that SIPC is some type of insurance, akin to FDIC insurance for banks. It is also clear in SIPC's application of the law that SIPA was not intended to be insurance for fraud, but only for replacing cash, as well as securities missing from customer accounts not connected to the actual value of investment into the securities purchased or believed to have been purchased, and not based on a risk of loss fundamental. If Congressional intent is to change SIPC into FDIC type insurance-based protection, then the parameters of the level of funding would change. The misconception has been historically exacerbated by references to FDIC as a comparison and by the broker-dealer community who tout the SIPC protection levels. Education initiatives to correct the misconception have proven to be inadequate. Therefore, I would suggest that to seriously educate investors with an understanding as to what levels of protection are available and the true nature of SIPC protection, a constant and systemic notification (education) effort will be required. I would suggest that every brokerage account statement that is sent to investors include a page or a section that clearly underscores what SIPC is and is not. I would also suggest that it include

examples which change every quarter so that the public can see what to expect or not to expect from SIPC. The fact of the matter is that television advertisements, public presentations and newspaper reports are one-shot efforts that will not overturn a history of belief and expectation. I would also not recommend an insert into the account statements as they have a tendency to be discarded, instead, every account statement would have a portion of a page dedicated to SIPC coverage. It may take several years of constant message delivery to reverse the current tide of misconception. This is not to say that elimination of other types of investor education is desirable. However, for true education, the repetitive nature of account statement receipt should assist in disseminating correct information of the purpose and role of SIPC. I am also aware that SIPC does not have the power or authority to require this type of account statement inclusion and the matter would have to be implemented through the SEC and FINRA.

Response to Issues Presented in the Subcommittee's Invitation of September 16, 2010:

In the September 16, 2010 invitation to appear before this Subcommittee, there were certain issues that the panelists were invited to address. I will respond to them in the order presented.

1. Whether the SIPC board should include a representative of the Securities & Exchange Commission (SEC) and what, if any, other modifications to the government structure may be appropriate. It is my understanding that SIPC reports to the SEC by way of required records and reports, as well as the filing of an audited annual report, and that SIPC must obtain SEC approval for changes to its operational rules and bylaws. Although I see little harm in having an SEC representative on the SIPC board, caution should be exercised. It appears that since SIPC, in essence, reports to the SEC, an SEC representative could possibly exercise undue influence over the board in its recommendations or positions which may, in some instances, become a conflict of interest. It appears that the question of an SEC representative should be addressed to an expert on corporate governance for a determination of possible conflicts in this area. In any case, an SEC representative should continue to attend each SIPC board meeting as an observer or adviser, which I am advised is currently done.

2. Whether the statutory minimum balance of the SIPC Fund should be adjusted in light of the recent increase in the target balance, and if so, explain how it should be adjusted. As I mentioned earlier, I believe the balance in the fund should be adjusted substantially upwards given the effect that a major case may have on SIPC's reserves. According to the SIPC staff, the former $1 billion balance has historically proved adequate to meet the requirements of SIPC cases, however, it is my belief that in light of the growth of the securities industry, plans should be made for a larger target and that is why I have recommended a target of $10 billion, composed of $5 billion in reserves and $5 billion revolving line of credit. I have no mathematical formula for this opinion. However, by increasing the coverage amount to $1 million, essentially a doubling of the current $500,000.00 limit, and looking at the possibility of the potential impact of future fraud cases, it appears prudent to be prepared so that assessments over time will be realistic and that the balance of the fund is also increased over time.
3. Whether any trustee appointed by SIPC should also be subject to bankruptcy court approval and whether trustees appointed in civil liquidations have been as efficient and effective as those appointed under similarly sized non-SIPC liquidations. It is my understanding that the bankruptcy court appoints the trustees in SIPC cases and that there must be a designation that the trustees are "disinterested parties". The Task Force has asked for further information from the SIPC staff on the history of trustee appointments and details on liquidations. This information will be studied as discussions continue.
4. Whether the standard to file a SIPC claim is too low and whether it results in frivolous claims that slow down the liquidation proceedings or otherwise creates an expectation on behalf of the customers that their claim is bona fide. I think it can be reasonably assumed that when people file claims with regard to any type of action, they believe they are entitled to some recompense. From that point of view there is a possibility that filing a SIPC claim creates an expectation, however, limiting a potential claim may cause greater harm in that the claimant who fails to file a timely claim but was eligible will be barred from recovery. From a public policy point of view it appears that encouraging investors to file a claim when they think they have a claim is preferable than trying to eliminate claims on the front end and then discovering that some with viable claims have

not filed. Since this is a fine line, I would err on the side of encouraging anyone who believes they have a claim to make the appropriate filing. Although this may result in an increase in time and perhaps costs, covering the universe of potential claimants is preferable to inadvertently leaving someone eligible out of the claims process. We are advised by staff that they have no historical indication that there have been a large number of frivolous claims in SIPA proceedings. Understanding that the *Madoff* situation may be unique, the *Madoff* matter may be an exception to the general rule.

5. Whether SIPA's direct payment procedures result in an efficient and effective way to return customer property and whether and how such criteria ought to be modified. In discussions with the SIPC staff and reviewing SIPC's direct payment procedures, it is my opinion that the direct payment procedures appear to be efficient and effective in returning customer property.[7] I have suggested to the Task Force that the direct payment amount threshold should be increased[8] to utilize the efficiency of the direct payment procedures. The Task Force is currently discussing what that proper amount should be and I have recommended that the Task Force consider $2 million as the appropriate amount.
6. Whether the statutory definition of a customer eligible for SIPC coverage remains relevant given indirect investing increases via retirement plans and hedge funds. The Task Force has had initial discussions with regard to indirect investors. It is my opinion that certain retirement plans are appropriate for customer eligibility. I am unsure with respect to the hedge fund arena due to the nature of hedge fund investing, including lack of transparency, lack of oversight and higher risk strategies. However, this matter is on the agenda for further discussion with the Task Force. The Task Force is also aware that certain pension plans and employee benefit plans have been covered by FDIC and NCUA on a pass-through basis since 1978.[9] The limitation is that each beneficiary could only receive the "present vested and ascertainable interest of each beneficiary". Issues concerning deferred compensation plans and non-bank covered pension

[7] SIPC records indicate that the direct payment procedure has been used in 35 of the 204 proceedings since 1978.
[8] Current law authorizes use of out-of-court direct payment procedure where aggregate claims are less than $250,000.00 [15 U.S.C. '78fff-(4)(a)].

funds are issues for Task Force discussion. It appears to me that pension plans and employee benefit plans matching those covered by FDIA and FCUA would be appropriate for protection under SIPA.

7. Whether and how SIPA's definition of customer property should be amended in light of the changing nature of customer arrangement with their broker-dealer, including account balances tied to client commission agreements and innovative investment vehicles such as security based swaps and to-be-announced security transactions. There is a substantial difference between individual retail investors and large institutional investors (including large sophisticated investors) who have interrelated and complex agreements with brokerage firms. Clearly the original intent of SIPA in 1970 was protection of the retail market and it appears that the complex relationship investment arrangements implicit in the question were not contemplated at the time. While this area deserves study, truly sophisticated investors, especially institutional investors, are in most cases a different type of investor and therefore it may be appropriate for these non Main Street large investors to be subject to a different standard than traditional SIPA protected investors.

8. Whether and how SIPA's definition of "net equity" should be revised to address situations whereby a customer statement from their broker-dealer does not agree with the broker-dealer's books and records and the extent to which customers should be entitled to rely on a statement they have received. Historically, customers net equity has been determined by the securities position shown on the customer's account statements. And again, historically, the account statements would show accurately the transactions that occurred, but the securities were then missing. In most cases, where statements are received the securities positions that had been purchased at the customer's instructions are accurate and those securities are expected to be in their accounts. It is a different matter, however, when securities positions are fictitiously created, as in the *Madoff* case. The Madoff customers expected that the money given to Madoff would be placed in legitimate trading circles. Concocting account statements with 20/20 hindsight is more akin to the type of Ponzi and pyramid schemes

[9] Allowing for each beneficiary of a pension, profit sharing plan (401(d) of IRS Code) or individual retirement account (408(a) of IRS Code) – FDIA amended in 1991 to allow for 457 plans (deferred

generally seen by state regulators in which no SIPC member is involved. The vast majority of these cases which occur on an alarmingly frequent basis cause the same monumental damage to individual investors as any *Madoff* or *Stanford* case. These situations have generally been handled through the cash-in cash-out method of calculating equity. In the 15 years my office has been handling cases involving Ponzi, pyramids and other schemes outside the SIPC arena, most cases only return pennies on the dollar with the assets marshaled through a receivership and distributed based on a cash-in cash-out basis. Where there are inflated account statements, they do not reflect actual cash in but a promise of expectation computed retroactively or completely fabricated. Where there are insufficient assets to pay all parties, the most fair determination has been to compute all cash in, all distributions out, resulting in the net loss, then determining the pro rata basis for payments of whatever assets have been marshaled. This is significantly different than a customer who directs a broker to buy a specific security, the trade is paid for and the broker sends a false confirmation. In a non-SIPC covered fraud, this would be of no effect since there is no coverage for said transaction. However, under SIPA, the customer's net equity would be the market value of the security the broker should have purchased that the customer actually paid for and the broker-dealer lied about having purchased. SIPC would then obtain the security in the marketplace or credit the customer with the actual market value as of the appropriate filing date. Utilizing the last inflated account statement would give a preference to earlier investors while disenfranchising later investors. It should be noted that the time-value of the funds is not considered in the non-SIPA cases generally handled by the states. Most Ponzi schemes do not last for decades, are relatively short in time and therefore the time value interest differential is generally not significant. It is my understanding that the SEC has taken a position with regard to the *Madoff* case that the calculations could include a factor with regard to time value or time equivalent (constant dollars)[10]. It would appear that each case would have to be reviewed for a determination based on the amount of investments and the <u>time</u> that the fraud was ongoing. I would respectfully suggest, based on our

compensation plans) and certain non-profits.

history of cases and prosecutions involving Ponzi schemes, that generally the cash-in cash-out is the most equitable method in most cases. However, cases involving a situation of long-standing ongoing fraud could consider a cash-in cash-out and a factor of time value or time equivalent conversion, *except* that each investor's claim should be measured from a date certain, whereupon an inflation factor would be applied. This type of time value of money approach appears to require a statutory change to SIPA as this variable treatment is not recognized under current law.

Judging from the complexity and duration of certain current Ponzi schemes, some flexibility in the SIPA rules and SIPC administration is due to be considered and should be reviewed by the Task Force.

9. Whether the requirement for SIPC to pay interest on customer named securities and customer property not distributed within 60-days of filing the SIPA Liquidation Application is an effective way to ensure that customer claims are properly satisfied. In discussions with the SIPC staff, it appears that the issue of substantial delays rarely arises. We are advised that the typical liquidation involves a transfer to a solvent brokerage. However, provisions requiring SIPC to pay interest on property not distributed within 60-days may not be much of a motivating factor to encourage customer claims to be paid promptly and, further, could add to the complexity of the payment calculation. Questions may arise as to when the 60-days begin to run, or, if claimant waits until the end of the six month period to file a claim. Also, it appears that, in general, interest is not paid on bankruptcy claims. For these reasons, I believe a provision for the payment of interest would not effectively ensure claims are satisfied more efficiently. On the other hand, one issue to be considered is that under state law if an improper sale of securities has occurred or where a recission is ordered by the state securities regulator, each state may apply a statutory rate of interest. For example, in Alabama, a recission of a transaction order or a buy-back includes a 6% interest factor. Other states will have varying amounts of statutory interest. Whether this has any practical value in a SIPC claims situation has not yet been discussed by the Task Force.

[10] U.S. House Committee on Financial Services, Subcommittee on Capital Markets – Testimony of Mr. Michael Conley, Deputy Solicitor, U.S. SEC, December 9, 2009.

10. Whether the avoidance powers granted to a trustee in a SIPA liquidation should differ from US Bankruptcy Code. The US Bankruptcy Code has been a primary vehicle with regard to determining avoidance powers and setting precedents. I see no reason to create a separate system for SIPA liquidations that differ from the US Bankruptcy Code. Not only will a different system cause confusion, but considering there is a national system in place under the US Bankruptcy Code, uniformity with respect to avoidance powers would be preferable. At the present time, the Task Force has this matter under consideration and after further discussion I believe a recommendation will be made.
11. Whether the mechanics for informing investors about the existence of and protections afforded by SIPC should be altered. The issue with regard to investor education and the existence and levels of protection afforded by SIPC was discussed earlier and I would refer the Subcommittee back to Page 4 of this paper.
12. Whether the private sector could provide primary coverage in the event that SIPA was modified to eliminate and replace SIPC's coverage with a requirement for broker-dealers to obtain private coverage comparable to the coverage currently provided by SIPC and whether excess SIPC coverage by the private sector is appropriate. For all practical purposes, a meaningful broker blanket bond does not exist with respect to fraud claims. A number of brokers have minimal capital requirements to begin with. Problems will exist as to whether or not the broker who has placed itself in financial jeopardy would continue the blanket bond and whether the damage, already done to investors, would have any real recompense. Without a central entity, such as SIPC, the "coverage" is only as good as the insurance company behind the blanket bond, assuming that it remains in effect and generally, in the business community, fraud claims are either not covered or vigorously defended. I do not believe this would be a practical approach and in the current environment, private insurers are generally not interested in selling this type of coverage. If available, the cost could be prohibitive to most brokers thereby reducing the competitive nature of the industry. This is not an area that I have studied in any great detail and would leave to others more qualified to comment, however replacing SIPC which a private sector insurer does not appear workable or desirable.

13. Whether the capital adequacy rules for broker-dealers are sufficient to prevent significant customer losses. In my experience as a state regulator, the capital rules are generally insufficient to cover losses. This is an area for SEC and FINRA to utilize their experience to consider the capital rules in light of today's environment and issue a report and recommendation. In a situation where fraud exists or other obligations such as an award in arbitration that has not been paid, there is generally insufficient capital to cover those customer losses.[11]
14. Whether investment advisers should be scoped into and subject to assessments under SIPA or a similar protection regime. In general, investment advisers do not hold customer assets, as the assets and the transactions involving those assets are held at a broker-dealer who would be a SIPC member. In light of the current switch of a significant portion of the investment adviser population from SEC to state level, the question by the Subcommittee has prompted my office to undertake a review of the activities of those investment advisers, between $25 million and $100 million, to determine the differences in their operations with respect to the investment advisers we have historically regulated (those under $25 million). I expect to share the results of my staff's examination with the Task Force. Until such time of the determination as to whether or not this is a significant issue, I am reserving an opinion.

International Relations.

In addition to the above discussion, I have been requested by the Task Force to look at SIPC's involvement in international relations. For a number of years I have been honored to represent NASAA[12] at the International Organization of Securities Commissions (IOSCO) and the Council of Securities Regulators of the Americas (COSRA). From 2004 through 2009 I served as a U.S. Delegate as an expert on securities fraud to the United Nations Committee on International Trade and Law (UNCITRAL). In reviewing SIPC's activities, it is apparent that SIPC has taken a more active role in international affairs as broker-dealers increasingly have overseas affiliates or subsidiaries, and, as demonstrated by the failure of Lehman Bros., these overseas affiliates and subsidiaries can have world-wide implications. The questions being asked by the Task Force include:

[11] Please also see related discussion in Item 12 above.
[12] NASAA (International Securities Administrators Association) is a voluntary association whose membership consists of 67 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

1. "Does SIPA adequately protect customers in the event of the insolvency of a member which is a multi-national corporation?"
2. "How can membership in an international association of investor protection agencies be used effectively?"
3. "What lessons can be learned from the liquidation of Lehman Bros., Inc.?"

SIPC's records show that it has entered into Memoranda of Understanding with a number of foreign regulators, including the Financial Services Compensation Board (United Kingdom), Canadian Investor Protection Fund, Securities and Futures Investor Protection Center (Taiwan), Korea Deposit Insurance Corporation, China Securities Investor Protection Fund Company, Ltd., and Egyptian Investor Protection Fund. Recently SIPC has joined IOSCO as an auxiliary member. The SEC is the primary member of IOSCO for the United States, followed by the North American Securities Administrators Association (NASAA) as an affiliate member, FINRA as an affiliate member, and SIPC as an auxiliary member beginning in 2009. Current discussions are underway concerning creation of a new organization to deal exclusively with investor protection in the context of cross-border financial intermediary collapse. It is therefore appropriate for SIPC to enter discussions with the Secretary General of IOSCO concerning a new international association of investor protection entities. There appears to be preliminary interest from the IOSCO Secretariat in the creation of this entity under the auspices of IOSCO. Such an international cooperation mechanism could formulate and develop policies as:

1. Formal rules on cross-border protection issues,
2. Create a dispute resolution mechanism with a team of experts available,
3. Develop a platform for exchange of information, and
4. Establish cooperative principles.

Work towards development of an international forum has already begun through the efforts of Mr. Chen Gongyan, Chairman of the China Securities Investor Protection Fund Corporation and a member of the Task Force. Discussions with SIPC to build an international cooperation mechanism were brought about primarily due to the *Lehman Bros.* case and Chairman Gongyan has indicated his willingness to co-sponsor an international forum together with SIPC and the Canadian Investor Protection Fund. Communications with the IOSCO Secretary General are underway to organize an open forum to discuss the issues and determine protocols for creation of such an international organization. Work in this arena is extremely preliminary and is subject to a number of factors, including relevant application of law to cross-border investor protection, varying laws involving bankruptcy, development of an information sharing platform and transparency with regard to the rules of compensation and protection to ensure that investors within the country and abroad have a fair chance to submit an application for compensation and access to relevant information.

I thank you again for the invitation and opportunity to appear before you today.

(cwdocs/2010 house subcommittee testimony/2010 testimony borg.14)

Statement

Of

Sharon Y. Bowen, Acting Chair

Securities Investor Protection Corporation

Before the

Capital Markets and Government Sponsored Enterprises Subcommittee

of the

House Committee on Financial Services

March 7, 2012

Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the important work of the Securities Investor Protection Corporation ("SIPC"). My name is Sharon Bowen, and I am the Acting Chair of SIPC. Because I also served as the Vice Chair of the SIPC Modernization Task Force, I will address the forward looking issues raised by the Task Force and Mr. Harbeck, President and CEO of SIPC, will address the operational and other matters the Subcommittee requested we cover in our testimony.

SIPC is a non-profit membership corporation created under the Securities Investor Protection Act ("SIPA")[1] in 1970. With some narrow exceptions, every registered securities

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[1] 15 U.S.C. §78aaa et seq.

broker or dealer is a member of SIPC. Membership in SIPC is not voluntary; it is automatic upon registration as a broker or dealer. By statute, SIPC is not a government agency or establishment. Its policies are set by its seven-member Board of Directors, five of whom are appointed by the President and confirmed by the Senate. Three of the five Directors are selected from the securities industry and two are non-industry Directors. The remaining two Directors, respectively, are representatives of the United States Treasury and the Federal Reserve.

A central goal of SIPC is to protect customers of failed securities brokerage firms that are members of SIPC and that are in liquidation under SIPA. A firm is placed in liquidation upon an application by SIPC in federal District Court. In this regard, SIPC works closely with the United States Securities and Exchange Commission and securities self-regulatory organizations. Because SIPC has no investigatory or regulatory authority, these entities must notify SIPC when a broker- dealer is in financial trouble and unable to meet its obligations to customers. Once a District Court places a firm in SIPA liquidation and appoints a trustee to administer the liquidation, the case is removed to Bankruptcy Court where the matter proceeds like a bankruptcy case but with special customer protection features.

SIPC administers a Fund which is comprised of assessments paid by its members. The Fund is used to support SIPC's mission of customer protection and to finance SIPC's operations. Should the Fund become inadequate for its purposes, SIPC may borrow against a $2.5 billion line of credit from the United States Treasury. In its nearly 40-year history, SIPC has never drawn on the credit line.

Every customer is protected by SIPC up to $500,000 against lost or missing cash and securities deposited with the broker or dealer for the customer's account. Of the $500,000, up to $250,000 may be used to satisfy a claim for cash only. SIPC advances also may be used to pay the expenses of administering the liquidation proceeding where the debtor's general estate is insufficient.

To date, SIPC has overseen the administration of 324 customer protection proceedings which have involved the distribution, through 2010, of roughly $109.3 billion of assets for customers. Of that sum, approximately $108.2 billion has come from debtors' estates and $1.1 billion has come from the SIPC Fund.

The Report and Recommendations of the SIPC Modernization Task Force Report

Former Chairman Orlan Johnson promised Congress at his confirmation hearing that he would form a Task Force to conduct the first comprehensive review of the Securities Investor Protection Act ("SIPA"), and SIPC's operations, since the significant amendments to SIPA in 1978. The SIPC Modernization Task Force has completed its work, and the Report and Recommendations of the SIPC Modernization Task Force is attached as Exhibit A.

The Task Force was composed of professionals with differing backgrounds and approaches. The group contained investor advocates, state regulatory officials, an academic expert, a trustee experienced in the 'real world' problems of brokerage firm insolvency, the Chairman of SIPC's Chinese counterpart, and securities industry representatives. Their divergent views make for a balanced set of proposals worthy of serious consideration.

The Task Force conducted a live forum in New York to receive the personal views of individual investors, and held an internet "question and answer" dialogue with investors, as well. A website was also established to advise the public of the issues being considered and to solicit input from investors on those topics. In addition, the Task Force received presentations from investor education experts and representatives of the mutual fund industry, as well as a briefing from representatives of the Treasury and Federal Reserve Board.

For purposes of analysis, and to assist the Subcommittee, I believe it would be useful to divide the Task Force Recommendations into four categories, and summarize the conclusions of the Task Force. The categories are:

- Recommendations which will require legislation.
- Recommendations which will require SEC rule changes.
- Recommendations where the Task Force studied possible changes, but determined existing law should not be changed.
- Recommendations SIPC can implement now.

In particular, the Task Force reviewed issues raised by recent liquidations, and in some instances, the Task Force recommended changes to the outcomes under SIPA as currently enacted, while in other instances the group determined that the existing law should remain unchanged. I can tell the Subcommittee that all viewpoints were aired, discussed, and debated. In the end, each Recommendation represented the consensus of the group.

Recommendations Which Will Require Legislation

1. Increasing the maximum level of protection.

The Task Force concluded that the SIPA should be amended to allow for inflation since 1980. In that year, the maximum SIPC advance was set at $500,000. In inflation-adjusted current dollars, that level of protection would be $1,300,000, and the Task Force concluded that sum should be periodically adjusted for inflation.

2. Eliminating the distinction in the levels of protection for cash and securities.

The Task Force was presented with numerous historical examples of cash being "caught" at a moment just prior to a securities purchase, or subsequent to a securities sale, and thus subject to lower protection. Because these results are arbitrary, the Task Force suggests a change to eliminate the disparate treatment of claims for cash and claims for securities.

3. Protection for pension plan participants.

SIPA was designed to protect small investors. Since such small investors often have so much of their wealth in pension plans, the Task Force recommends "pass-through" SIPC protection for pension plan participants not found in current law. I would note that the Task Force limited this suggestion to pension funds, and no other forms of collective "pooled" investments.

4. Setting a minimum assessment of $1,000 on SIPC members.

In what I believe was an unintentional consequence of a Dodd Frank amendment to SIPA, some SIPC members actually had their SIPC assessments reduced. This recommendation resolves this oversight.

I would add that the four recommendations above have financial consequences not only for customers, but for SIPC members, and, possibly, for the Treasury, which can provide a credit line to SIPA. I will recommend a full analysis of the economic consequences of these proposals be considered by the SIPC Board before SIPC seeks legislative change.

5. Expanded use of the "direct payment procedure" to assist customers expeditiously.

SIPC has had considerable success since 1978 in using a streamlined procedure to pay victims swiftly and directly in smaller brokerage failures. This recommendation would amend SIPA to expand this very efficient and effective program.

Recommendations Which Will Require Rule Changes

6. Auditors should file audit reports with SIPC.

The Task Force reviewed situations where, arguably, audit reviews of SIPC members were severely deficient. SIPC and Trustees under SIPA have rarely sued such auditors. However, SIPC has been faced with a defense that SIPC had not relied directly upon the audit -- because it did not receive it and did not have access to its contents -- and thus had no standing to sue.

The Task Force recommends that SIPC receive and review those audits. SIPC would demonstrably rely upon those audits, and this fact would be known to auditors. SIPC would thus have standing to recover losses incurred from negligent or tortious conduct related to an audit.

7. Safeguarding customer assets by Rule.

The heart of SIPC's protection to investors is to deliver assets left on deposit with brokerage firms. The Task Force recommends that the SEC issue an interpretive release clarifying SEC Rules on the segregation of customer assets.

I am very pleased to report that the Supreme Court of the United Kingdom has, last week, clarified British rules in this regard in the Lehman Brothers case. I urge the SEC to consult with SIPC in light of this recent ruling.

Recommendations where the Task Force studied possible change but determined existing law should not be changed

8. Vesting SIPA Trustees with avoiding powers.

The so-called "avoiding powers" possessed by bankruptcy trustees also apply in SIPA cases. Their powers have been highlighted in the Madoff case. After debate, the Task Force concluded that a Trustee in a SIPA case should have the same tools available to distribute limited assets as equitably as possible that any other bankruptcy trustee may have.

9 -12. Other Recommendations requiring no change.

It bears repeating that SIPA was conceived and designed by Congress to protect small investors. In any bankruptcy, creditors will naturally seek the most protected status possible. In a SIPA case, "customer" status is such a preferred category. The Task Force reviewed a number of transactions and other situations involving institutional and sophisticated retail customers and determined that the outcome under existing law should not be changed. Thus:

- Participants in repurchase and reverse repurchase agreements should continue to be treated as general creditor claims.
- Open "to be announced" contracts should continue to result in general creditor claims.
- "Soft dollar" arrangements should continue to result in general creditor claims.
- Commission or underwriting fees should continue to result in general creditor claims.

Recommendations SIPC can implement now

13. **A study concerning asset segregation**.

The Task Force recommends that SIPC and the SEC consult on resolving discrepancies between SEC Rule 15c3-3 and the SIPA defined term of "customer property." The object of this exercise is to reconcile the two regimes to avoid disputes as to what assets are to be segregated for investors.

14. **International Relations**.

The Task Force recommends that SIPC assist in creating an international association of investor protection entities. While SIPC has memorandum of understanding agreements with a number of similar organizations, the Lehman and MF Global cases show that international issues will only increase in future cases. An organization addressing those issues on a regular basis seems prudent.

15. SIPC should continue investor education efforts.

SIPA is a complex statute. Describing both the protections and the limitations of those protections is important. The Task Force urged that SIPC continue to develop programs to do so.

CONCLUSION

On behalf of SIPC, I would like to take this opportunity to thank the members of the Task Force for their thoughtful consideration of SIPC's work. I would be happy to discuss any particular Recommendation that is of interest to the Subcommittee.

Report and Recommendations of the SIPC Modernization Task Force

Presented to the Board of Directors
Securities Investor Protection Corporation

February 2012

MEMBERS OF THE
SIPC MODERNIZATION TASK FORCE

Chairman
Orlan M. Johnson, Chairman of the Board, SIPC
Saul Ewing LLP

Vice Chairman
Sharon Y. Bowen, Vice Chairman of the Board, SIPC
Latham & Watkins LLP

Philip M. Aidikoff
Aidikoff, Uhl & Bakhtiari

Joseph P. Borg
Director, Alabama Securities Commission

Steven B. Caruso
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Chen Gongyan
Former Board Chairman, China Securities Investor Protection Fund Corporation Limited

John C. Coffee, Jr.
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James W. Giddens, Trustee of Lehman Brothers Inc., Trustee of MF Global Inc.
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Ira D. Hammerman
Senior Managing Director and General Counsel,
Securities Industry and Financial Markets Association (SIFMA)

William H. Heyman
The Travelers Companies, Inc.

Observer: Michael A. Macchiaroli
Associate Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

A Message from Orlan M. Johnson, Chairman of the SIPC Modernization Task Force:

When I began my tenure as SIPC's Chairman in February 2010, SIPC faced challenges unprecedented in its 40 year history. The financial crisis had caused SIPC to initiate a liquidation proceeding in September 2008 for Lehman Brothers Inc., one of the world's largest brokerage firms. Barely three months later, in December 2008, SIPC was confronted with the stunning exposure of the long running fraud at Bernard L. Madoff Investment Securities LLC, reportedly the largest Ponzi Scheme in history. These two cases placed SIPC at the epicenter of both the financial crisis and the public eye.

The last significant overhaul of the Securities Investor Protection Act ("SIPA") occurred in 1978. In February 2010, SIPC's Board of Directors authorized the formation of the SIPC Modernization Task Force to review SIPA and SIPC's operations and policies comprehensively, and propose reforms to modernize SIPA and SIPC.

The Task Force includes investor advocates, regulatory specialists, and academic experts. As a member of the Task Force, the Trustee for the liquidation of Lehman Brothers Inc. (and more recently, MF Global Inc.) offers the practical perspective of a trustee dealing with the complexities of a large scale brokerage failure. The failures of Lehman, Madoff, and now, MF Global, have profound international consequences. The addition to the Task Force of Chairman Chen Gongyan of the China Securities Investor Protection Corporation (who has moved on to become Chairman of the Securities Association of China) brings a unique perspective to the international aspects of brokerage failures.

In the Report, the Task Force has made a number of recommendations which will require further empirical study by SIPC's Board of Directors. The recommendation to eliminate the distinction between claims for cash and claims for securities is an example, as is the recommendation to protect individual participants in certain pension programs. SIPC will have to evaluate the financial and other consequences of those proposals before deciding whether to recommend possible legislation going forward. It is my pledge to the hard working members of the Task Force that SIPC will move promptly on those evaluations.

In addition to bringing together the Task Force, comprised of volunteers, SIPC commissioned an independent Corporate Governance Review by Professor Lawrence A. Cunningham, the Henry St. George Tucker III Research Professor of Law, of the George Washington University Law School. The thorough Review will, I am sure, guide the Board in a number of areas.

My heartfelt thanks go to the Vice Chairman, and each member of the Task Force, for their valuable contributions, and their selfless devotion of time and energy to the production of the following Report and Recommendations.

Orlan M. Johnson
Chairman
SIPC Modernization Task Force

REPORT AND RECOMMENDATIONS OF THE SIPC MODERNIZATION TASK FORCE

INTRODUCTION

At its inaugural meeting in June 2010, the SIPC Modernization Task Force considered a broad range of issues to determine which were appropriate for review. The Task Force separated into two working subgroups, each of which would undertake a review of half of the issues and make recommendations to the full Task Force. The Task Force decided that, as a whole, it would consider the following three issues: any change to the minimum assessment amount, the preservation of the avoidance powers of a trustee appointed pursuant to the Securities Investor Protection Act, 15 U.S.C. section 78aaa *et seq.* ("SIPA"), and the increased use of the Direct Payment Procedure.

Over the course of the next year, the subgroups met individually, both in person and by telephone conference, to discuss and debate the issues before them. The subgroups researched the issues, conducted briefings with experts on particular topics, and considered public comments. In addition, the Task Force met with outside guests, including SIPC's Government Directors, investor education experts from the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"), and representatives of the Depository Trust & Clearing Corporation and the Investment Company Institute. In total, the Task Force held 14 meetings either in person or by telephone; each of the subgroups met four times, and the full Task Force met six times.

The Task Force was acutely interested in hearing from the public. To that end, the Task Force created a web site, www.SIPCModernization.org, which explained the various issues to the public and solicited comments. Since its launch in June 2010, www.SIPCModernization.org received approximately 70 comments. In addition, the Task Force solicited and received numerous letters and emails. The Task Force also held two live events – a web event during which the public made comments and asked questions of Task Force members, and a live public forum held at the Grand Hyatt Hotel in New York City where attendees offered comments to Task Force members. The Task Force reviewed and discussed the various comments made by the public through the web site, individual letters, and the forums. Finally, in testifying before the House Financial Services Committee, Task Force members listened to concerns about the adequacy and effectiveness of SIPA, as expressed by various members of Congress during the hearing.[1]

After undertaking a comprehensive review of the issues, the subgroup voted on a resolution for each issue. The resolutions, whether approved or rejected by either of the subgroups, were presented to the full Task Force for a vote.

[1] *Assessing the Limitations of the Securities Investor Protection Act: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. (2010)

This Report sets forth the recommendations of the Task Force. The Report also includes a corporate governance review of SIPC, annexed hereto as Appendix A, which was undertaken by a corporate governance expert, Professor Lawrence A. Cunningham, Henry St. George Tucker III Research Professor of Law, The George Washington University Law School.

The Task Force Report and the recommendations therein are being presented to SIPC's Board of Directors for consideration. It is the Task Force's hope that the recommendations will be reviewed by the Board, and ultimately presented to Congress for adoption as appropriate. The Task Force wishes to stress that its recommendations are made in consideration of the purposes of SIPA as understood at the time of the formation of the group, namely, to protect public, retail customers of a member broker-dealer, within specified limits, against the loss of their customer property custodied with the broker-dealer. The recently raised issue of protecting investors against market loss or damages resulting from fraud, misrepresentation, or wrongful acts similar to the Stanford situation has not been considered. The recommendations of the Task Force should be evaluated by SIPC's Board in the context of the historical legislative purposes and judicial interpretations of SIPA, and changes may be necessary if Congress passes expansive legislation or courts determine that SIPA should be interpreted differently.

Respectfully submitted,

The SIPC Modernization Task Force[2]

Orlan M. Johnson, Chairman
Sharon Y. Bowen, Vice Chairman
Philip M. Aidikoff
Joseph P. Borg
Steven B. Caruso
Chen Gongyan
John C. Coffee, Jr.
James W. Giddens
Ira D. Hammerman
William H. Heyman

[2] After making significant contributions, particularly on the subject of investor education, Melanie Senter Lubin, Securities Commissioner, Office of the Attorney General, Division of Securities, State of Maryland, and Daphne Smith, Assistant Commissioner for Securities, Tennessee Department of Commerce and Insurance, Securities Division, withdrew from the Task Force, due to other pressing obligations.

Task Force materials were made available to representatives of the SEC and the Department of the Treasury who attended many of the meetings of the Task Force. On occasion, an SEC representative participated in the Task Force's discussions.

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Recommendation No. 1:

Increase the Maximum Level of Protection to $1.3 Million
Index the Level of Protection to Inflation

Overview

The Task Force considered whether the current level of protection – a maximum of $500,000, up to $250,000 of which may be in satisfaction of a cash claim – is sufficient to protect customers and instill investor confidence in the securities markets. The $500,000 maximum has not been increased since 1980. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929H (2010) (the "Dodd-Frank Act"), increased the cash maximum from $100,000 to $250,000, and created a mechanism for indexing the level of cash protection to inflation.

The Task Force has determined that the $500,000 maximum should be meaningfully increased. Increasing the level of protection while continuing to index the amount to inflation furthers the important objective of modernizing SIPA.

Task Force Recommendation

The Task Force recommends that the maximum limit of protection be increased to $1.3 million and that the limit continue to be indexed to inflation.

SIPA's Levels of Protection

The SIPA limit of protection for cash claims has tracked the corresponding amount protected by the FDIC throughout SIPC's history. The initial limits of protection in 1970 included advances from SIPC of up to $50,000, with a maximum of $20,000 for cash. The $20,000 cash protection matched the level of FDIC protection at the time. Pub. L. No. 91-151, 83 Stat. 375 (1969).

In 1978, SIPA was amended to permit an advance of up to $100,000 for each customer, with a maximum of $40,000 for cash. Pub. L. No. 95-283, 92 Stat. 249 (1978). The increase in cash protection was designed to match a 1974 increase for depositors with institutions protected by the FDIC or the Federal Savings and Loan Insurance Corporation. *See* H. R. Rep. No. 95-746, at 40 (1977).

A similar increase in SIPA's levels of protection was enacted in 1980, when Congress raised the amount that SIPC could advance for a customer to up to $500,000, of which a maximum of $100,000 could be based upon a claim for cash. Pub. L. No. 96-433, 94 Stat. 1855 (1980). FDIC protection had been increased to $100,000 as well. Pub. L. No. 96-221, 94 Stat. 147 (1980).

On July 22, 2010, pursuant to the Dodd-Frank Act, the cash level of protection under SIPA was increased to $250,000. The Dodd-Frank Act also made permanent the FDIC protection increase to $250,000. *See* Dodd-Frank Act § 335.

Policy Considerations

The Task Force looked at various factors to determine the appropriate level of protection. Ultimately, the Task Force was strongly influenced by the following considerations in arriving at its Recommendation:

- The level of protection should be sufficient to protect 90% or more of retail customer accounts. *See Securities Investor Protection: Hearings on H.R. 13308, H.R. 17585, H.R. 18081, H.R. 18109 and H.R. 18458 before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 339-340 (1970) (Statement of Hon. Hamer H. Budge, Chairman, Securities and Exchange Commission) (explaining that the level of protection was set at $50,000, which was sufficient to protect fully 94.5% of cash and margin accounts);

- The level of protection should be consistent with the rate of inflation, and $500,000 in 1980 is worth $1.3 million in 2011, *see* Consumer Price Index Inflation Calculator, available at the Bureau of Labor Statistics website, http://data.bls.gov/cgi-bin/cpicalc.pl;

- In 1980, James F. Keegan, Chairman, Board of Governors, National Association of Securities Dealers, Inc., stated that SIPC should protect 100% of customer claims: "We believe that the coverage provided by the SIPC fund should ultimately extend to all customer claims and that [the increase in the level of protection to $500,000] will take us one step further toward the realization of that goal." *See Securities Investor Protection Act Amendment: Hearing Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 96th Cong. 27 (1980); and

- The level of protection should "be consistent with one of the fundamental principles guiding the establishment of SIPC, and that is that it protect the small investor, but not the professional." *Id.* at 5.

An increase in the level of protection also may increase the amount of claims asserted against the SIPC Fund. The Board of Directors may wish to study the additional amount that the SIPC Fund will be required to absorb as a result of such a change, and whether the target level of the SIPC Fund will need to be increased as well.

The Board of Directors also may wish to consider this increase together with a recommendation to eliminate the distinction between claims for cash and claims for securities. Should the distinction be eliminated, the protection for cash claims would increase from $250,000 to $1.3 million. On the other hand, if the limit on claims for cash remains at $250,000, the disparity between protection for cash claims and securities claims will increase.

Recommendation No. 2:
Eliminate the Distinction in the Levels of Protection for Cash and Securities

Overview

The Task Force examined whether the current distinction in the levels of protection for cash versus securities claims adequately protects customers and is appropriate in light of the way that customer assets are kept at modern broker dealers. Currently, the level of protection per customer is capped at $500,000, up to $250,000 of which may be in satisfaction of a customer's cash claim.

The Task Force has determined that the distinction between the protection based on claims for cash and claims for securities should be eliminated. This distinction leads to arbitrary resolution of claims as between customers, may no longer reflect the way that cash and securities are held at broker dealers, and has created confusion over the way that claims based on fictitious securities are treated.

Task Force Recommendation

The Task Force recommends that the distinction in the level of protection between claims for cash and claims for securities be eliminated.

The Method of Satisfying Claims for Securities

A goal of a SIPA proceeding is to restore customers to their accounts as nearly as possible as the accounts existed on the "filing date," as defined in SIPA section 78*lll*(7). *See* SIPA § 78fff-2(d). *See also* S. Rep. No. 95-763 at 2 (1978), *reprinted in* 1978 U.S.C.C.A.N. 765 ("By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, [the 1978 amendments to SIPA] . . . would restore the customer to his position prior to the broker-dealer's financial difficulties."). As such, customers who are owed securities typically receive securities in satisfaction of their claims. *See, e.g.*, H.R. Rep. No. 95-746, at 21, 41 (1977) ("Our expectation is that, in almost all cases, a customer's claim for securities would be satisfied by the delivery of securities . . . ."). If the fund of customer property does not include enough securities to satisfy customer claims, the trustee will purchase securities that are available in a fair and orderly market. SIPA § 78fff-2(d).[3] If replacement securities are not available in a fair and orderly market, however, the trustee may satisfy a claim for securities by providing cash equal to the market value of the security on the filing date. SIPA § 78fff-2(b).

The Cash Sweep

At the time that SIPA was drafted, cash for the purpose of purchasing securities generally was held in customers' securities accounts. Since the 1970s, however, the use of money market funds has increased dramatically,[4] with many customers now having their brokerage cash swept overnight into money market funds or bank deposit accounts. *See, e.g.*, Jane J. Kim, *Wall Street Cuts Yields on Investors' Cash*, Wall St. J., August 31, 2005, *available at* http://online.wsj.com/article/NA_WSJ_PUB:SB112545003610027383.html. Customers of broker dealers using such sweeps are more likely to have cash in their brokerage accounts only when it is "caught," that is, when a customer deposits cash into his account immediately before the firm's failure, or his securities have been liquidated and, at the time of the brokerage failure, the customer has not yet reinvested the cash or withdrawn the cash sales proceeds. Because of this random timing, the customer is left with a claim for cash and lesser protection than if his assets were held in securities.

Courts are Divided on Whether a Claim for Fictitious Securities Is a Claim for Cash or a Claim for Securities

Currently, two federal courts of appeals are divided over whether a claim for fictitious securities is a claim for cash or a claim for securities under SIPA. The Sixth Circuit, in *Plumbers & Steamfitters Local No. 490 Severance and Ret. Fund v. Appleton (In re First Ohio Secs. Co.)*, 1994 U.S. App. LEXIS 31347 (6th Cir. Nov. 1, 1994) ("*First Ohio*"), ruled that certain claims involving fictitious securities should be treated as claims for cash, while the Second Circuit, in *In re New Times Sec. Servs. Inc.*, 371 F.3d 68 (2d Cir. 2004) ("*New Times*"), ruled that certain claims for fictitious securities should be treated as claims for securities. This distinction is

[3] The trustee's authority to satisfy claims in either cash or securities is preserved in certain circumstances. *See* H.R. Rep. No. 95-746, at 41-42 (1977) ("One chief concern is that the trustee not be required to make purchases in a market which is being improperly controlled or manipulated."). Likewise, if a claim for securities is not timely filed, the trustee may satisfy the claim in cash or securities, or both, as the trustee decides is most economical. SIPA § 78fff-2(a)(3).

[4] By 1978, total net assets held in money market funds had grown to over $5 billion. *See* Marcia Stigum, *The Money Market: Myth, Reality and Practice*, 534 (1978). However, in 1978, money market funds "still play[ed] a relatively small role." *Id.* According to the Investment Company Institute, for the week ended February 1, 2012, the total net assets for money market funds was $2.69 trillion. *See* Weekly Money Market Mutual Assets, *available at* http://www.ici.org/research#statistics.

important because claims for securities have a higher limit for the SIPC advance than cash only claims: the overall SIPC advance is limited to $500,000, but the cash portion is limited to $250,000, subject to an inflation adjustment. SIPA § 78fff-3(a), (d).

The *New Times* interpretation is inconsistent with how claims for securities are to be satisfied under SIPA. Under SIPA, customers who are owed securities receive either the securities or their filing date market value. Thus, it is impossible to deliver securities or a filing date market value of securities when the "securities" are fictitious. Nevertheless, the *New Times* position holds that the customer who is owed fictitious securities has a claim for securities, the claim is protected up to $500,000, and the value of the "securities" is not the market value of zero, but the amount of cash deposited by the customer with the broker to pay for the "securities." The *New Times* position therefore requires a trustee to satisfy a claim for fictitious securities differently than claims for legitimate securities.

Problems with the Cash/Securities Distinction

The cash/securities distinction has been problematic throughout SIPC's history. Examples include the following:

1. A customer sold her entire securities portfolio and ordered the proceeds to be sent to her. That portfolio exceeded the then current maximum of $20,000 SIPC could advance for a cash claim. She received a check, but it was not honored because the brokerage firm failed before she could cash the check. A sympathetic bankruptcy judge held that the customer was "an involuntary cash depositor," in an attempt to avoid the clear limit of protection.[5] On appeal, the United States District Court reversed, noting that the court below had disregarded the explicit language of the statute.[6]

2. A pension plan ordered its portfolio liquidated, and the brokerage firm complied. The pension plan sought to avoid the consequences of the sale so that it could have a claim for securities, but the court ruled, correctly, that the pension plan had a claim for cash.[7]

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[5] *In re Weis (Estate of Irene H. Tuchler, Claimant)*, No. 73 Civ. 2332, slip op. at 14 (S.D.N.Y. Nov. 7, 1975) (Babitt, B.J.)

[6] *In re Weis (Estate of Irene H. Tuchler, Claimant)*, No. 73 Civ. 2332, slip op. at 1 (S.D.N.Y. Dec. 28, 1977) (Knapp, D.J.)

[7] *In re Morgan, Kennedy & Co., Inc.*, 3 Bankr. Ct. Dec. (CRR) 15 (Bankr. S.D.N.Y. 1977)

3. Customers who had sold their securities tried to avoid the consequences of that sale by arguing that the brokerage firm had never delivered the securities to the buyers. This argument was unsuccessful.[8]

The pattern in the foregoing cases is inescapable. When confronted with a "claim for cash" that exceeds SIPA's capacity to satisfy, claimants attempt to shoehorn their particular fact pattern into a "claim for securities." The law as plainly written requires opposition to such attempts.

Policy Considerations

Eliminating the distinction between claims for cash and claims for securities resolves potential disparate treatment of customers, as well as the split between the courts of appeals over whether fictitious securities give rise to claims for cash or claims for securities. In addition, it increases the amount of protection available to customers of broker-dealers. As a result of this increase in protection, however, the amount of claims against the SIPC Fund also may increase commensurately. The Board of Directors may wish to examine the additional amount that the SIPC Fund would be required to absorb as a result of such a change.

It is also worth noting that if the distinction between claims for cash and claims for securities is eliminated, SIPC will offer greater protection against the loss of cash than the FDIC. This would depart from the practice of the cash limit under SIPA tracking that of the FDIC. Accordingly, the Board of Directors may wish to study whether an increase in the amount of cash protection will result in customers holding more cash at broker dealers, taking into consideration, among other things, the different purposes for which cash is left on deposit with each institution and the modern-day practice that favors sweeps of funds out of the brokerage.

[8] *Murray v. McGraw (In re Bell & Beckwith)*, 821 F.2d 333 (6th Cir. 1987).

Recommendation No. 3:
Protect Participants in Pension Funds on a Pass-Through Basis

Overview

Currently, under SIPA, persons without accounts at the brokerage, but invested with a plan or a fund with an account at the brokerage, are not eligible for separate SIPC advances. In that situation, the fund or the benefit plan is the "customer," and it alone is eligible for SIPC advances.

The Task Force examined whether pass-through protection should be provided for individual claimants without an account. Among other things, the Task Force considered the possible expansion of protection in conjunction with a review of the trust and fiduciary provisions under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.* ("ERISA").

Task Force Recommendation

The Task Force recommends that SIPA be amended to provide pass-through protection for individual participants in the following ERISA-qualified plans: defined benefit pension plans, defined contribution plans, and deferred profit sharing plans. Each individual participant should be subject to the SIPC protection limits. The combined net equities of all plan participants should not be greater than the net equity of the plan's assets held by the SIPC member.

Overview of SIPA's Treatment of Claimants Without an Account

In a brokerage firm liquidation under SIPA, SIPC funds may be used to replace missing assets for each brokerage "customer," as that term is defined in section 78*lll*(2) of SIPA. Currently, persons without accounts at the brokerage, but invested with a plan or a fund with an account at the brokerage, are not eligible for separate SIPC advances. In that situation, the fund or the benefit plan is the "customer," and it alone is eligible for SIPC advances.

Most claimants who do not have an account at a brokerage firm in their name (or as beneficiaries of a nominee or agent) are not treated as separate "customers" under SIPA. *See, SIPC v. BLMIS,* 454 B.R. 285 (Bankr. S.D.N.Y. 2011), *aff'd, In re Aozora Bank Ltd., (SIPC v. BLMIS)*, 2012 WL 28468 (S.D.N.Y. Jan. 4., 2012); *Plumbers & Steamfitters Local No. 490 Severance and Retirement Fund v. Appleton (In re First Ohio Sec. Co.)*, 1994 U.S. App. LEXIS

31347 (6th Cir. Nov. 1, 1994); *SIPC v. Morgan Kennedy & Co.*, 533 F.2d 1314 (2d Cir.), *cert. den. sub nom., Trustees of the Reading Body Works, Inc. v. SIPC*, 426 U.S. 936 (1976). SIPA creates an exception to this general rule for customers and broker dealers of banks where the broker dealer or bank is the account holder. In that situation, customer status "passes through" to a customer of a broker, dealer or bank that, acting on behalf of such customer, has a net equity claim against the debtor. When a broker, dealer or bank has a net equity claim against a debtor arising out of a transaction on behalf of its customers, each such underlying customer is considered to be an individual "customer" of the debtor. SIPA § 78fff-3(a)(5).

Categories of Investors Without an Account at the SIPC Member Broker Dealer

The following are currently not eligible for pass-through protection, and the Task Force is recommending no change to their treatment:

1. *Individual shareholders, where a corporation is the account holder;*
2. *Individual limited or general partners, where a partnership is the account holder;*
3. *Individual members of an unincorporated association, where the association is the account holder; and*
4. *Investors who own shares of a hedge fund, fund of funds, or mutual fund, where the fund is the account holder.*

The Task Force determined that the treatment of claimants in these categories should not change. The investors in these categories have no relationship with the broker and may have recourse against their corporation, partnership, or association to the extent that their investment was not proper. In addition, much of the information concerning the underlying investors and the size of their investments is proprietary, and generally is unavailable to the broker. Without access to the books and records of the underlying funds, it is impossible to ascertain the amount of additional exposure to the SIPC Fund if protection is extended to this group. Accordingly, the Task Force recommends that these investors be educated that their investments are not protected.

The following are currently not eligible for pass-through protection, but the Task Force is recommending that treatment of these individuals be changed:

1. *Individual participants of a defined benefit pension plan, where the plan is the account holder;*
2. *Individual participants in a defined contribution plan, where the plan is the account holder (whether or not the broker sends statements to each of the participants);*[9] *and*

[9] If the defined contribution plan is the account holder and sole customer, and the broker does not send account statements to each of the participants, the individual participants normally would not separately be eligible for SIPC advances. On the other hand, if the broker sends account statements to each participant, and each participant exercises authority to make trades in his or her account, each participant currently is treated as a separate customer.

3. *Individual participants in a deferred profit sharing plan, where the plan is the account holder.*

Privately sponsored pension plans hold the assets of over 40 million active participants, 10 million of which are retirees. *See, e.g.*, Lee T. Polk, ERISA Practice and Litigation 1:5 (2010). Over the past 50 years, there has been a shift in the way that savings are held and an increased use of retirement accounts by typical retail investors. *See Finances of Employee Benefits, 1960–2003*, Employee Benefits Research Institute, *available at* http://www.ebri.org/pdf/publications/facts/0205fact.b.pdf (explaining that payments to individuals from private employer pension and profit sharing plans increased from $1.7 billion in 1960 to $320.4 billion in 2003). The Task Force believes that this recommendation would be an important modernization to SIPA, particularly because these investments typically represent the retirement accounts and life savings of many indirect investors who do not have a choice in where their plans' assets are held.

Carve-Out for Avoidance Actions

In making this Recommendation, the Task Force does not intend to suggest that a SIPA trustee should not be allowed to pursue avoidance actions against any claimant in any of the categories listed above. In the case of defined benefit plans, beneficiaries may have benefited from the receipt of avoidable transfers, and a defined benefit plan should not be allowed to recover the amount of its *pro rata* share of customer property *and* retain the avoidable transfer. As such, it should be made clear that the full amount of any avoidable transfer should be deducted from the amount of a fund's distribution to the extent that the avoidable transfer was not recovered by the trustee.

Policy Considerations

Because of the way that pension fund assets are currently held, the Task Force expects that most pension funds, particularly large pension funds, will continue to keep their cash and securities in banks even if they execute trades through their brokerage accounts. However, as the scope of protection is increased, the amount of claims asserted against the SIPC Fund may also increase. As part of any change to the scope of protection, the Board of Directors may wish to consider whether a commensurate increase to the target level of the SIPC Fund is necessary.

It also will be important to consider how the specific mechanisms of protection would work, such as which parties will be required to file claims and the level of proof that is necessary to determine whether a claimant is actually a participant in the fund and the extent of its participation. The Task Force is not making a recommendation as to these procedural issues.

Recommendation No. 4:

Amend the Minimum Assessment to the Greater of 1) $1,000; or 2) the Amount Set by SIPC Bylaw Not to Exceed 0.02% of the Member's Gross Revenues from the Securities Business

Overview

Under SIPA section 78ddd(d)(1)(C), SIPC may impose upon each of its members a minimum assessment in an amount to be set from time to time by SIPC Bylaw within limits set by Congress. Under the Dodd-Frank Act, § 929V, Congress amended the minimum assessment amount to be no greater than 0.02 percent of gross revenues from the securities business of each member. Prior to the enactment of the Dodd-Frank Act, the minimum assessment was no greater than $150 per annum. *See* SIPA § 78ddd(d)(1)(C) (2009).

Currently, members are assessed on 0.25% of their net operating revenues from the securities business. In 2009, for approximately 25% of the membership, 0.25% of net operating revenues was between $0 and $150. Prior to the enactment of the Dodd-Frank Act, these members would have paid a flat $150 assessment fee. After the amendment, these members pay less than $150 – and in some cases, $0. Thus, under the Dodd-Frank Act, in some instances, the assessments actually have decreased or been eliminated.

Because all SIPC member broker-dealers benefit from the SIPC program, the Task Force has determined that all members should pay an assessment fee.

Task Force Recommendation

The Task Force recommends that all SIPC members pay an assessment fee which is the amount set by SIPC Bylaw and the minimum amount of which shall not be more than 0.02% of the member's gross revenues from the securities business, but if the aforementioned amount is less than $1,000, the member shall pay a minimum assessment fee of $1,000.

Recommendation No. 5:

Allow for the Use of the Direct Payment Procedure in Cases in Which the Total Amount of Claims Aggregates Less than $5 million

Overview:

The Task Force considered whether the use of the Direct Payment Procedure should be updated and/or expanded. Currently, a Direct Payment Procedure is available only if SIPC determines that:

- the SIPC member cannot meet its obligations to customers;
- one or more of the conditions specified in SIPA section 78eee(b)(1) are present;
- the claim of each customer is within the limits of protection under SIPA;
- the cost of satisfying customers in the Procedure will be less than the cost under a liquidation proceeding;
- the member's broker-dealer registration has terminated or the member has consented to use of the Procedure; and
- the claims of all customers of the member total less than $250,000.

The $250,000 claim limit has not been adjusted since 1978.

Task Force Recommendation

The Task Force recommends that the Direct Payment Procedure be available in cases in which the aforementioned conditions are present except that the total amount of claims should aggregate less than $5 million instead of $250,000.

Direct Payment Procedure

The Direct Payment Procedure includes notice and claims procedures similar to those in a judicial liquidation proceeding, but limits bankruptcy court involvement to the review of the determination of any "customer" claim as to which proper objection has been filed in court within six months of the date SIPC mails the determination. Significantly, it is the claimant who initiates court involvement by the filing of an objection. All allowed claims are satisfied from SIPC advances; there is no collection of customer property.

The Direct Payment Procedure is designed to enable SIPC quickly, and inexpensively, to make customers whole, without the use of the more time-consuming and expensive procedures of a judicial liquidation proceeding. In SIPC's experience, Direct Payment Procedures have cost less, have provided an efficient mechanism for returning missing cash and securities to customers, and are advisable where the brokerage is judgment proof and there is little or no customer property to be had.

The Task Force has determined that the Procedure affords customer protection in a manner that is cost-effective and time-efficient. The Task Force recognizes, however, that because the Procedure is conducted out of court, it is only suitable in certain instances.

Recommendation No. 6:

Require Auditors of SIPC Members to File Copies of Audit Reports With SIPC

Overview

For more than sixty years, in order to safeguard customers' assets, the SEC, by means of its Rule 17a-5, 17 C.F.R. § 240.17a-5, has required an independent public accountant to provide certain assurances regarding financial information reported by the broker-dealer. *See* Exchange Act Release No. 3338, 7 Fed. Reg. 9917 (Dec. 1, 1942). Toward that end, the accountant must perform an "examination of accountabilities and responsibilities of a firm resulting in a report to regulatory bodies concerning that firm's fiduciary obligations to customers." *See* SEC, *Study of Unsafe and Unsound Practices of Broker-Dealers* ("SEC Study"), H.R. Doc. No. 92-231, at 152 (1971). The information is filed with the SEC and the securities self-regulatory organizations. The information provides these authorities "with a sufficiently early warning to enable them to take appropriate action to protect investors before the financial collapse of the particular broker-dealer involved." *Touche Ross & Co. v. Redington,* 442 U.S. 560, 570 (1979) (footnote omitted).

The purpose of the accountant's audit report is the same as that of SIPA: to provide greater protection to customers. The accountant's audit report includes detailed information regarding the SEC's net capital requirements (Rule 15c3-1) and customer reserve requirements (Rule 15c3-3). Non-compliance with these Rules requires the SEC to inform SIPC for the benefit of customers. *See* SIPA § 78eee(a)(1). However, SIPC does not receive a copy of accountants' audit reports. As a result, SIPC cannot rely directly on these audit reports and thus has been held by courts not to have standing to sue an auditor for any negligent or tortious conduct related to the audit.

Task Force Recommendation

The Task Force recommends that SIPC members be required to file audit reports with SIPC concurrently with their filing with the SEC. The purpose of such a requirement would be to allow SIPC to rely on the audit report and provide SIPC with standing to sue an auditor for any negligent or tortious conduct related to an audit.

Related Litigation in SIPA Liquidation Proceedings

SIPC and/or SIPA trustees have taken action against accounting firms based on the firms' audit responsibilities in six liquidation proceedings. Settlements were reached regarding the actions in three of those proceedings.[10] In the other three liquidation proceedings, the courts held that the accountant could not be held liable to SIPC. *See SIPC v. BDO Seidman (In re A.R. Baron & Co.)*, 245 F.3d 174 (2d Cir. 2001); *SIPC v. Munninghoff Lange & Co. (In re Donahue Securities, Inc.)*, 2004 WL 3152763 (Bankr. S.D. Ohio Nov. 23, 2004); *SIPC v. Cheshier & Fuller (In re Sunpoint Sec., Inc.)*, 377 B.R. 513 (Bankr. E.D. Tex. 2007), *aff'd sub nom., Richardson v. Cheshier & Fuller LLP*, 2008 WL 5122122 (E.D. Tex. Dec. 3, 2008). In *Sunpoint Securities*, the court explained that "[b]ecause SIPC was never aware of the contents of the audit reports, it cannot demonstrate that it justifiably relied on any statement made by the auditors in those reports, and it cannot recover against C&F upon a theory of negligent misrepresentation." 377 B.R. at 561.

Proposal to Change Applicable SEC Rule

Presently, SEC Rule 17a-5(d)(6), 17 C.F.R. § 240.17a-5(d)(6), provides that the audit report is to be filed with the SEC in Washington, D.C., the SEC's office in the broker-dealer's region, and the principal office of the broker-dealer's designated examining authority. While the report is thus available for regulators' use in monitoring the broker-dealer's financial health, the report is not provided to SIPC even though it ultimately may trigger the start of a liquidation proceeding. *See* Rule 17a-5(e)(3).

Against this background, SIPC has proposed recommending that SEC Rule 17a-5(d)(6) be changed to require that the audit reports also be filed with SIPC.[11] Including SIPC as a

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[10] The three liquidation proceedings were (1) R.D. Kushnir & Co.; (2) Rocky Mountain Securities and Investments, Inc.; and (3) NEBS Financial Services, Inc.

[11] The proposed rule change would revise SEC Rule 17a-5(d)(6) to add SIPC as a designated entity to receive a copy of the annual audit report filed with the SEC. The rule is set forth below, and the proposed revision is italicized.

> The annual audit report shall be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, D.C., and the principal office of the designated examining authority for said broker or dealer. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member, *and to the Securities Investor Protection Corporation ("SIPC").*

The addition of SIPC to Rule 17a-5(d)(6) would require a technical amendment to SEC Rule 17a-5(e)(4), striking the reference to the "Securities Investor Protection Corporation," and substituting "SIPC" in its place.

designated recipient would further the goal of investor protection by providing another layer of review of the report by an organization directly affected by its contents. In addition, including SIPC as a recipient would help to address the persistent concern that any signs of "financial weakness, as by non-compliance with net capital requirements or otherwise, [be] watched very carefully and followed up" in order to augment the financial responsibility requirements SIPA was intended to enhance, and to provide greater investor protection. *See* SEC Study, *supra* at 25.

Recommendation No. 7:

Affirm the Obligation of Banks and Other Custodians to Safeguard Rule 15c3-3 Accounts and to Reaffirm That Such Accounts Are Subject to Trustee Control Upon Broker-Dealer Liquidation

Overview

SEC Rule 15c3-3, 17 C.F.R. § 240.15c3-3, also referred to as the Customer Protection Rule, like SIPA, is designed to ensure, among other things, that customers who entrust cash or securities to a broker-dealer for the purpose of effecting securities transactions are able to recover that property, even if the broker-dealer fails financially.

Under Rule 15c3-3, banks and other custodians acknowledge or agree in writing (for example, by way of a "no lien letter"), with respect to accounts opened by broker-dealers in order to comply with Rule 15c3-3 ("Rule 15c3-3 Accounts"), that the accounts are not subject to any "right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank." The Task Force has determined that it should be made clear that banks and other custodians are not permitted to hypothecate or subject to a lien any assets carried in Rule 15c3-3 Accounts. It also should be made clear that, in the liquidation of a broker-dealer under SIPA, banks or other custodians carrying the broker-dealer's Rule 15c3-3 Accounts are required to turn over to the liquidation trustee all property in a Rule 15c3-3 Account, and that a failure to turn over such property may subject the bank or other custodian to sanctions for violating Sections 362 and 562 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*,[12] as well as any applicable court order, and may expose them to sanctions (potentially including punitive damages for a willful refusal) for violating such sections (and, where applicable, any order).

Task Force Recommendation

The Task Force recommends that SIPC request that the SEC issue an interpretive release with respect to Rule 15c3-3 that makes clear that

- ***after providing an acknowledgment or agreement (including without limitation a "no lien letter") that an account used for compliance with Rule 15c3-3 is not subject to any right, charge, security interest, lien, or claim of any kind in favor of such bank or custodian or any***

[12] Under SIPA section 78fff(b), specified sections of the Bankruptcy Code apply in a SIPA liquidation to the extent not inconsistent with SIPA.

person claiming through the bank or custodian (a "Claim"), a bank or other custodian may not subsequently create a Claim against such account, and

- ***a request by a trustee for the liquidation of a broker-dealer for control of such an account or any property on deposit therein shall put the bank or custodian on notice that its failure to comply with such a request may subject the bank or custodian to possible sanctions and/or penalties for violating Sections 362 and 542 of the Bankruptcy Code, or aiding and abetting a violation of, Rule 15c3-3.***

Background

SEC Rule 15c3-3 provides, in relevant part:

(c) *Control of securities.* Securities under the control of a broker or dealer shall be deemed to be securities which: . . .

> (5) Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities to the broker or dealer does not require the payment of money or value and the bank having acknowledged in writing that the securities in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank; or . . .

(f) *Notification of banks.* A broker or dealer required to maintain the reserve bank account prescribed by this section or who maintains a special account referred to in paragraph (k) of this section shall obtain and preserve in accordance with § 240.17a–4 written notification from each bank in which he has his reserve bank account or special account that the bank was informed that all cash and/or qualified securities deposited therein are being held by the bank for the exclusive benefit of customers of the broker or dealer in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker or dealer with the bank, and the broker or dealer shall have a written contract with the bank which provides that the cash and/or qualified securities shall at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

Notwithstanding the notification to banks and other related provisions of SEC Rules, bank custodians at times have refused to release to the SIPA trustee property in Rule 15c3-3

Accounts. In some cases, the refusal was purportedly based upon assertions of a subsequently granted right, charge, security interest, lien, or claim of any kind in favor of a bank or any person claiming through the bank (a "Claim") against the Rule 15c3-3 Account. It would facilitate and expedite the recovery of customer property by the trustee for the benefit of customers if it is made clear that banks and other custodians may not create Claims over Rule 15c3-3 Accounts, that property in a Rule 15c3-3 Account is subject to the SIPA trustee's control and disposition upon the commencement of a SIPA liquidation proceeding, and that the trustee shall be authorized to recover from the custodian any property improperly released, seized or hypothecated by the bank in violation of its agreement. This clarification would further the enforcement of Rule 15c3-3 and reaffirm existing applicable case law. *See, e.g., Dowden v. Cross County Bank (In re Brittenum),* 97 B.R. 503 (E.D. Ark. 1987) (holding that a Rule 15c3-3 deposit is not subject to bank's setoff claim).

In that regard, the Task Force believes that this proposed clarification with respect to the treatment of customer property by a custodian is best accomplished through the issuance of an interpretive release by the SEC respecting Rule 15c3-3. The following language is suggested to be made part of an SEC release:

> Upon the commencement of a liquidation under the Securities Investor Protection Act, 15 U.S.C. § 78aaa *et seq.* ("SIPA"), of any broker or dealer, funds or securities deposited by or on behalf of such broker or dealer in any bank account at any point acknowledged or agreed by the bank not to be subject to any "right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank" including without limitation by way of a "no lien letter" (a "Rule 15c3-3 Account") shall be subject solely to the control and direction of, and disposition by, the trustee appointed for the liquidation of such broker-dealer (the "Trustee"). A broker-dealer violates Rule 15c3-3 if it creates any right, charge, security interest, lien, or claim of any kind in or over a Rule 15c3-3 Account (or the assets from time to time on deposit therein) in favor of the bank or any person claiming through the bank (a "Claim") against a Rule 15c3-3 Account; therefore any bank accepting or acting on the basis of such a subsequently granted Claim shall be deemed to be aiding and abetting a violation of Rule 15c3-3. A request to a bank by the Trustee for control of funds or securities in a Rule 15c3-3 Account carried by such bank shall put the bank on notice that its failure to comply with such request will violate Sections 362 and 542 of the Bankruptcy Code and/or aid and abet a violation of Rule 15c3-3, and may subject the bank to sanctions (including punitive damages).

Recommendation No. 8:
Continue to Vest the SIPA Trustee with the Same Avoidance Powers as a Trustee in a Case under the Bankruptcy Code

Overview

The Task Force considered whether the avoidance powers available to a trustee under SIPA should be modified. Currently, the avoidance powers vested in a SIPA trustee are the avoidance powers available to a trustee in a case under the Bankruptcy Code.

The Task Force has determined that avoidance powers are an important tool for returning customers as nearly as possible to their accounts as they existed prior to the commencement of the liquidation proceeding. Allowing a trustee to avoid certain transfers ensures that creditors are treated equally and that certain creditors are not favored over others. Avoidance actions are particularly important when, for example, the debtor broker-dealer has transferred customer assets to a third party (including a customer) within a specified time period preceding the date of liquidation and other than in the ordinary course of business. If these transfers are not recovered by the trustee, the third party or customer who received the funds pre-filing is able to receive 100% of the money transferred, to the detriment of other customers for whom fewer assets remain in the broker's possession for distribution. The avoidance powers, however, allow trustees to recover under specified conditions amounts transferred and to redistribute those assets to all customers, so that all customers share equally.

The Task Force recognizes that in light of SIPA's close interrelationship with the Bankruptcy Code, any change to the avoidance powers should first be made under the Bankruptcy Code. Because under SIPA, the avoidance provisions of the Bankruptcy Code automatically apply to a SIPA case, unless inconsistent with SIPA, such changes would apply without the need for an amendment to SIPA.

Task Force Recommendation

The Task Force recommends that SIPA trustees continue to be vested with the same avoidance powers as trustees in cases under the Bankruptcy Code. To the extent that any adjustments to the avoidance powers are warranted, the adjustments should be made to the avoidance provisions of the Bankruptcy Code, and thereby incorporated by reference into SIPA. The Task Force does not recommend that the avoidance powers of a SIPA trustee be limited, as they would be under the proposed Ponzi Scheme Investor Protection Act.

The Proposed Ponzi Scheme Investor Protection Act

Pending legislation in the draft Ponzi Scheme Investor Protection Act of 2011[13] ("Draft Bill"), which, on May 25, 2011, was referred to the House Committee on Financial Services, seeks to limit a trustee's avoidance powers in SIPA liquidations involving Ponzi schemes. The Draft Bill was introduced after the Ponzi Scheme Investor Protection Act of 2010[14] died in Committee.

Section 8A(f) of the Draft Bill states that the "trustee of a Ponzi scheme may not seek to recover money, including profits, from any investor in the Ponzi scheme unless such investor (1) was complicit in the Ponzi scheme; or (2) was registered, or should have been registered, with the Commission under the securities laws as an investment adviser, broker, dealer, or other person with a fiduciary duty to the customers or investors of the person." As explained above, divesting a trustee of his power to avoid transfers inevitably results in inequitable distributions to customers by favoring some customers over others. This is particularly troublesome in the case of a Ponzi scheme where no actual investments are made and funds that have been paid to certain customers consist of other customers' money. Customers who received no transfer of funds from the broker-dealer before its failure would be subject to a potentially more limited distribution in the SIPA liquidation proceeding.

[13] H.R. 1987, 112th Cong. (2011).

[14] H.R. 5032, 111th Cong. (2010).

Recommendation No. 9:

Continue to Treat Claims Arising from Repurchase and Reverse Repurchase Agreements as General Creditor Claims

Recommendation No. 10:

Continue to Treat Claims Arising from Open TBA Contracts as General Creditor Claims

Recommendation No. 11:

Continue to Treat Claims Arising From Credits Received Pursuant to Soft Dollar Arrangements as General Creditor Claims

Recommendation No. 12:

Continue to Treat Claims for Fees Earned in Connection with Underwriting or Other Transactions Effected by a Syndicate as General Creditor Claims

Recommendations 9 through 12 were considered together, as they each rely on common legal principles and policy considerations. Specifically, each Recommendation addresses a potential claim by either institutional customers or sophisticated retail customers, which are customers not intended to have their claims satisfied out of funds advanced by SIPC by the original drafters of SIPA. In addition, each of these Recommendations depends upon the definition of key terms under SIPA such as "customer," "customer property" and "security." The below summary of the law therefore applies to each of the Recommendations.[15]

"Customer" and "Customer Property" Under SIPA

"Customer" status under SIPA is limited. Customer status is only available to those persons who, on the "filing date," have a claim to securities or cash held in custody by the broker for the customer as an investor in securities. In determining the nature of a claimant's status in relation to the debtor, the court must look at the claimant's account, as it existed on the books and records of the debtor on the "filing date." In order to be a "customer" under SIPA, a claimant in a SIPA liquidation proceeding must have a claim to securities or cash custodied in a

[15] Mr. Hammerman indicated that his approval of Recommendations 9 through 12 reflected SIFMA's view that the recommendations were meaningful recommendations for the improvement of SIPA, but were prospective only and should not be used to inform the current state of the law.

securities account in his, her or its name and must have established a relationship with the debtor as a securities investor. Thus, under the definition of "customer" in SIPA, customer status is imparted on persons pursuant to their "transactional relationship:" broker-investor transactions are distinguished from the ordinary debtor-creditor relationships.[16]

Courts have held that the actual entrustment of securities or cash into the possession of a debtor is a "bright line" test that separates customer claims from all other claims. As the Fifth Circuit stated in *In re Stalvey & Assocs., Inc.*, "in 'the absence of actual receipt, acquisition or possession of the property of a claimant by the brokerage firm under liquidation,'" a claimant is not entitled to customer protection under SIPA.[17] For purposes of customer status under SIPA, entrustment means both the transfer of possession of property to the broker, and that this transfer be "in the ordinary course of its business as a broker or dealer." SIPA § 78*lll*(2). This contemplates a "public" customer who tenders securities "for the purpose of having them traded" by the broker.[18] Thus, at a minimum, to qualify for "customer" status under SIPA, claimants must demonstrate that cash or securities were entrusted to the debtor for the purpose of effecting protected securities transactions. Such entrustment of property for the purpose of trading creates the broker-customer fiduciary relationship that is the essence of customer status under SIPA.

Contracts, Loans, and Executory Contracts are Not Protected by SIPA

As the court explained in *In re Weis Securities*, SIPA only protects customers "with 'an unrestricted right to receive on demand these [*sic*] securities which belong to them.'"[19] For example, in *In re Adler Coleman Clearing Corp.*, the court rejected broker-dealers' attempts to attain "customer" status for commissions held at the firm, concluding that the account did not contain "customer property" as defined in SIPA § 78*lll*(4).[20] Accordingly, claims for fraud and breach of contract are not protected by SIPA.[21] Likewise, lenders[22] and parties to executory contracts[23] are not protected by SIPA.

[16] *See, e.g., Stafford v. Giddens (In re New Times Securities Services, Inc.)*, 463 F.3d 125, 128 (2d Cir. 2006), *citing SEC v. F.O. Baroff*, 497 F.2d 280, 284 (2d Cir. 1974).

[17] 750 F.2d 464, 469 (5th Cir. 1985), *quoting SEC v. Kenneth Bove & Co.*, 378 F.Supp. 697 (S.D.N.Y. 1974).

[18] *In re Hanover Square Secs.*, 55 B.R. 235, 240 (Bankr. S.D.N.Y. 1985).

[19] 1977 WL 1043, at *4 (S.D.N.Y. Sept. 29, 1977), *quoting* H.R. Rep. No. 91-1613 (1970).

[20] 216 B.R. 719, 724-25 (Bankr S.D.N.Y. 1998).

[21] *See, e.g., In re MV Secs., Inc.*, 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985) ("SIPA does not protect customer claims based on fraud or breach of contract." (quoting *SEC v. Howard Lawrence & Co., Inc.*, 1 Bankr. Ct. Dec. 577, 579 (Bankr. S.D.N.Y. 1975)).

Policy Considerations

Only investors who qualify as "customers" under SIPA share in "customer property," that is, the cash and securities custodied with the broker for its customers. By limiting the investors who share in such property to "customers," the interest of such investors in a limited pool of customer assets is not diluted by non-customer claims against it. Thus, if the definition of "customer" were expanded, the only beneficiaries to share in customer property would be persons with non-customer claims against the broker.

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[22] *In re New Times Sec. Servs., Inc.*, 463 F.3d at 129 ("The promissory notes held by [claimants] . . . are just the type of debt instruments whose possession brings claimants within the category of unprotected lenders."); *In re Hanover Square Sec.*, 55 B.R. 235, 238 (Bankr. S.D.N.Y. 1985) ("Lenders are simply not a class to be specially protected under SIPA and in fact were expressly excluded from the definition of customer upon the enactment of the 1978 amendments to SIPA.").

[23] *See Securities Investor Protection Act Amendments of 1975: Hearings Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 94th Cong. 171 (1975) (considering, but not enacting, proposed changes to the statutory definition of "customer" to extend protection to persons who had not yet entrusted property but held "executory contracts" for the purchase of securities).

Recommendation No. 9:

Continue to Treat Claims Arising from Repurchase and Reverse Repurchase Agreements as General Creditor Claims

Overview

In repurchase ("repo") transactions, a broker-dealer, as ostensible "seller," transfers to a counterparty, the ostensible "buyer," certain identified securities (the "Purchased Securities"), against the transfer of funds by the buyer. Simultaneously, the parties agree that the broker-dealer will buy back or repurchase, at a specified future date, the same securities for the same price plus a financing charge or "Pricing Rate," which is fixed during the life of the repo agreement. As in securities lending transactions, the repo buyer essentially earns interest on the cash that it transferred to the seller for the securities, and has the freedom to use the securities in its business following the initial purchase until the date of repurchase.

Unlike typical customer claims under SIPA, a claim by a repo counterparty is not seeking the return of cash or securities on deposit by the customer for trading purposes. Rather, in a broker-dealer liquidation, a counterparty to an "open" repo or reverse repo transaction often seeks contract damages arising from the broker-dealer's default on its obligation to resell or repurchase. The amounts claimed generally consist of the difference between the repurchase price of the Purchased Securities (including interest due upon performance) and the Filing Date value of the Purchased Securities, plus any accrued interest. Those counterparties who failed to take possession of their repo collateral may claim the collateral in the liquidation. For example, if the repo participant agreed to lend the broker $1 million in exchange for securities but left the securities on deposit with the broker, the counterparty might claim the securities if the brokerage fails.

The following factors set these types of claims apart from typical "customer" claims under SIPA:

- Repo transactions are in economic effect secured loan transactions rather than securities investment transactions as contemplated by SIPA;
- The repo contract itself is not a "security" under SIPA;

- Breach of a repo agreement gives rise to a contract claim for damages; and
- The counterparties do not entrust cash or securities to a broker-dealer for trading purposes so as to create the custodial function that is essential to customer status under SIPA.[24]

Task Force Recommendation

The Task Force recommends that claims arising out of repurchase agreements and reverse repurchase agreements not be treated as "customer" claims under SIPA. The Task Force has not addressed hold-in-custody repurchase agreements and takes no position on them.

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[24] Under Rule 15c3-3, a broker-dealer is generally not obligated to segregate any property in connection with repo transactions. One exception to this rule is where the transaction is a repo transaction where the broker- dealer retains securities it has transferred to the buyer (a "hold-in-custody" or "HIC" repo). *See* 17 C.F.R. § 240.15c3-3(b)(4)(i)(D). This Rule requires that the broker-dealer obtain the repurchase agreement in writing, and confirm the securities subject to the repurchase agreement in writing. *See* 17 C.F.R. § 240.15c3-3(b)(4)(i), (iii). In a liquidation of the broker-dealer, the HIC repo counterparty may attempt to claim the securities subject to the repo. (For example, if the counterparty provided $1 million to the broker-dealer in exchange for $1.1 million of securities left on deposit with the broker-dealer, the counterparty might attempt to claim the securities if the broker-dealer fails.) Significantly, the broker-dealer also must "[a]dvise the counterparty in the repurchase agreement that the Securities Investor Protection Corporation has taken the position that the provisions of the Securities Investor Protection Act of 1970 do not protect the counterparty with respect to the repurchase agreement." 17 C.F.R. § 240.15c3-3(b)(4)(i)(A)-(C); *see* 17 C.F.R. § 240.15c3-3(b)(4)(iii) (specifying additional requirements regarding the right to substitute securities subject to the agreement). The SEC explained that it amended Rule 15c3-3 as a result of "the apparent lack of understanding of hold in custody repo counterparties of their rights and liabilities." *Customer Protection Rule*, Exchange Act Release No. 24778, 52 Fed. Reg. 30331 (Aug. 14, 1987); *see also Securities; Net Capital, Customer Protection, Recordkeeping and Quarterly Securities Count Rules*, Exchange Act Release No. 23602, 51 Fed. Reg. 32658, 32659-60 (Sept. 15, 1986). *See generally Cohen v. Army Moral Support Fund (Matter of Bevill, Bresler & Schulman Asset)*, 67 B.R. 557 (S.D.N.Y. 1986).

Recommendation No. 10:

Continue to Treat Claims Arising from Open TBA Contracts as General Creditor Claims

Overview

TBA contracts are forward contracts for the future purchase or sale of "to be announced" U.S. agency debt obligations. In TBA contracts, the parties promise to buy or sell at a future date "to be announced" mortgage-backed obligations of U.S. Agencies,[25] *i.e.*, obligations having defined characteristics (issuing agency, coupon rate, maturity, etc.) but not yet specified (and often not yet in existence) at the time the TBA contract was entered into by the parties. TBA contracts are bilateral agreements between the debtor and the TBA claimants, and are not traded on any securities or commodities exchange or registered with the SEC. The rights of the parties typically are governed by the Master Securities Forward Transaction Agreement (the "MSFTA"), an industry-standard contract designed for transactions of this nature.

This resolution pertains to TBA contracts that are "open" on the "filing date" of the liquidation proceeding because as of that date, the time for performance (the "settlement date") has not occurred and the obligations of the parties to purchase or sell remain wholly unperformed. Because no securities are specified to the contracts as of the filing date and no securities or cash are transferred to the debtor, the claims in this group are not, like typical customer claims, for the return of cash or securities; instead, they are contract damages claims arising from the debtor's breach of the TBA contracts. Damages are the breach remedy provided in the MSFTA and established by custom and usage in the industry.

The following factors set these contract damage claims apart from typical "customer" claims under SIPA, and support the argument that they actually are, at best, general creditor claims:[26]

- TBA claimants do not "entrust" cash or securities to the debtor but exchange promises of future performance;

[25] Such obligations are issued, guaranteed, or issued and guaranteed by the Federal National Mortgage Corporation, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association.

[26] In *In re Lehman Brothers Inc.*, 2011 WL 6098067 (Bankr. S.D.N.Y. Dec. 8, 2011), the court held that claims arising from TBA contracts did not qualify as customer claims under SIPA.

- The TBA contract itself is not a "security" under SIPA;
- The relationship of TBA claimants and a debtor is contractual, typically governed by the industry-standard MSFTA, which disclaims any fiduciary relationship and contains other features that are inconsistent with SIPA customer status; and
- Open TBA contracts are executory contracts, and Congress declined to amend SIPA to consider executory contracts for the purchase of securities as the subject of "customer" claims.

Task Force Recommendation

The Task Force recommends that because parties to a TBA agreement merely hold contract rights to purchase or sell as yet unidentified securities on a TBA basis, they not be deemed "customers" under SIPA.

Recommendation No. 11:

Continue to Treat Claims Arising From Credits Received Pursuant to Soft Dollar Arrangements as General Creditor Claims

Overview

The term "soft dollars" refers to arrangements in which "a discretionary money manager receives research or other services from a broker-dealer in addition to transaction execution, and does so in exchange for the brokerage commissions from transactions for discretionary clients' accounts." Thomas P. Lemke & Gerald T. Lins, *Soft Dollars and Other Trading Activities* § 1:1 (2010). A typical example of a soft dollar arrangement is where a money manager receives a $1 credit towards research or brokerage services for every $1.60 in commissions that the broker receives. *Id.* These credits may be used only to pay for research or brokerage services, and cannot be used as a credit towards the purchase of securities.

SIPA imparts customer status only on investors who deposit cash "for the purpose of purchasing securities." *See* SIPA § 78*lll*(2)(B)(i). Because soft dollar credits are only used towards the purchase of research or related services, soft dollars do not qualify as "customer property" under SIPA.

Task Force Recommendation

The Task Force recommends that credits received pursuant to soft dollar arrangements not be deemed customer property and not give rise to "customer" claims.

Recommendation No. 12:

Continue to Treat Claims for Fees Earned in Connection with Underwriting or Other Transactions Effected by a Syndicate as General Creditor Claims

Overview

Brokers may hold fees earned by syndicate members in connection with underwriting or other transactions effected by a syndicate. These fees, however, are not part of the customary broker/customer relationship, as they are not held for the purpose of investment by customers. Accordingly, the fees do not qualify as "customer property" under SIPA.

Task Force Recommendation

The Task Force recommends that fees earned in connection with underwriting or other transactions effected by a syndicate not be deemed "customer property" under SIPA.

Recommendation No. 13:

Study Discrepancies Between SEC Rule 15c3-3 and "Customer Property" Under SIPA

Overview

The Task Force has identified, examined, and discussed various discrepancies that exist between SIPA and the "Customer Protection Rule" Rule 15c3-3, promulgated by the SEC under the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* Whether and to what extent the discrepancies should be reconciled, and in what respect, will require substantial study and consultation between SIPC and the SEC, taking into account the stated concerns of interested parties. Because a thorough analysis of the reasons for, and the policies that underscore, the differences, and of whether and to what extent the differences should be reconciled, if at all, is best done by SIPC in concert with the SEC, the Task Force makes the following recommendation:

Task Force Recommendation

Although there are discrepancies between SEC Rule 15c3-3 and provisions of SIPA, the discrepancies may be necessary. Both the Securities Exchange Act of 1934 and SIPA share the goal of customer protection, but in some cases, the regulatory functions of the SEC may compel one approach while the limited protection afforded under SIPA may require a different approach. The Task Force recommends that SIPC, in consultation with the SEC, taking into account the stated concerns of interested parties, study the discrepancies between SEC Rule 15c3-3 and SIPA, and determine whether resolution of these discrepancies is appropriate, and if so, to what extent and in what manner.

Recommendation No. 14:

International Relations:
SIPC to Assist in the Creation of an International Association

Overview

Broker-dealers increasingly have overseas affiliates or subsidiaries and do business across the globe. As such, the failure of a multi-national brokerage can have cross-border implications affecting domestic and foreign customers. In light of the realities of modern day broker-dealer operations, the Task Force is considering how customers of a multinational broker-dealer may be better protected by SIPC and whether membership in an international association of investor protection entities ("International Association") would further SIPC's mission.

The Task Force has examined SIPC's past international activity and the cross-border issues that have arisen in the liquidation of Lehman Brothers Inc. and its related entities ("Lehman"). The Task Force believes that membership in an International Association could assist in the resolution of these issues in future multi-national firm liquidations. An International Association would create a forum for discourse among its members and could promote cooperation among securities investor protection organizations.

Task Force Recommendation

The Task Force recommends that SIPC, in cooperation with the international investor protection community, take a leading role in the creation of an International Association, provide suggestions for the primary goals of the Association, and study whether the Association should be independent or affiliated with an established organization.

A Brief History of SIPC's International Efforts

SIPC's history of international outreach began in the 1990s with a series of seminars regarding the capital markets to former Soviet republics, and the examination by an internal SIPC committee of the effect of globalization of the securities markets on SIPC. Since 1999, SIPC has made presentations to representatives from countries in the European Union, China, Egypt, and Jordan, as they were in the process of forming their respective national investor protection schemes. SIPC also has made presentations to, and joined, the International Organization of Securities Commissions ("IOSCO") as an affiliate member.

The Memorandum of Understanding Program

Recognizing the importance of international cooperation, SIPC has negotiated and signed Memoranda of Understanding ("MoU") with a number of its foreign counterparts. Although they are non-binding at law, these cooperation agreements provide for annual information exchanges and a platform to deal with the failure of a financial intermediary that has a footprint in both jurisdictions.

The following is a list of SIPC's MoU partners, and the years the agreements were signed:

- Financial Services Compensation Scheme, United Kingdom, 2004
- Canadian Investor Protection Fund, 2005
- Securities and Futures Investor Protection Center, Taiwan, 2006
- Korea Deposit Insurance Corporation, 2007
- China Securities Investor Protection Fund Co., Ltd., 2009
- Egyptian Investor Protection Fund, 2009

A New International Association of Investor Protection Entities

The China Securities Investor Protection Fund ("CSIPF") has taken a leadership role in international cooperation between and among similar entities, and has moved to solidify the ties between them. In 2009, the CSIPF urged SIPC and the Canadian Investor Protection Fund to join with it to create a new entity to deal exclusively with investor protection in the context of financial intermediary failure. Chairman Chen Gongyan, former head of the CSIPF and now Chairman of the Securities Association of China, recommended the idea of an International Association to the Task Force at its initial meeting.

The Need for an International Association

The liquidation of large, multinational brokers has required substantial cross-border cooperation. An International Association could help to forge relationships between and among the securities investor protection entities. An International Association could also facilitate the exchange of information between and among members and provide an established channel for communication. This would allow closer collaboration among the affiliated debtors and investor protection schemes. Other existing international associations, such as IOSCO and the International Insolvency Institute (the "*III*"), have created mechanisms for cross-border cooperation. For example, in 2001, the *III* adopted the Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases, which were created in conjunction with the American Law Institute. A more targeted set of guidelines for investor protection entities could prove helpful in cross-border liquidations.

The Goals of an International Association of Securities Investor Protection Entities

An international securities investor protection forum could work towards the following specific goals:

1. Facilitate the communication, coordination and cooperation among all securities investor protection entities and tribunals, when appropriate;
2. Promote cooperation among securities investor protection entities with respect to cross-border compensations for securities investors;
3. Provide for the sharing of relevant information and data among members when appropriate;
4. Explore potential mechanisms for the preservation of the value of a debtor's worldwide assets and the maximization of recovery for all securities investors;
5. Promote methods for coordination of an efficient and transparent claims process;
6. Promote discussion of comity among independent jurisdictions;
7. Promote the development of securities investor protection internationally; and
8. Explore methods for international dispute resolution in cases involving cross-border issues.

An International Association May be Independent or Affiliated

An International Association may be affiliated with an existing international securities or insolvency association or be a completely stand-alone entity. Having an affiliation with an existing international association, such as IOSCO or the *III,* could be advantageous because each of these organizations has an infrastructure in place, including annual meetings, a mechanism for leadership and decision making, and established channels for communication. In addition, the relationships forged between investor protection entities and other members of the existing organizations could prove beneficial. On the other hand, an International Association as a stand-alone entity allows complete independence, autonomy, and authority, although it may place a greater burden on the members to create an infrastructure and increase administrative duties.

Recommendation No. 15:
SIPC to Continue Investor Education Efforts

Overview

Since 2000, SIPC investor education efforts have included (i) literature and a web site in investor friendly terminology; (ii) five separate public service announcement (PSA) campaigns; and (iii) a paid million-dollar advertising campaign.

Task Force Recommendation

Subject to SIPC's consultation with FINRA and the SEC, the Task Force recommends that:

(1) The Board should consider the feasibility of including plain-English information about SIPC on brokerage statements and whether its benefits would outweigh its costs;
(2) SIPC recommend an increase in the amount of information that brokers are required to learn about SIPC as part of their continuing education;
(3) SIPC hire a dedicated investor education employee; and
(4) SIPC ask state regulators to include information about SIPC as part of their outreach efforts.

The Task Force also recommends that SIPC conduct a study, including through the use of focus groups, both before and after implementing these changes to determine investors' level of knowledge of SIPC and the effectiveness of these changes.

(1) The Board Should Consider the Feasibility of Including Plain-English Information about SIPC on Brokerage Statements and Whether Its Benefits Would Outweigh Its Costs

The Task Force recognizes the importance of educating the investing public through the information provided by broker-dealers. Thus, certain members of the Task Force suggested including information on SIPC protection on the initial brokerage statement, whether provided in paper or electronic form, and periodically thereafter. They emphasized that the information included on the brokerage statement should be simple, easy to understand, and eye-catching. In addition, the information should provide the scope and limits of protection, including what is not protected by SIPC.

Certain other members of the Task Force expressed concerns at the cost and effectiveness of including information on the brokerage statement. The Task Force is therefore presenting this issue to the Board to consider in conjunction with the below recommendation to hire a dedicated investor education employee.

(2) SIPC Should Recommend an Increase in the Amount of Information that Brokers Are Required to Learn about SIPC as Part of Their Continuing Education

Pursuant to FINRA Rule 1250, securities professionals have a continuing education requirement. *See* FINRA Rule 1250, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10204. In addition, firms are required to establish a formal training program for their registered representatives. *See id.*; Continuing Education, FINRA, *available at* http://www.finra.org/Industry/Compliance/ContinuingEducation/. As a way to ensure that registered individuals are relaying accurate information about SIPC to their customers, the Task Force recommends that registered individuals be required to learn about SIPC as part of FINRA's continuing education requirements. SIPC staff can work in conjunction with FINRA to develop this information, which should include an explanation to investors of SIPC protection.

(3) SIPC Should Hire a Dedicated Investor Education Employee

A dedicated investor education employee may enhance SIPC's investor education efforts. He or she could work with the SEC, FINRA and state securities regulators to coordinate investor education and ensure that accurate information about SIPC is reaching investors. The Task Force recommends that SIPC hire a dedicated investor education employee.

(4) SIPC Should Ask State Securities Regulators to Include Information about SIPC as Part of Their Outreach Efforts

State securities regulators regularly engage in outreach to investors. SIPC should request each state securities regulator to include information on SIPC and SIPA as part of its regular outreach. This recommendation would be a cost-effective way to achieve the investor education goals of both the state regulators and SIPC.

Comment:

SIPA's Mandate of Customer Protection Generally Means that Committees Representing Unsecured Creditors of the Debtor's General Estate Serve Little Purpose in a SIPA Case

SIPA does not provide for the appointment of a committee to represent the interests of unsecured creditors. Historically, creditors' committees have not played any role in proceedings under SIPA in part because the emphasis of these proceedings has been on protecting customers through maximization and distribution of the "Fund of Customer Property."

The creation of a creditors' committee, as a result of several fundamental aspects of SIPA, would be of limited or no benefit in most cases, and would potentially even require SIPC to advance additional funds for expenses without any material benefit to the estate. For example, the supervisory functions that otherwise typically would be performed by a creditors' committee in a bankruptcy case are, in a SIPA case, performed by SIPC, which is closely involved in the oversight of every SIPA proceeding. In addition, as SIPA provides only for liquidation, not reorganization, there is no plan of reorganization for a creditors' committee to participate in formulating, and most importantly, there rarely is a materially significant unsecured general estate in a SIPA proceeding to be reorganized. Moreover, Congress intended the SIPA proceeding to resemble most closely a Chapter 7 liquidation under the Bankruptcy Code and not a bankruptcy reorganization. While used in reorganization cases, unsecured creditors' committees rarely occur in Chapter 7 cases because unlike the situation in reorganization cases, the Bankruptcy Code does not provide for compensation to professionals assisting the committee in Chapter 7 cases.

The creation of such a committee could be detrimental to the goals of the efficient administration of the assets and prompt resolution and payment of the claims of securities customers who are the intended beneficiaries of a SIPA proceeding and potentially impose needless additional administrative costs on SIPC.[27]

Task Force Comment

The Task Force has concluded that SIPA's mandate of customer protection generally means that an Unsecured Creditors' Committee serves little purpose in a SIPA liquidation.

[27] *See In re MF Global, Inc.*, 2011 WL 5884247 (Bankr. S.D.N.Y. Nov. 23, 2011).

ACKNOWLEDGMENTS

The Task Force extends its appreciation to those persons who met with the Task Force and shared their time, experience and valued insight on issues of concern to the Task Force. This includes representatives of the Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Depository Trust & Clearing Corporation, the Investment Company Institute, and the Government Directors of the Securities Investor Protection Corporation from the Department of the Treasury and the Federal Reserve Board.

The Task Force also wishes to thank those members of the public who took the time to share their views, opinions, and concerns on matters relating to SIPA and SIPC.

Finally, the Task Force expresses special gratitude for the assistance rendered by our colleagues and associates in the firms or organizations that we represent, and by staff members of the Securities Investor Protection Corporation.

APPENDIX A

CORPORATE GOVERNANCE REVIEW
by
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The George Washington University Law School

**REPORT FOR SIPC MODERNIZATION TASK FORCE:
SIPC CORPORATE GOVERNANCE REVIEW**

By Lawrence A. Cunningham

August 13, 2010

Thank you for the opportunity to provide this report of my independent corporate governance review of some of the operations of the Securities Investor Protection Corporation. I understand that, in light of the insolvencies of the brokerage firm Lehman Brothers Inc. and the revelation of a Ponzi scheme at Bernard L. Madoff Investment Securities LLC, SIPC's Board of Directors formed the SIPC Modernization Task Force to examine SIPC's mandate under the Securities Investor Protection Act and operations and make related recommendations. As part of that effort, you engaged me to conduct a governance review and provide this report. I was delighted to conduct the review and am pleased to provide this report.

I. My Review and this Report

In my review, I communicated with nearly half the members of SIPC's staff, many in-person, several by telephone, and several by electronic mail, and made similarly varied inquiries of outside lawyers who have been involved in SIPC customer protection proceedings. My review included reading the Securities Investor Protection Act (including as amended by the Dodd-Frank Act of 2010); related rules appearing in the Code of Federal Regulations (known as the Series 100 through Series 500 Rules); SIPC's By-Laws (Nov. 2009 rev. ed.); SIPC's Annual Reports for 2009 and 2008; SIPC's statement of Organization and Responsibilities (May 12, 2010); SIPC's Operations Manual (August 2004); SIPC's Trustee's Guide (undated), including exhibits containing scholarly commentary; SIPC's Personnel Guide (Sept. 2006 rev. ed.); SIPC's brochure (in the form accompanying its 2009 Annual Report, apparently dated as of 2007); and parts of SIPC's internet Web site.

I also read a letter from Representative Paul E. Kanjorski (March 3, 2010) and related press release concerning the SIPC Modernization Task Force; reports about SIPC prepared by the U.S. General Accounting Office (May 2001 and July 2003) (concerning customer information and excess insurance), Ernst & Young (February 2002) (concerning internal audit), and Corporate Review Services (April 30, 2004) (concerning selection and supervision of external consultants); and an internal SIPC memorandum addressing recommendations of the Securities and Exchange Commission (June 2003) (concerning review of fee applications of external SIPC trustees and counsel).

The purpose of my review was to evaluate aspects of SIPC's corporate governance. This refers to internal organization, structure, staffing, policies, and procedures concerning operations and execution by SIPC's staff of its assigned mission. Outside the scope of this review are broader matters concerning SIPC's mission and this Task Force's undertakings. Except in passing, therefore, this report does not evaluate SIPC's statutory mandate or specific policy or other matters raised by the statute, such as what securities are covered, what asset distribution methods are used, or maximum customer protection limits set; relations with member firms, or assessments on them or financial resources; investor knowledge or education about investments or SIPC; or the selection, structure, composition, compensation or activities of SIPC's board of directors or relations between it and the rest of the corporation; or other similar broad policy matters.

Within those parameters, on the basis of my review, it is my opinion that SIPC's corporate governance is excellent. Its organizational structure is coherent; its supporting documentation outstanding; its technological capabilities becoming state of the art; its staff of optimal size, enabling a nimbleness necessary to respond quickly to execute its mission; its professional team exceptionally well-qualified, dedicated and collegial; and its network of external consultants and experts rich to enable leveraging internal swiftness and expertise with external manpower as needed. No organization or its governance is perfect, of course, and my review enables me to make a few recommendations.

My recommendations, detailed in what follows, may generally be classified as objects of modernization but I have not limited suggestions to that classification: The recommendations I suggest considering, in substantially the order of importance, are as follows:

A. Technical Document Updates: make technical updates to existing documentary support, including (1) the statement of Organization and Responsibilities to increase detail and uniformity, (2) the Trustee's Guide to reflect technological and other developments and actual practices, and (3) the Operations Manual for the same purposes, and to adopt a plan to update these using annual supplements followed by regular periodic (five year) revised editions.

B. Expand Document Wealth: sustain the accumulation of written experience for transmission to incoming staff, including by (1) developing additional corporate manuals concerning matters like prevailing brokerage firm practices and securities product innovations, and (2) make existing data bases of consultants and trustees accessible to staff rather than within the province of senior SIPC officials and consider expanding content.

C. Human Resources Investment: (1) assure adequate future staffing in SIPC's Operations Division by recruiting examiners across generations and be prepared to give them the training that the existing team has provided to other relatively recent recruits on a systematic basis, (2) compare the organizational structure contemplated by the list of authorized officers in SIPC's By-Laws to the existing officer corps, and (3) increase support of professional development for staff, including for completing unfinished college degrees and advanced specialized degrees relevant to the field, and for promoting the production of written materials for external publication.

D. Substantive Document Updates and Highlights: (1) make substantive updates to existing documentary support, in the Trustee's Guide and Operations Manual, to better reflect SIPC's prevailing practice on compensation policies for outside consultants and trustees, and (2) highlight in distinctive repositories SIPC's mission (by abstracting it from the statute) and ethical commitment (by reformatting existing By-Law and Personnel Guide provisions). SIPC may also wish to consider whether to have its internal controls audited, though I refrain from recommending that.

None of these suggestions requires changes to SIPA; most can readily be implemented by SIPC's staff; some may warrant or require SIPC Board review or approval; and suggestions concerning reformatting some By-Law provisions would require SEC involvement. In making these suggestions, I emphasize that my review indicated a highly effective corporate governance environment at SIPC and yielded confidence in its existing governance regime. Accordingly, as the level of detail provided in the recommendations may also signal, these suggestions should not be seen as criticizing SIPC's leadership or staff but to represent expectable ideas that an independent outside review might crystallize.

II. SIPC in Review

A. Design and Execution

1. Mission. The Securities Investor Protection Corporation was created by the Securities Investor Protection Act of 1970 to provide stated protection to customers of troubled U.S. securities brokers and dealers. SIPC is a nonprofit private corporation whose members are securities brokers and dealers registered under the Securities Exchange Act of 1934. Though not part of the federal government, its seven-member board consists of five presidential appointees and two government officials, and it is overseen by the Securities and Exchange Commission. Its primary purpose is to take charge of and liquidate failing brokerages and promptly arrange to return customer assets and pay customer claims within statutory limits.

SIPC administers a fund supported by member assessments available when a failing firm's general estate is insufficient to cover customer claims and also has access to credit through the SEC from the U.S. Treasury. Specific statutory language in SIPA defines the class of "customers" covered and provides a term of art to define the "securities" that are covered. Other technical legal and business terms arise in SIPC's day-to-day operations, including concepts such as customer name securities, customer property, and customer net equity, many elaborated in the Series 100 to 500 CFR rules. SIPA prescribes in clear terms rules governing the commencement of customer protection proceedings. These include appointment of a trustee and applicable judicial procedures and other aspects of the liquidation process. Despite lucidity, litigation and practical judgment over the meaning of some of these terms and rules recurs.

2. Performance. From its inception in 1971 through 2009, SIPC commenced 322 customer protection proceedings. Over the past decade, it commenced an average of four cases annually. In its history, SIPC has returned to more than 700,000 customers some $108 billion in assets, most from failed firms' estates, along with about $1 billon from the SIPC fund. Only a small minority of claims have exceeded the statutory limits. Eight cases are currently open, due to litigation or ongoing claims processing. Internal work flow at SIPC therefore varies over time in ways not always predictable but that require the staff and its team of outside consultants and trustees to act swiftly whenever new failed firms appear.

Among current cases are two unprecedented in magnitude that began in 2008: Lehman Brothers Inc. (involving some $92 billion in securities of some 135,000 customers) and Bernard L. Madoff Investment Securities LLC (involving an entirely fraudulent mirage costing SIPC an estimated $1.6 billion to protect customers, based on assumptions explained in SIPC's 2009 financial statements, Annual Report, p. 18 n.4). It's unlikely that multiple calamities of that magnitude will recur within such short order; recent statutory changes in the Dodd-Frank Act of 2010 appear to repose considerable responsibility for dealing with systemically important firm failure, including broker/dealers, in federal agencies; and SIPC operated effectively in the face of this pair of unprecedented failures, following longstanding practice of retaining experts with large staffs and resources and participating alongside them throughout related customer protection proceedings.

3. Proceedings. SIPC does not regulate brokers or dealers or supervise them. It relies on referrals from regulatory authorities, such as the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission, of pending firm financial difficulties. When a referral is received, SIPC's Vice President - Operations and Finance reviews it, preparing a worksheet (called Form 26) to evaluate whether to recommend commencing a proceeding, in consultation with SIPC's General Counsel. The two report recommendations to SIPC's President who submits ultimate recommendations to SIPC's Board Chair. The Chair is authorized by SIPC's By-Laws to direct the staff to initiate proceedings and that approval on recommendation is virtually automatic. This streamlined but collaborative process is well-designed to enable acting quickly and decisively on referrals.

Once authorized, the President and General Counsel confer to assign a SIPC staff attorney to head up the legal aspects of the proceeding and the Vice President – Operations and Finance assigns an examiner. SIPC staff members then proceed to their assigned tasks, its lawyers obtaining requisite judicial orders and legal staffing and its examiners closing down the firm and marshaling its assets in preparation for its liquidation and distributions to customers. Throughout, SIPC's and its staff's primary goal is expeditious movement to return and pay customer funds. To do that usually involves SIPC making advances to customers, through trustees, that it thereafter seeks to recover in later stages of a proceeding. The process is efficient and swift, even in large cases.

B. Approach and Implementation

1. Structure. SIPC's organizational structure is simple and coherent and its internal staffing both sophisticated and lean. Under its Board of Directors, SIPC's President is charged with overall corporate responsibility. That includes interacting with Congress and supervising SIPC's staff, of about 32 people, consisting of lawyers, examiners, other professionals, and support personnel. The staff assumes sole responsibility for the vast majority of customer protection proceedings SIPC initiates, with the team of lawyers and examiners managing all aspects of the case and claims.

A network of skilled professionals with expertise in brokerage operations and liquidations is available to it nationwide to assist in the process. For larger or unusually complex cases, SIPC retains an outside trustee and counsel to carry much of the day-to-day burden of managing a liquidation, though its lawyers and examiners remain primarily responsible for the case and claims and supervise retained experts closely. This model, invented at SIPC's founding by SIPC's initial leadership who helped draft SIPA and implement it, has served SIPC and securities customers well and continues to do so. As an example, the outside trustee and trustee's counsel in the Lehman case deploy more than 100 lawyers on the case, half of whom devote substantially their entire practice to that one case for nearly two years already. It would be foolish to expand SIPC itself to be so equipped.

SIPC is organized into two primary divisions, whose heads are officers of the corporation who report directly to the President: the Legal Division and the Operations & Finance Division, with the latter sub-divided into three further units, Operations, Finance, and Information Technology. The Legal Division is headed by SIPC's General Counsel and Secretary, and staffed by a total of six full-time attorneys, including her. They hold various titles designating seniority: General Counsel and Secretary (both officer positions); Senior Associate General Counsel; Senior Associate General Counsel for Dispute Resolution; Associate General Counsel; Assistant General Counsel; and Staff Attorney. There is also a Law Librarian/Paralegal, who provides vital assistance with document maintenance, and two legal secretaries. There is another legal secretary slot that is currently vacant.

SIPC's Operations and Finance Division is headed by a Vice President, an officer of the corporation, and each sub-division by an Assistant Vice President (of Operations, Finance, and Information Technology). Within Operations, there are three Senior Examiners and one Examiner. All are supported, adequately, by two secretaries. Within Finance, there is a Cash Manager, Manager – Accounting (supported by an Accounting Supervisor reporting to Manager – Accounting, and a staff accountant below that) and a single person wearing three hats (Manager-Member Assessments/Human Resources/Plant and Facilities), all supported by three clerks. Within Information Technology, there are two staff workers, imaging coordinator and computer support specialist. About a dozen additional support staff round out the operation.

2. Documentary Support. SIPC maintains exceptional written materials succinctly reflecting the accumulated wisdom of its personnel over four decades. Primary governance documents are a comprehensive Trustee's Guide, of particular value to the lawyers in the Legal Division, and a detailed Operations Manual, of particular value to the examiners in the Operations Division. In addition, SIPC has recently updated its statement of internal Organizations and Responsibilities, identifying functions of the Divisions, containing an organizational chart, and listing all current staff members. The Securities Investor Protection Act provides specific guidance for SIPC operations and staff responsibilities. SIPC's By-Laws and Personnel Guide contain codes of conduct and statements of business ethics. The By-Laws also contain governance provisions at the levels of directors, officers and members. The Personnel Guide also contains provisions about employee duties and benefits. The Finance Division maintains assorted guides and materials concerning accounting procedures and policies.

SIPC's annual reports mirror the leanness and simplicity of the corporation's operations. Its 2009 edition consists of a transmittal letter to the SEC, a succinct Chairman's message, an overview of SIPC, list of directors (with photographs) and officers, summary of customer protection proceedings, discussion of membership and the SIPC fund, a summary of pending litigation and other actions, an auditor's report and accompanying financial statements, followed by a table depicting the historical size of the SIPC fund since inception and a series of appendices capturing full historical distributions to customers, five-years of revenue-expense analysis, and data on pending and recently completed customer protection proceedings. This gives a useful and comprehensive picture of SIPC, all in 35 pages of clear presentation. It also offers a CD in its back cover, containing extensive additional information, including a copy of SIPC's brochure and applicable member rules.

3. Technological Support. SIPC's general computer system provides office-wide access to all case materials, including legal documentation in pending and past cases and related forms. Virtually all archival materials are preserved using modern imaging techniques. SIPC maintains computer operations in its Washington office backed up by separate facilities off-site in Virginia, further backed up using a third-party service provider at a site in another nearby state. These practices, initially prompted by anticipated national challenges ahead of the turn of the millennium (the so-called Y2K bug) and enhanced by the terrorist destruction of computer capabilities on September 11, 2001, follow prevailing business practice.

SIPC is in the midst of a computer enhancement project that will enable customers to prepare and file claims on-line and examiners to review them electronically. That's important because, until now, as the SIPC Web site acknowledges, speaking to customers: "You can't file your SIPC claim form electronically, but you can use this Web site feature to fill out your form and print it out. You must still copy the completed form, all attachments, and then mail the original to the designated address."

In response to recommendations GAO made in 2001 and 2003, SIPC updated its Web site and brochure to clarify that investors should register brokerage firm complaints with those firms; expanded statements discussing market risk and SIPC coverage; and amended its By-Laws (Article 11, 4§ (a)(6)), concerning member advertising, to require firms displaying a statement about SIPC coverage to include links to SIPC's Web site. SIPC also added to its brochure links to its Web site offering information concerning investment fraud.

C. Human Resources

1. Expertise. SIPC's staff commands rich and varied experience and boasts extensive reservoirs of knowledge. The staff seems to treat SIPC as a destination career site, with seven of its current personnel originally employed by SIPC in the 1970s, shortly after its creation, and another one-third of the staff each beginning employment in the 1980s and 1990s. Average current employee tenure is approximately 18 years, down slightly in the past two years due to retirements of two veteran employees and hiring of six new staff members. SIPC's President has been employed by SIPC since 1975 and is a former SIPC General Counsel; its current General Counsel has been employed by SIPC since 1983; its current Vice President – Operations and Finance started in 1998; and its Assistant Vice Presidents for both Operations and Finance both began working at SIPC in 1973.

All SIPC's lawyers were hired laterally (not just out of law school), have distinguished academic records, and collectively a laddered degree of experience (being out of law school, 37, 32, 26, 18, 11, and 3 years, respectively, and varying in age accordingly). All the examiners were also hired laterally, usually with extensive (multi-decades long) experience in back office brokerage operations. They are individually and as a group older than the lawyers. The Finance

Division likewise boasts seasoned experts and, like the Legal Division, staff varies widely in age. The Information Technology Division is small, consisting of a Vice President and two staffers.

2. Recruiting and Training. All professional staff hiring is done laterally. The Legal Division emphasizes academic achievement; the Operations Division emphasizes back office brokerage experience. As a result, and given that SIPC's overall staff is small, SIPC does not maintain any formal in-house professional training programs. Lawyers and examiners, with experience in other organizations, bring skills with them. Even so, lawyers may have experience and skills in securities and litigation generally, but that may not include brokerage firm liquidations or even bankruptcy; examiners are assumed to have extensive experience in back office brokerage operations and that may include brokerage liquidations but not necessarily. Training of new recruits consists primarily of assigned reading of internal documents, especially the Trustee's Guide for lawyers and Operations Manual for examiners, along with ad hoc direction and supervision in early cases by senior staff in the respective Divisions. Aside from professional training, SIPC technology experts offer training in computer and software applications.

3. Culture. SIPC's small personnel size makes for a lean and nimble organization. SIPC's statement of Organization and Responsibilities succinctly delineates the functions and responsibilities of each Division. Some functions require involvement of more than one Division, particularly between its Legal Division and Operations Division concerning presenting financial information in court documents and relations with external trustees, but clearly divides responsibility and calls for cooperation.

In response to my questions of people in both Divisions, there's evidence of full adherence to that cooperation requirement. Those interviewed, in all Divisions, expressed enthusiasm for colleagues, within and across Divisions. Examiners and lawyers alike emphasized that work tends to be done in groups, with ongoing consultation among examiners and among lawyers. People often described SIPC as akin to a family, where people all get along and work for the common good, acknowledging the occasional disagreement or pique. Reports indicate that staff gathers annually for regular outings and that more informal socializing occurs; many employees regularly exercise in the gym within SIPC's building that's free to employees of the building's tenants. That building and SIPC's offices are first class modern professional facilities in downtown Washington DC, offering a comfortable work environment.

The long length of service of many SIPC employees demonstrates employee satisfaction, institutional loyalty, and the opportunity for internal advancement. The continuing recruitment of others over recent years shows SIPC's appeal as an employer. SIPC's statement of Organization and Responsibilities lists the entire SIPC staff, starting with the Chairman and President, and including the receptionist, mailroom and other clerks, and secretaries. That reflects a healthy and inclusive organizational identity. There is no mandatory retirement age (though the SIPC retirement plan contains provisions keyed to age) and many staff members have worked and do work well into their seventies.

4. Compensation and Benefits. Just as SIPC is not part of the federal government, its salary system is independent of the federal government and its compensation scale. Nevertheless,

SIPC monitors government pay scales and levels of private industry compensation. SIPC's scale probably falls somewhere in between the two. Compensation and employee performance are reviewed annually by an employee's direct supervisor; compensation of officers is set by the Board. SIPC's benefits package includes a retirement plan, savings plan, flexible spending account, and health, life and long-term disability insurance coverage. SIPC also pays the cost of continuing education, such as for CPE and CLE credits, and absorbs the cost of professional fees including state registration fees for attorneys and accountants. The corporation also pays for work-related seminars for all employees. SIPC does not pay for tuition to cover finishing a college degree or earning an advanced degree.

No components of SIPC employee compensation involve any form of incentives to achieve particular results. In fact, the entire operating framework—from the SIPA statute throughout internal operations—is designed with essentially neutral incentives, focused on expeditious customer protection. The staff members get no more or less whether they open and close a particular case or any given number of cases or recover any particular form or amount of customer property. There's no sense of conflict between paying brokerage customers and preserving the SIPC fund, given that most customer distributions are recovered from firm assets and how supplemental resources in the fund and available lines of credit are ample. Staff members acknowledge psychic satisfaction when they are able to call customers to inform them they are protected and covered under valid claims.

5. Leveraging by Outsourcing. Though SIPC prefers to rely upon its internal staff whenever possible to handle legal and operational aspects of all customer protection proceedings, it also regularly relies upon outside consultants to assist examiners when serving as trustee and engages trustees and trustee's counsel in other cases. SIPC staff remains primarily responsible for all aspects of any proceeding and work alongside of and supervise closely those outside experts. Consultants and trustees tend to be selected on an ad hoc basis in light of particular needs of a case, geographic location, and the need to choose professionals immediately. Several prominent New York law firms have partners who have developed a specialty in SIPC proceedings. Outside trustees SIPC selects are usually partners at such firms who in turn retain their law firm as trustee's counsel. That approach is highly efficient and minimizes conflicts; to resolve conflicts that may arise, the trustee may also retain a separate boutique law firm.

SIPC maintains careful policies governing retention of external consultants and their compensation. Retention policies include maintaining data bases of approved consultants and associated oversight as recommended in a 2004 report made by Corporate Review Services after an isolated case of a SIPC examiner charged with receiving kickbacks from third-party vendor assignments. On cost containment, policies include seeking discounts, commitments that quoted rates remain in effect for at least one year, and assurances that work will be performed by the least-costly competent personnel. Pricing appears to be competitive, with plenty of consulting and law firms available who prize working with SIPC. For complex litigation assignments, budgets are requested, and invoices mandated quarterly (or monthly for large cases during busy periods), in accordance with SEC recommendations made in 2003. (See Trustee's Guide, page 11-3.) Likewise in accord with those recommendations, all fee discussions and negotiations are documented, usually by exchanges of emails. Legal fees are subjected to numerous rounds of review, first within the outside firm, then between the SIPC lawyer assigned to the case, followed by SIPC's general counsel, and ultimately subject to court approval.

D. Oversight

SIPC's entire substantive operation is dictated by the Securities Investor Protection Act and SIPC is subject to extensive and periodic review and oversight by numerous organizations. These include Congress, the SEC, the GAO, various judges overseeing its customer protection proceedings, and its regular outside auditor, of recent years, Grant Thornton. Reviews of input from those and other organizations in the past decade indicate that SIPC is responsive. SIPC also faces de facto oversight from securities brokerage customers nationwide and the outside attorneys serving from time to time as external trustees and trustees' counsel. Occasionally, as in the aftermath of the Madoff fraud revelation, SIPC faces the scrutiny of media and even of advocates in private civil litigation. The Task Force in June 2010 opened a separate Web site to solicit input into its process from members of the general public.

III. Report and Recommendations

Before offering a series of recommendations for consideration, I note two modernization projects underway or recently completed that should be sustained. The first is enhancing SIPC's customer liquidation processing computer system to enable claimants to prepare and submit claims over the internet. This will also enable SIPC examiners to review submitted claims and support documentation through SIPC's in house computer system and to evaluate and determine claims through that system. This process should be completed by year end and any resources the Information Technology Division requires to complete and sustain it should be provided.

The other is the revised statement of Organization and Responsibilities, dated as of May 2010, prepared for the Modernization Task Force and updating the previous version dating to 2000. This version adds a SIPC organizational chart. Though some are not enamored of the utility of such a chart, it represents prevailing best practice and is useful in thinking about an operation and its people, even for a small group like SIPC.

A. Technical Document Updates

1. Statement of Organization and Responsibilities (May 12, 2010). SIPC's new statement of Organization and Responsibilities is substantively excellent, particularly its delineation of the functions and responsibilities, especially of the relation between the Legal Division and Operation Division concerning matters where issues overlap and require inter-Divisional cooperation. Producing this statement obviously required input from various Divisions and personnel. The input appeared to vary. That may reflect differing outlooks of the respective Division heads. Even so, some harmonization may be warranted, in part because of how the variation may suggest underlying points warranting improvement.

All employees are listed. Biographical highlights are abstract and limited, suggesting what's seen as most important. The singular detail is the starting employment date at SIPC. That seems a matter of pride worth highlighting. Other details vary, some noting prior experience and some not. Some people have college or advanced degrees and some do not, at least one has an advanced degree that isn't listed; those who do not are listed as having attended a given college or as having attended or completed high school. Closer attention to presentation and uniformity in this document may be warranted.

Policy information concerning the Legal Division is incrementally more detailed than that for the other Divisions. It explains (p. 5) that the Legal Division "functions as much like a law firm as a corporate environment permits." That means performing most SIPC legal services internally, except in rare cases, and explains why SIPC puts "emphasis on high academic standards and litigation experience" in recruiting. (This is suggested by but not detailed in the abstract biographical data appearing beneath each lawyer's name, with the staff having earned law degrees from Georgetown University, New York Law School, St. John's University, University of Pittsburgh, Columbia University, and Fordham University. Undergraduate degrees are not listed. I understand that one of the lawyers also holds an advanced law degree, the LL.M., though this is not listed.)

The Operations Division's parallel page does not describe what it emphasizes in recruiting or why. My review indicates that it emphasizes practical and comprehensive back office brokerage experience. It may be worth stating that. Accompanying biographical notes state that experience for two senior members of this Division (24 years for the Vice President and 23 years for a senior examiner) but not for the others (I found out that one has more than 20 years and another has nearly 30 years of experience). The four employees designated as examiners are all shown to have attended identified colleges, without earning degrees. Listing their brokerage experience seems desirable.

The Finance Division's parallel page also does not describe what it emphasizes in recruiting or why. All personnel but two (a secretary and a member status clerk) earned college degrees (the phrase High School appears under the names of those two). The description of its functions and responsibilities emphasizes handling mostly SIPC's administrative affairs, including internal accounting, retirement plan, member assessments, and SIPC's credit agreement, along with administration of debtor estates. In practice, although the Finance Division occasionally handles administration of debtor estates, and easily has the capacity and expertise to do so, most of that work is handled by external trustees or other consultants. The Information Technology Division is also silent on recruiting criteria, though it's small, consisting of an AVP and two others (one with the phrase High School appearing).

2. Trustee's Guide (undated). The Trustee's Guide appears to be a generally reliable guide to the law and practice of customer protection proceedings under SIPA that SIPC carries out. Newer lawyers in the Legal Division and lawyers working for trustees or counsel attested to the value of this Guide. My own impression is that it provides a comprehensive and detailed reference for trustees, whether within SIPC or external. It seems to be a vital tool of SIPC's corporate governance. It is written clearly, contains copious statutory and other references, and includes extensive exhibits of repeatedly used legal forms and other materials central to a trustee's duties. It appears to have been prepared by senior or former lawyers in the Legal Division and shows a considerable exertion of effort to consolidate relevant and useful information in one place.

That said, the Trustee's Guide is undated but looks dated, other than a few pages that have obviously been updated recently. The first recommendation is to date it and consider preparing annual updates with complete incorporating revisions every five or so years. It shows its age in several ways, many trivial but some important and all worth updating now. I have not compared the Trustee's Guide to relevant statutory requirements as these may have been amended since the last publication, and a legal review of that may be warranted. I also understand that some advanced complexities in the Lehman case require addressing matters beyond the Guide's scope. To the extent those issues may recur, lessons from that proceeding should be incorporated into the Guide and its exhibits.

A cursory review shows that the Trustee's Guide appears to have been written before the proliferation of voice-mail, e-mail and the dawn of the internet. Examples that should be updated include the following. Add electronic passwords to the list of things the trustee should secure (p. 2-2: "get keys, burglar alarm codes, combinations, or anything else which will facilitate entry into the premises and files or offices") and to change (p. 2-2, referring to changing locks on doors and safes). When directing trustees to post a sign on the brokerage's office listing name, address and telephone number (p. 2-2), add the trustee's e-mail address and any Web page. When advising trustees to assume control of mail (p. 2-3), add e-mail. Add computers and internet access to the list of necessary services that trustees must maintain that now lists telephone, electricity, and water (p. 2-7). In the references to various kinds of leases (p. 2-7), add a reference to computers. When telling trustees to respond to answering machine messages and letters (pp. 3-1 and 3-2), change the reference to answering machines to voice-mail and add e-mail and advise updating any internet Web sites.

All these examples prompt suggesting creating a separate section to the Trustee's Guide on updating or creating an internet Web site for the failing firm and its liquidation. That would also be a logical place to discuss SIPC's new technological capabilities relating to submitting and reviewing customer claim forms on line. That page or other sections of the Trustee's Guide might discuss other examples of technological modernization the current version addresses but that are less obviously outmoded. These include the reference to making publication in newspapers (p. 5-2) and a suggestion to consider updating that to include publication on a firm's Web site or for trustees to create a Web site. Another example concerns references to getting stock price quotes from *The Wall Street Journal* (p. 5-2), which does not publish the comprehensive list it once did, and suggesting updating that to reference reputable online sources like Yahoo Finance or E-Trade.

A few other minor questions or suggestions concerning technology arise. The Trustee's Guide references (p. 5-1) short retention periods by clearing brokers for computer tapes. I wonder whether that is still true. Page 11-4 refers to a SIPC spreadsheet formatted in Quattro Pro; it says that will be sent to the trustee on diskette, but now that's probably sent by e-mail attachment. There are references to the NASD that should be updated to FINRA (examples appear on pages 5-2 and 18-1). Also showing signs of age is the reference on page 8-1: "If there will be a distribution of a large block of securities, review Exhibit 26 and consult with SIPC's legal staff." Exhibit 26 is a 1972 document and I wonder whether it is still current. For the avoidance of doubt, I suggest updating the 1972 document by rewriting it in the form of a currently dated memorandum.

Statements on page 17-1 should also be updated. These refer to R.M. Smythe & Co., Inc., at 170 Broadway, New York, New York, as in the business of appraising non-marketable securities. Smythe was acquired in 2008 by Spink and is now called Spink Smythe, and its current address is 145 West 57th Street (18th floor), New York, New York 10019, telephone 800-622-1880, and its internet address is www.spinksmythe.com. The Guide adds that Smythe publishes a reference book called "*Robert D. Fisher Manuals of Valuable and Worthless Securities 1926 to 1971*." It appears that the suffix (referring to years) has been dropped from that volume's title. The Trustee's Guide also says that Smythe will research whether seemingly worthless securities actually have value and, if so, will sell them through Herzog and Company, taking a fee. It's worth verifying whether Spink Smythe still does that through Herzog. The Guide says that Smythe is the "only firm in America which performs this type of research." An SEC web site page suggests there may be others, including Financial Information, Inc., publisher of *Financial Stock Guide Service*.

As a question of style, this edition of the Trustee's Guide invariably uses masculine pronouns, which is no longer the norm for corporate documents in America. (An exception appears on page 11-4 where reference is made to "his or her." Related pages, discussing reviewing fee applications of trustees and counsel, were obviously updated around 2003 after the SEC made related policy suggestions on that subject.) Of minor importance, but worth doing if updating the Trustee's Guide: the Guide's dozens of exhibits are referenced out of order, with Exhibits 27, 28, and 29 referenced on page 1-4, and references to other exhibits, beginning with exhibit 1, appearing on page 2-1 and later pages. Similarly, the Guide's index of exhibits as they appear in the accompanying CD presents them in a random order; the list should be revised to appear in alpha-numeric order. It would also be helpful to include in the list of exhibits a cross-reference to pages in the Guide where exhibits are referenced or discussed.

3. Operations Manual (August 2004). The Operations Manual offers a clear and comprehensive guide of great utility to examiners within SIPC and to consultants they may retain from time to time. It is clearly written and makes the process easy to understand. The Operations Manual manifests a valuable repository of accumulated practical wisdom essential to the liquidation process. I understand that it was last updated in August 2004, in a project led by an examiner recently recruited at that time. It could now use some updating, though its content and style makes it appear less outdated than the Trustee's Guide (including its routine use of both masculine and feminine or neutral pronouns). For example, the Operations Manual should be updated to reference the internet as a resource in several places (an example appears on page 16 when discussing dealing with a debtor's office space) and to change occasional references from the NASD to FINRA (e.g., p. 27).

Concerning the Operating Manual's style, there is some duplication of text in the Trustee's Guide. (Examples appear on p. 12, Public Relations; p. 15, Immediate Actions of Liquidation Proceedings; and p. 23, Bank Loans.) This duplication may be intentional and desirable, to the extent that the two resources are of primary value to different professional groups, lawyers and examiners, who may not be assumed to read both documents. But that may be doubtful and in any event worth noting. In addition, the paragraphs on page 40 (concerning allocation in connection with an account transfer) and page 41 (on final housekeeping matters) span nearly a full page each. They should be broken up into multiple paragraphs. Once broken up, the discussion of final housekeeping may warrant unpacking and expansion, as it seems to condense important steps into dense prose unlike the clarity in the rest of the Manual. It compresses topics I would expect to see spelled out in an operations manual.

As with the Trustee's Guide, of like minor importance but worth doing if updating the Operations Manual, the exhibits are referenced out of order. (For example, exhibit 3 is first referenced on page 11 while exhibit 2 is first referenced on page 15; and on page 32 a series of exhibits appears in this confusing order: 4, 5, 8, 9, 11, 7, 10, 6). Also as with the Trustee's Guide, it would help to include in the list of exhibits (p. 42) a cross-reference to pages in the Manual where they are referenced or discussed.

Page 25 of the Operations Manual says: "The Trustee should bring any Repo transactions to the attention of the SIPC attorney assigned to the case." This reads as if it was inserted as a one-off addition when a more comprehensive approach may be warranted. I can see why this is not delineated, given the potentially uncertain classification of such transactions as securities or not. But there are likely other instruments that defy easy classification that may warrant similar direction too—as discussed next.

B. Expand Document Wealth

1. Current Practices. The Trustee's Guide and Operations Manual cover substantial territory and may have been comprehensive when originally published and most recently updated. Since then, however, developments may have occurred that warrant considering additional documentary support, either as parts of those documents, as exhibits, or as stand-alone resources. In the spirit of the modernization motif, it's clear that many of today's brokerage firms and securities products differ substantially from those that existed during the first several decades of SIPC's existence. That is certainly true of larger firms, like Lehman, and is also likely true of many other SIPC members.

The sheer volume of brokerage and securities activity has led to firms that are more decentralized and have staffs with more specialized tasks and assignments. The pace of innovation in securities products has accelerated rapidly and results in a variety of securities well beyond stocks, bonds, shorts, options, and even repurchase agreements, to include a bewildering array of structured products, derivatives, advanced forms of options, like long-term equity appreciation securities (LEAPS), and other instruments, held in additional kinds of accounts, like portfolio margin accounts. These developments and how examiners and trustees may be expected to handle them—when, whether and how to close them out, under the Series 300 rules of the CFR, for example—may warrant capturing in documentary form, as a repository of collective and accumulated wisdom and experience among SIPC's staff, both in the Legal and Operations Divisions.

In some ways, the two groups have different needs and may have different interests. Examiners are interested in clarity concerning such matters as whether particular financial instruments are securities within the meaning of that term of art or not, and how to handle them; some lawyers may desire like clarity, though others may be more willing to leave contestable classification issues like that to particular contexts when they arise. Even so, some effort to synthesize the variety of firms and products could be fruitful. That may be particularly useful to enable staff with more recent maturation points to share cutting edge knowledge with veterans for whom the pace of innovation and change may seem overwhelming. It's a way to consolidate knowledge that likely would prove useful to new recruits to both Divisions, whatever wealth of experience they may bring with them to SIPC.

That can also provide an organizational road map for dealing with problems that can be foreseen though faintly. A comparative historical example may illuminate. SIPA was amended in 1978 to require trustees to replace customer securities with open market purchases. That change was made without any advance planning and there was no written reflection or guidance about what that would involve or how a trustee should proceed. Within SIPC, a consensus emerged merely to muddle through the process without formally stating policy in a manual or otherwise.

As it happened, that approach worked reasonably well and trustees developed procedures and practices informally and case by case over time to implement that statutory requirement. But it remained true that advance written guidance would have been helpful in many cases. In today's world, with greater complexity, and a more conscious tendency for organizations to adopt formal written manuals on various subjects concerning operations, attempting to articulate aspects, issues, and resolution procedures concerning brokerage firms and securities products may be warranted, all in the spirit of modernization.

2. <u>Consultants/Trustees Data Base</u>. Despite considerable internal expertise, it's common for SIPC staff to engage outside experts on various matters, including when examiners engage accountants, consultants and others for discrete tasks, and when lawyers retain external trustees and trustee's counsel. The Vice President – Operations maintains a data base of consultants and this is reportedly available to examiners. That list includes information they supply about themselves and capabilities. There are as many as eight to ten based in New York and others of smaller size scattered nationwide. For trustees (and counsel), a dozen easily-recognized large New York based firms are available for most cases (with about four tapped regularly throughout SIPC's history); for smaller cases elsewhere in the country, the legal team finds local counsel in local areas when needed using customary techniques for identifying legal professionals.

But it was not obvious in my review that all examiners or lawyers are aware of such data bases, access them regularly, or can readily identify required expertise quickly. I understand that this may be due to how retention of external professionals is determined at SIPC's officer level and in accordance with other policies recommended in the 2004 Corporate Review Services report. Even so, given the varying complexities and needs of different liquidation cases and the value of consultants having just the right expertise for a job, and familiarity with SIPC (see Operations Manual, p. 14), it may be desirable to provide staff-wide access to data bases of consultants and trustees on whom examiners and lawyers can call as needed. Ideally, the data base would include not only information the external professionals supply but notes on previous SIPC assignments completed, and brief notes on its value and cost. This could simply involve incorporating into the data base evaluations of external consultants made at the conclusion of cases. That may be helpful to relatively newer SIPC staff and may also formalize a pool of potential future employees SIPC may from time to time wish to recruit.

C. Human Resources Investment

1. Recruiting and Training. It's vital to SIPC's continued success that it be able to recruit capable professionals in all its Divisions. Among staff in the Legal Division and Operations, it's essential that professionals be familiar with ongoing securities brokerage business developments and practices, able to work toe-to-toe with trustees and their counsel and outside accountants and other consultants. Ideally, the professional staff would consist of persons across the career ladder, to enable the team as a whole to possess the range of value that comes from a combination of veteran experience along with energetic new perspectives. That facilitates the transmission of senior knowledge down the career ladder and mutual education about evolving trends and practices.

The Legal Division's current composition approximates that ideal, with its members each separated roughly by a decade of seniority and representing all cohorts. The Operations Division, in contrast, tends to be congregated among more senior personnel, making it, as one noted, "a bit long in the tooth." It could be desirable to plan a recruitment program to address that imbalance. One reason for the difference in the Divisions may be due to the required skill set or recruiting philosophy. Recruiting of lawyers at SIPC emphasizes academic achievement along with some securities litigation experience. Lawyers younger and older will qualify and find the job offer strongly appealing.

The Operations Division emphasizes back office brokerage experience, with less emphasis on formal education. And in today's brokerage environment, with highly specialized tasks, there are simply fewer people towards the earlier career stages who have seen the broader range of back office operations. The result may be a natural and rational propensity to recruit in the more senior ranks. That's may be optimal, so long as a continuing supply of talent is available. But it does reduce the particular and overall length of service examiners have with SIPC. One solution is continuing to recruit examiners for SIPC from among the group of outside consultants used in other customer protection proceedings. Another would be a combination of accepting less experienced applicants with beefed up training may be useful. That said, it's notable that kindred recruiting challenges seem to appear at cousin organizations in Washington, such as the FDIC and SEC.

2. Officers. SIPC's existing organizational structure is coherent, essentially dividing the corporation into two Divisions, Legal and Operations/Finance, with one officer overseeing each and each of them reporting to the President, the only other officer. The Operations/Finance half of the corporation is further segmented into those two components, each overseen by an Assistant Vice President, plus a technology sub-division. SIPC's By-Laws don't exactly map onto that reality, though. They contemplate as officers a Senior Vice President – Finance, a position that's not presently occupied, along with a Vice President for each of Finance and Operations, positions currently combined and held by a single individual (as the By-Laws authorize). Given existing governance realities, however, it seems that if SIPC wished, for

promotion, retention, or recruitment, to name a Senior Vice President, the role would be at least as desirable overseeing Operations as Finance. Adding such an authorized officer to the By-Laws, a Senior Vice President – Operations, may thus be desirable.

It's also notable that two other officer positions authorized in the By-Laws, Controller and Treasurer, are not presently occupied. Instead, the current Vice President – Operations and Finance oversees the non-officer Assistant Vice President – Finance, who discharges related functions. This comparison of the By-Laws to existing entitlement indicates that there is room within the organizational structure to recognize achievement and provide advancement, should that be desirable. It's not possible to make any particular recommendations in this regard, as nothing has come to my attention that would justify any, but the built-in flexibility and other points warrant noting.

3. Professional Development. The Trustee's Guide contains as exhibits two law review articles published by SIPC lawyers, one by its current President and former General Counsel when he was Assistant General Counsel (1982) and one co-authored by its current General Counsel when she was Associate General Counsel (1990) (her co-author was then SIPC's Deputy General Counsel and later its President). These are excellent, and oft-cited, overviews of much of what SIPC does and its statutory mandate. They were undoubtedly valuable exercises for those authors and useful contributions to the field when published two and three decades ago. It may be desirable to encourage current SIPC lawyers to consider undertaking similar contemporary endeavors, as suggested by a more recent (2006) shorter piece by its President (and former General Counsel) and Associate General Counsel appearing in the American Bankruptcy Institute Journal. It could be particularly interesting and valuable to provide case studies of the customer protection proceedings arising out of the Lehman insolvency and Madoff fraud.

More broadly, it could be desirable to increase support for external training of the professional staff. That certainly includes maintaining existing support for periodic professional development events. More important, it would include tuition support to complete unfinished college degrees and for advanced specialized degrees relevant to the field. Four of SIPC's six examiners (not the Vice President or Assistant Vice President) attended college but did not complete it or earn the degree. For any of those who may find it desirable, and have the time, it would be a wonderful employer outreach to support that, as many other modern corporations do. That may be an especially appealing tool to help address the recruiting challenge discussed earlier. Likewise, all SIPC lawyers obviously earned their J.D. degrees, and one holds an advanced law degree, the LLM (in tax law). If any of those should wish to pursue an LL.M., especially one focused on securities law or other related specialty, it would be an appealing show of professional support for SIPC to back that, again as many other modern corporations do.[1]

[1] Corporate examples include large corporations like JC Penney and Northrop Grumman; quasi-public agencies like the Port Authority of New York and New Jersey; and smaller enterprises like WaWa Corp. Human resource management firms like Cerdian can help. *See* www.ceridian.com/employee_benefits_nav/1,6267,15689,00.html. There are tax-advantaged and tax- limited ones. *See* www.finaid.org/otheraid/employertuitionassistance.phtml.

D. Substantive Document Updates and Highlights

1. Compensation Policy for Outside Consultants. Aside from employee salaries and benefits, SIPC's largest category of operating expenses, important expense line items reflect legal, accounting, and other professional fees. Though obtaining excellent professional services is the paramount concern, SIPC maintains policies designed to contain those costs and SIPA addresses this by requiring court approval of certain fees. Policies include those emphasized in the 2004 Corporate Review Services report addressing controls to prevent improprieties in retaining and paying external consultants. They include policies such as the Legal Division has of asking for litigation budgets from retained outside counsel. They include suggestions the SEC made in 2003 concerning requesting invoices at least quarterly and, for large cases during great activity periods, monthly. SIPC policies also speak to requesting discounts for services and assurance that quoted rates will remain in effect for at least one year.

They also routinely reference language such as the following. Concerning fees of trustees and trustee's counsel, the Trustee's Guide states: "Tasks which can be competently performed by an associate should not be performed by others whose time commands higher rates." Trustee's Guide, pages 1-3 and 11-1. The Trustee's Guide and the Operations Manual amplify that point for compensation of all external consultants, whether trustees, counsel, accountants, or others, seeking an "understanding that the firm will use persons with the lowest grade who are qualified to perform the tasks required." Trustee's Guide, page 12-1; Operations Manual, page 13. These expressions and others reflect a commitment to compensation based on hourly rates. The SEC's intervention clearly contemplated fees for legal services based on hourly rates, suggesting that hours be classified in designated categories, and the Trustee's Guide requires fee statements to provide detailed record of time expended, including the number of hours and the hourly rate. Trustee's Guide, pages 1-2 and 12-1.

Though hourly rates, performed at lowest-priced competent levels, may contribute to ideal cost containment policies, it's important to appreciate that SIPC's practices do not adhere rigidly to this model. They are more congruent with current developments in professional fee practices that increasingly depart from both the hourly rate and the formulation about least-cost competent providers. This is especially so in the legal profession, though extends to other professional service providers too.

Law firms traditionally grew through associate leverage for profitability. The business model admitted large numbers of young associates, paying $80 per hour (say $160,000 for a 2000 hour year) and billing them at $180 to $250. Firm partners made money and enticed some associates to make partner. Today, corporate clients have become stronger, with in-house counsel wielding more power. Many don't accept the leverage pyramid structure anymore or fund it. They say something like: "I'll pay $750 per hour to get advice and representation from a true expert, but won't pay $250 per hour for an associate learning what they're doing." Examples abound. The "Value Challenge" issued by the Association of Corporate Counsel calls for corporate clients to move away from hourly billing altogether.[2] Some ACC members are refusing to pay anything for work done by anyone without at least two years practice experience.

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[2] See www.acc.com.

SIPC's own practices reflect these developments and, of course, even its written policies about external compensation are not inconsistent with it. Significant discounting occurs, including a considerable discount for the trustee and its counsel in the Lehman case. The law firm has reduced its monthly billings for hourly rates significantly and isn't charging, as other firms do, for the cost of meals and transportation. SIPC pursues such flexibility in other ways, including negotiating to adjust for the value of services rendered without slavish adherence to hourly billings or rates. When feasible, contingency fees are used, especially for collection cases, though that's only feasible for matters with discrete outcomes. Accordingly, it may be desirable to update SIPC's written policies to reflect its flexibility in practice as a way to assure that this knowledge is communicated to newer SIPC staff and to external consultants, trustees, and trustees' counsel.

Modest adjustments to the existing language may be all that's warranted. Examples may include: "Though SIPC is accustomed to accepting proposals and fee applications based on hourly rates using the least-cost competent personnel, overall cost for outstanding professional value is what's sought. SIPC is interested in discussing alternative billing arrangements, which may include fixed pricing for discrete assignments and/or involving higher-cost personnel to perform assignments in less time so that, on balance, least cost is achieved with greatest professional skill."

2. Highlighting Vital Statements. Modern corporations, including those of SIPC's size, tend to have adopted several specific manuals or statements. Standard examples are mission statements; codes of corporate ethics; and policies concerning internal control. SIPC already has versions of materials like these scattered in various governing documents but it could be beneficial to highlight these vital statements differently. Doing so should not result in complex documents or foster bureaucracy within SIPC or diminish its nimbleness and family spirit. They should embrace a positive sense of mission, ethics, and compliance.

A mission statement may seem like a redundancy within SIPC, given the clear and often repeated directive derived from SIPA to promote investor confidence by providing protection to customers of securities brokers and dealers. Yet that would also render the task of producing a mission statement easy, and the statute doesn't exactly use those phrases. There is a widespread view among SIPC personnel, and among outsiders, that SIPC's mission and their jobs are particularly noble. They are to protect customers by returning cash or securities in failed brokerages, and "within statutory limits, to replace such cash or securities when they are missing. That's an easy mission statement to write and would both cement and build morale. It can certainly help get through difficult days or cases and can have other salutary effects.

SIPC has a code of conduct set out in its By-Laws and restated verbatim in its Personnel Guide, along with additional statements concerning seeking employment elsewhere and whistleblower procedures and protections. These are provided to all employees, who are also asked to attest to receiving and understanding them. In the past, that attestation exercise was repeated for all employees whenever the documents were amended; in the future, this will be done annually whether amendments were made during the year or not. These policies reflect prevailing best practices among corporate employers, a norm reflected in the Sarbanes-Oxley Act of 2002, which requires public companies either to adopt a code of ethics or explain why they don't.

SIPC's By-Law and Guide provisions are important statements of core values and warrant just a few suggestions. The code of conduct appears in the By-Laws in a penultimate Article labeled "Miscellaneous" (pp. 17-20). While substantively unobjectionable, that classification may wrongly signal a triviality to the provisions that should not be sent. Accordingly, it may be desirable to revise the By-Laws to add a separate newly named article containing the code of ethics. In turn, the Personnel Guide reiterates those provisions and adds material, including whistleblower policy.

It's not obvious why the additional material appears in the Guide but not in the By-Laws. Perhaps this is because the Board adopts the By-Laws, subject to SEC approval, and SIPC's officers adopt the Guide. Yet that procedural point doesn't diminish the substantive value of the full combined code of conduct and other statements of ethics. Consideration should be given to giving both sets of standards equal prominence in both the By-Laws and the Guide. (As with the Trustee's Guide, these materials also invariably use solely the masculine pronoun, something to edit when updating them.) I understand that even such reformatting of the By-Laws would require SEC involvement and approval. It still may be worth doing.

A parallel example, may help. SIPC's By-Laws also contain vital provisions concerning member advertising. This is seen as so vital that SIPC has separately created a stand-alone document presenting it, republishing it on its CD-ROM accompanying its 2009 Annual Report. A similar separate presentation of the By-Law concerning the code of ethics, combined with the additional material from its Personnel Guide, could be prepared. (As with the code of conduct, this advertising By-Law appears in the Article called "Miscellaneous." (pp. 13-17). That heading isn't proportional to the topic's vitality, which would be reflected by giving the topic its own Article.[3])

Sarbanes-Oxley imposes specific requirements for internal control over financial reporting, and most corporations maintain extensive systems for that and to assure compliance with law. SIPC maintains internal control over financial reporting on substantially, though not exactly, the same basis as prescribed by Sarbanes-Oxley and related standards promulgated by COSO and adopted by the PCAOB. Those are reviewed annually by SIPC's outside independent auditor, Grant Thornton in recent years, though only for the purpose of auditing SIPC's financial statements—not as a separate audit of internal controls as Sarbanes-Oxley requires. Such audits are costly and there is no obvious justification for SIPC to follow that practice. Indeed, SIPC occasionally has requested its outside auditor to conduct particular tests of certain controls, including whether employees received and understand SIPC's Personnel Guide, especially its whistleblower provisions. That may be sufficient. Accordingly, I do not necessarily recommend expanding the annual audit to include internal controls, but this report wouldn't seem complete without mentioning it.

* * * *

[3] If revising the By-Laws, it may also be good housekeeping to relocate another item classified as miscellaneous, limiting corporate capital expenditures, to Article 8, which likewise limits corporate borrowing, making assessments, and pledging security.

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Testimony Before the

United States House of Representatives Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises

"The Securities Investor Protection Corporation: Past, Present & Future"

Wednesday, March 7, 2012

By

Steven B. Caruso

Maddox Hargett & Caruso, P.C.

Chairman Garrett, Ranking Member Waters and members of the Subcommittee:

I am Steven B. Caruso, the resident partner in the New York City office of Maddox Hargett & Caruso, P.C., a law firm whose practice is almost exclusively devoted to the representation of public investors in connection with their disputes with the securities industry. I am a past President and a past member of the Board of Directors of the Public Investors Arbitration Bar Association ("PIABA"), which is the largest national association of attorneys whose individual law practices focus on the representation and protection of public investors in securities arbitration proceedings, and I am also the current Chairman of the National Arbitration and Mediation Committee ("NAMC") of the Financial Industry Regulatory Authority, Inc. ("FINRA"), which is the advisory group that provides recommendations on the rules, regulations and procedures governing securities arbitrations, mediations and dispute resolution activities.

[1]Admitted in IN [2]Admitted in IN & IL [3]Admitted in NY [4]Admitted in OH [5]Admitted in IN & MI [6]Deceased

In June of 2010, I was asked to serve as one of the twelve (12) members of the SIPC Modernization Task Force ("SIPC Task Force"), a group which consisted of investor advocates, representatives of the securities industry, government regulators and academia, from across the nation, as well as one international member.

The stated mission of the SIPC Task Force was to undertake a comprehensive review of both the Securities Investor Protection Act ("SIPA") and the Securities Investors Protection Corporation's ("SIPC") operations and policies, and to propose reforms to the Board of Directors of SIPC and other interested parties, with respect to statutory amendments and other operational and/or procedural refinements, as may be appropriate, given the passage of time since the original enactment of SIPA, changes that we have all experienced in the securities industry and judicial precedents and/or interpretations thereof.

I am honored to be able to have the opportunity to share with you my thoughts and perspectives on the SIPA and SIPC, from the point of view of both my professional experiences as an investor advocate and, of equal importance, as a member of the SIPC Task Force.

Historical Overview of SIPA & SIPC

When the United States Congress enacted SIPA in 1970, and created the SIPC, its stated purpose was to promote investor confidence in the nation's securities markets through the extension of certain protections against certain losses to customers resulting from the financial difficulties and/or failures of their broker-dealer firms.

SIPC is a nonprofit membership corporation whose members are, with certain limited statutory exceptions, all persons registered as brokers or dealers under Section 15(b) of the Securities Exchange Act of 1934 and all persons who are members of a national securities exchange. As of December 31, 2010, it is reported that there were 4,773 members of SIPC.

Since the inception of SIPC in 1970 through the end of 2010, it has been reported that SIPC had commenced 322 customer protection proceedings, in accordance with the requirements that are set forth in SIPA, and, during that same period of time, it is estimated that SIPC distributed cash and securities to an estimated 739,000 customers of those failed brokerage firms in the approximate aggregate amount of $109.3 billion.

The monetary resources that are required to protect and reimburse customers of failed broker-dealers are derived from three (3) primary sources – the assets in the possession of the trustee for the estate of the failed broker-dealer, assessments that are collected from SIPC members and interest that is earned on SIPC's investment in United States government securities (collectively the "SIPC Fund"). As a supplement to the SIPC Fund, the United States Securities & Exchange Commission ("SEC") has the authority to lend SIPC up to $1 billion which it, in turn, would borrow directly from the United States Treasury.

<u>The SIPC Modernization Task Force</u>

I believe that the objective of the SIPC Task Force was clear and unequivocal – to modernize SIPA and SIPC so as to ensure that its role in the protection of investors and the promotion of investor confidence in the nation's securities markets remains viable.

Beginning at the inaugural meeting of the SIPC Task Force in June of 2010 and continuing thereafter at a number of subsequent meetings and through numerous telephone conferences, the members of the SIPC Task Force discussed and debated a number of issues that were applicable to our mission statement and objective.

Among the topics that were reviewed by the SIPC Task Force were SIPC's corporate governance, adequacy of existing SIPC protection, the ongoing viability of the SIPC Fund, inherent limitations on investor protection, investor education, the misnomer of what has commonly been referred to as excess SIPC "insurance" and the relationship of all of these initiatives in the context of the international arena.

It is notable that, in connection with the efforts that were undertaken by the SIPC Task Force, an interactive website was established (www.SIPCModernization.org) through which the general public was given the opportunity to provide comments and recommendations to SIPC and each of the members of the SIPC Task Force. It is also notable that, in the course of the review that was undertaken by the SIPC Task Force, several public forums were held through which investors and other interested parties were given the opportunity to provide comments, thoughts and suggestions on the process that was undertaken.

In February of 2012, the SIPC Task Force presented its findings, conclusions and proposals for reform in a written report that was submitted to the SIPC Board of Directors ("SIPC Task Force Report"), for their consideration, and a complete copy of our report was made publicly available on both SIPC's website and the dedicated website of the SIPC Task Force.

Focus on Specific SIPC Task Force Topics

In my role, as a member of the SIPC Task Force, and based on my own personal experience with SIPA and SIPC, as an attorney who has provided representation to numerous investors in SIPC proceedings, it is my personal belief that there are a number of recommendations, that are included within the SIPC Task Force Report, which should be immediately adopted by SIPC's Board of Directors and remain a focus of the oversight responsibilities of the members of this Subcommittee.

These recommendations include, but are not necessarily limited to, the following:

1. First and foremost is the SIPC Task Force recommendation that the limitation on the maximum amount of protection that is provided by SIPC in a SIPA proceeding, which is currently $500,000 per customer, should be increased to $1.3 million and that, moving forward, the level of protection should be indexed to the rate of inflation.

The rationale of the SIPC Task Force, with respect to this recommendation, was predicated on a number of factors which included, for example, that $1.3 million would represent the current indexed value of what $500,000 in 1980 would be worth today; that the $1.3 million level of protection would be sufficient to protect more than 90% of all retail customer accounts; and that this increased level of protection would more adequately reflect the economic realities of the securities industry today and the amount of investable assets that investors entrust to their financial advisors.

2. The second SIPC Task Force recommendation is the recommendation that would eliminate the current distinction in the SIPA level of protection between "claims for cash" and "claims for securities."

The rationale of the SIPC Task Force, with respect to this recommendation, was predicated on a number of factors which included, for example, that the distinction is arbitrary and has, in the past, led to the disparate treatment of customers in SIPA proceedings; it has generated an atmosphere of confusion on behalf of the investing public who simply do not understand the distinction between the nature of the protections that are provided by SIPC when their broker-dealer firms encounter financial difficulties and/or fail; and it is a distinction that is no longer grounded in reality given the way that cash and securities are held at broker-dealers.

3. The third SIPC Task Force recommendation that I would like to highlight is the recommendation that would require amendments to SIPA so as to provide pass-through

SIPC protection to individual investor participants in defined benefit pension plans, defined contribution plans and deferred profit sharing plans.

The rationale of the SIPC Task Force, with respect to this recommendation, was predicated on a number of factors which included, for example, that there are an estimated 40 million participants who have their assets invested in privately sponsored pension plans who, under the current SIPA limitations, are exposed to catastrophic losses in the event that their broker-dealers should fail; and that these investments typically represent the retirement accounts and life savings of many indirect investors who do not have a choice as to where their assets are held.

4. And the fourth SIPC Task Force recommendation that I would like to mention in my comments today is the recommendation that would impose a minimum fee assessment of at least $1,000 on every SIPC broker-dealer member.

The rationale of the SIPC Task Force, with respect to this recommendation, was predicated on a number of factors which included, for example, a recognition of the fact that prior SIPC member assessment levels – which were historically $150 per year – were unjustifiable from an economic perspective; the amendments that were incorporated within the Dodd-Frank Act had the unintended consequence of reducing SIPC member assessment levels to amounts that were even lower than $150 per year or, in some instances, those assessments were eliminated in their entireties; and the continuing concerns as to the economic viability of the SIPC Fund itself given the potential adverse ramifications that could be associated with recent liquidations – and the potential future liquidations – of major broker-dealers.

Conclusion

Thank you for providing me with the opportunity, as a member of the SIPC Task Force, to share with you my thoughts and perspectives on both SIPA and SIPC.

I would be happy to entertain any questions that the members of the Subcommittee may have.

**TESTIMONY OF IRA D. HAMMERMAN,
SENIOR MANAGING DIRECTOR AND GENERAL COUNSEL,
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION**

**BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON:
THE SECURITIES INVESTOR PROTECTION CORPORATION:
PAST, PRESENT, AND FUTURE**

MARCH 7, 2012

I. Introduction

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee:

My name is Ira Hammerman, and I am Senior Managing Director and General Counsel of the Securities Industry and Financial Markets Association ("SIFMA")[1] and a member of the SIPC Modernization Task Force (the "Task Force") formed by the Securities Investor Protection Corporation ("SIPC"). I am appearing here today as an individual member of the Task Force and I am not speaking on behalf of my fellow Task Force members. Thank you for allowing me to submit my full statement for the record.

The Task Force undertook a comprehensive review of the Securities Investor Protection Act ("SIPA") and SIPC's operations and policies and proposed reforms to modernize SIPA and SIPC. The Task Force worked hard for approximately a year and a half, and recently presented its official Report and Recommendations to the Board of SIPC Directors. I would like to thank my fellow members of the Task Force, and SIPC's dedicated staff, for their hard work, commitment, and willingness to consider a variety of proposals. My testimony will focus on several of the Task Force's recommendations regarding appropriate revisions to SIPA.

II. Report and Recommendations of the Task Force

I want to begin by highlighting some of the important pro-investor changes recommended by the Task Force. The Task Force recommends expanding and increasing the protection available to customers of broker-dealers in three important ways. As you know, when a broker-

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1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington D.C., is the U.S. regional member of the Global Financial Markets Association. (More information about SIFMA is available at http://www.sifma.org.)

dealer is liquidated and the customer property marshaled by the trustee is inadequate to return to the broker-dealer's customers all funds and securities they entrusted to the custody of the broker-dealer, SIPC makes advances from its own funds to assure the return of the customers' property. Since 1980, these advances have been capped at $500,000 per customer. The Task Force recommends increasing the maximum advance amount from $500,000 to $1.3 million to adjust the limit to reflect inflation since 1980. SIPA also currently distinguishes between claims for cash and claims for securities, setting a lower $250,000 limit on advances to customers based on claims for cash entrusted to the broker-dealer. The Task Force recommends eliminating the distinction in levels of protection between investors' claims for cash and claims for securities, which has been a subject of controversy and a source of expensive and unproductive litigation. Finally, the Task Force also recommends a limited "pass through" of SIPC protection to make individual pension plan participants eligible for SIPC advances with respect to their share of the plan's account at a failed broker-dealer. These recommendations appropriately reflect SIPA's purpose of promoting investor confidence in the U.S. capital markets by protecting investors against a loss of cash or securities in a failure of the broker-dealer holding their property. They also reflect positive progress in the effort to modernize SIPA and SIPC.

While I support these recommendations, I wish to note that they were made without any real consideration of their cost to SIPC. This cost will be funded by the members of SIPC and, ultimately, by the investing public. Before implementing these recommendations, I urge Congress to obtain a reasonable estimate of the costs of the expanded protection and consider whether these costs would be justified by the increased investor confidence. As of this date, there has been no such analysis, and I believe an adequate analysis of the modernization of SIPA and SIPC is not possible without it, so as to ensure that well-intentioned investor protection and modernization measures do no inadvertently undercut SIPC's overall effectiveness in protecting investors.

III. SIFMA's Recommendations Not Fully Addressed by the Task Force

I am disappointed by the Task Force's failure to take action with respect to several critical areas previously identified by SIFMA. In particular, SIFMA believes it is essential to ensure consistency between SIPA and the SEC's Customer Protection Rule (Rule 15c3-3). When a broker-dealer fails and enters liquidation under SIPA, SIPA provides for the distribution of the customer property held by the failed broker-dealer to its customers, *pro rata*, based on the net value of the securities and cash in their respective accounts, known as their "net equity." Any mismatches between the Customer Protection Rule's reserve and segregation requirements and customers' net equity claims in a SIPA proceeding can result in an insolvent broker-dealer holding insufficient customer property to satisfy all customers' net equity claims. The current discrepancies between the Customer Protection Rule and SIPA were briefly addressed by the Task Force's report, which recommended further study. I believe the Task Force missed an opportunity to identify the specific discrepancies that currently exist and recommend resolutions. I also believe, however, that additional discrepancies are likely to arise as the SEC promulgates rules for the protection of securities-based swap customers, unless the SEC is given the power to make rules under SIPA that will harmonize the customer protection scheme and the liquidation process.

A. Need For Consistency between SIPA and the SEC's Customer Protection Rule

SIPA and the Customer Protection Rule must work together. The Customer Protection Rule requires each broker-dealer to maintain possession or control of its customers' fully paid and excess margin securities and deposit into a reserve account an amount generally equal to its net monetary obligations to customers or in respect of customer securities positions. When a broker-dealer enters liquidation under SIPA, the customer securities and the reserve account are available for distribution to customers. If SIPA and the Customer Protection Rule are harmonized (and the broker-dealer had complied with its obligations), the failed broker-dealer should have sufficient customer property to fully satisfy the net equity claims of all customers. Unfortunately, the two are not fully harmonized.

Perhaps the most significant divergence between SIPA and the Customer Protection Rule is the status of proprietary accounts of broker-dealers. A broker-dealer's net equity claim based on its proprietary account is a customer claim eligible to share in the *pro rata* distribution of customer property under SIPA (although not eligible for SIPC advances), but the proprietary account of a broker-dealer is not treated as a customer account for purposes of the Customer Protection Rule. As a consequence, there may be net equity claims entitled to share in the *pro rata* distribution of customer property for which no assets were set aside. In the liquidation of Lehman Brothers, Inc. ("LBI"), for instance, Lehman Brothers International (Europe) ("LBIE"), an English broker-dealer affiliate of LBI, has filed customer claims for approximately $10 billion based on its proprietary positions, but the Customer Protection Rule did not require LBI to maintain possession or control of LBIE's securities or make deposits into its reserve account in respect of obligations to LBIE. LBI's trustee has challenged the "customer" status of these claims, but if they ultimately are allowed as customer claims, the gap between SIPA and the Customer Protection Rule may cause a sizeable shortfall in the customer property available for distribution to LBI's customers.

The SEC has proposed to narrow this divergence by requiring broker-dealers to fund a separate reserve account with an amount generally equal to its net monetary obligations with respect to proprietary accounts of other broker-dealers or in respect of securities positions in such accounts. (The possession or control requirement, however, would not be applied to securities positions in these accounts, provided that written permission to use the securities is obtained.) While a step in the right direction – SIFMA has filed a generally favorable comment on this proposal – other divergences between SIPA and the Customer Protection Rule continue to exist and should be reconsidered. For example, a similar difference exists in the treatment of principal officers and directors of a broker-dealer, who are non-customers under the Customer Protection Rule but are eligible for customer status under SIPA.

B. Clarity and Consistency in the Treatment of Securities-Based Swaps

SIFMA is also concerned that, as the SEC develops the customer protection requirements applicable to broker-dealers that act as securities-based swap dealers, the divergences between the SEC's customer protection requirements and SIPA will only increase. The Dodd-Frank Act amended the stockbroker liquidation provisions of the Bankruptcy Code to treat accounts holding securities-based swaps as "securities accounts" (to the extent of any applicable customer protection or segregation requirement) but no similar amendment was made to SIPA, leaving unclear the treatment in a SIPA liquidation of customers' securities-based swaps (and related cash and securities margin). Although this issue was not addressed by the Task Force, SIFMA believes that customers who have securities-based swaps in an account at a broker-dealer generally should have a net equity claim calculated based on the value of the securities-based swaps, any cash or securities in the account, and the value of any other positions (*e.g.*, securities or commodities futures or non-securities-based swaps) in the account – at least to the extent of any applicable customer protection or segregation requirement.

SIFMA is concerned, however, that maintaining a single class of customers, which encompasses cash account customers, margin account customers, portfolio margin customers, and securities-based swap customers, may unfairly impose risks of the newer and more complex types of accounts and transactions (*i.e.*, portfolio margin and securities based swaps) on the customers who have simpler accounts (*i.e.*, cash accounts). Accordingly, SIFMA recommends that consideration be given to dividing broker-dealer customers into separate account classes, tailoring customer protection rules to each specific account class and activity in a way that provides for a separate pool of customer property for each separate account class, and, in a liquidation under SIPA or the Bankruptcy Code, distributing the customer property for each account class solely to members of that account class based on net equity calculated based on all positions in the customers' respective accounts of that class. It may be appropriate to separate customer accounts into at least the following three classes:

- Cash accounts. Cash account customers hold only fully-paid long securities positions and cash credit balances. The customer protection rules would require the broker-dealer to maintain possession or control of all securities belonging to these customers and fund a reserve account in the amount of all of their credit balances. In a liquidation of the broker-dealer, accounts in this class and the related customer property should be easily and efficiently transferred to a solvent broker-dealer or a bridge financial company (either in bulk or individually at the direction of the relevant customer).

- Margin accounts. More sophisticated margin account customers could have long and short positions and debit or credit balances in margin accounts subject to Federal Reserve Board Regulation T. This account class could generally be subject to the current customer protection rules relating to possession or control of certain securities (which allow some margin securities to be used by the broker-dealer to obtain financing related to customer positions) and requiring a reserve account to be funded on a formula basis.

- Portfolio Margin and Swaps Accounts. The most sophisticated customers have portfolio margin accounts and/or swaps accounts, containing long and short securities and options positions, securities-based and non-securities-based swaps, credit or debit balances and possibly also futures positions. This account class should also be subject to customer protection requirements relating to possession or control of customer securities and to the funding of a reserve account, but those rules would need to take into account the broker-dealer's use of funds or securities to carry swaps that hedge the customer swaps positions.

It may also be appropriate to develop additional account classes, or to modify the classes outlined above; the precise delineation of the separate account classes should be the subject of further review and careful study and should only be adopted after opportunity for public comment.

C. Rule-Making Power

The best way to accomplish the harmonization of SIPA, the Bankruptcy Code and the SEC's Customer Protection Rule is to grant rule-making authority to the SEC similar to the authority that the Commodity Futures Trading Commission (the "CFTC") has under Section 20 of the Commodity Exchange Act to make rules regarding the commodity broker liquidation provisions of the Bankruptcy Code, and to instruct the SEC to make rules under both the Bankruptcy Code and SIPA regarding the scope of customer property, the determination of a customer's net equity and the method of liquidation of a broker-dealer that are consistent with the customer protection rules applicable to operating broker-dealers. In carrying out this instruction, the SEC could follow the CFTC in creating different "account classes" as outlined above, each with rights in separate pools of customer property that may be created by customer protection rules adapted to the circumstances of the account class. (The SEC has already started down the path of creating separate account classes by proposing different customer protection requirements for proprietary accounts of broker-dealers, including the creation of a separate reserve deposit for these accounts, but the separation is meaningless if these accounts are lumped together with the securities accounts of public customers in a liquidation of the broker-dealer.)

IV. The Fundamental Purpose of SIPA Protection

Turning to the question of fraud committed by a broker-dealer, I would like to address two different but interrelated issues. As members of this Subcommittee know, SIPA's fundamental purpose is to promote investor confidence in the U.S. capital markets by protecting customers against the loss of cash or securities entrusted to the custody of the broker-dealer holding such property. To the extent the customer property held by the failed broker-dealer is not sufficient to satisfy the net equity claims of all of the customers of the failed broker-dealer, SIPC funds are advanced for each customer in order to replace the missing securities and funds. As intended by Congress, however, SIPC's funds are available only to replace missing customer property; they are not used to protect investors against any other risks.

I share in the sympathy with, and outrage on behalf of, the many innocent victims of massive frauds by the likes of Madoff and Stanford. Financial fraud undermines confidence in our markets and our regulatory system. However, SIPA is not intended to protect investors against losses ***on*** their investments, only against losses ***of*** their investments in the event of a broker-dealer failure. Investing in securities inherently exposes the investor to market fluctuations in the value of the securities. Investors who lose money because of a decline in the value of the securities purchased for their accounts are not protected by SIPA against such losses, whether the decline is due to market forces or even due to fraud. SIPA, for instance, would have provided no protection to investors who purchased Enron stock or bonds against the losses they realized through Enron's fraud and resulting bankruptcy (although it would have provided them protection against the loss of their Enron securities if their brokers failed). Under this principle, investors who purchased certificates of deposit in Stanford International Bank (an Antiguan bank that was allegedly operated as a Ponzi scheme) are not protected by SIPA against the possibility that those certificates of deposit are worthless. As such, SIFMA opposes efforts to extend

SIPC's protection to cover, for the first time, fraud by the issuer of certain securities (in this case, certificates of deposit) purchased by the customer which are neither lost nor stolen but in fact in the holders' possession. This extension would likely deplete SIPC's recently increased targeted reserves of $2.5 billion (up from $1 billion) and even exhaust the additional $2.5 billion that SIPC is able to borrow from the SEC (and, indirectly, from the U.S. Treasury), leaving SIPC unable to protect securities investors until its funds are replenished. Even more importantly, this extension would be an unprecedented expansion of the protection provided by SIPC and is in direct conflict with the fundamental purpose and intent of SIPA.

SIPA's protection for broker-dealer customers differs from the Federal Deposit Insurance Corporation's ("FDIC's") insurance for bank depositors in the same way that securities investments differ from bank deposits. Bank deposits represent a debt of the bank to the depositor. They are generally intended to be a safe use of funds and to provide only a limited, but low-risk return. The FDIC insures the payment of the bank deposit, including accrued interest, in the event of a bank failure (up to the limits of the insurance coverage). Securities accounts at a broker-dealer, by contrast, hold investments of the customer in securities (and related cash amounts). Customers invest in securities to benefit from increases in the value of the securities (and from dividends, interest or other distributions on the securities), but also take the risk that the value of the securities may drop, potentially to zero. SIPA is not intended to protect customers against declines in the value of their accounts due to changes in the value of their securities investments, but only against the loss of their actual securities due to a failure of the broker-dealer. SIPC's advances are therefore only available to customers who do not receive their cash and securities investments, not to customers whose investments go sour or turn out to be fraudulent.

V. "Net Equity" Calculation in the Context of a Fraudulent Scheme

In a SIPA liquidation, customers have claims for their "net equity" that are satisfied by a *pro rata* distribution of the failed broker-dealer's "customer property," plus, if that distribution is inadequate, up to $500,000 of SIPC advances. A customer's "net equity" is calculated by taking the value of the long securities and cash in the customer's account and subtracting the value of the short securities positions in the account and any indebtedness of the customer to the failed broker-dealer. In the ordinary course, a SIPA trustee looks to a customer's account statements and the books and records of the failed broker-dealer to establish the securities positions and cash balances used to compute the customer's net equity. When a broker-dealer is operated as a Ponzi scheme, however, the customer account statements will themselves be fraudulent – it is the essence of a Ponzi scheme that the perpetrator reports false profits to the investors – and therefore the statements do not truly represent positions in the customers' accounts.

Instead of relying on fraudulent account statements to determine the net equity of the customers of Bernard L. Madoff Investment Securities LLC ("Madoff"), the trustee appointed by SIPC to liquidate Madoff has used the "net investment" method. Under the net investment method, the fraudulent customer account statements are disregarded and a customer's net equity is determined solely by reference to the amount of money the customer entrusted to the Ponzi scheme operator and the amount of money the customer received from the Ponzi scheme. The customer's net equity is his or her net investment in the fraudulent scheme – the excess (if any) of the amount entrusted over the amount received. This method was originally developed with respect to fraudulent schemes outside of the SIPA context as far back as the 1920s and has been regularly applied by several trustees and courts in SIPA liquidations (including the Madoff liquidation, where it was recently upheld by the Court of Appeals for the Second Circuit).

When a failed broker-dealer was operated as a Ponzi scheme, SIFMA believes that, as a matter of fundamental fairness, this net investment method should be used to determine net equity for purposes of the distribution of customer property held by the failed broker-dealer. The property held by a Ponzi scheme and used to make distributions to the "investors" in the scheme is simply the pooled property of all victims of the scheme, and making distributions based on anything other than their net investment would be fundamentally unfair – at best it would result in sharing the losses unevenly among the victims, and in some cases it would result in perpetuating the scheme by taking money from some victims and paying it to others to satisfy their claims for false profits.

VIII. Conclusion

In conclusion, SIFMA appreciated the opportunity to participate in the work of the Task Force and is committed to working constructively to modernize SIPA to better protect investors and thereby increase investor confidence in the financial markets. SIFMA looks forward to continuing to work with the Subcommittee on these important investor protection issues.

Statement

of

Stephen P. Harbeck, President and Chief Executive Officer

Securities Investor Protection Corporation

Before the

Capital Markets and Government Sponsored Enterprises Subcommittee

of the

House Financial Services Committee

March 7, 2012

Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the important work of the Securities Investor Protection Corporation ("SIPC"). My name is Stephen Harbeck, and I am the President and CEO of SIPC. I am pleased to appear before you today with Ms. Sharon Bowen, the Acting Chair of SIPC, who will address the recommendations of the SIPC Modernization Task Force.

Since the collapse of the Lehman Brothers entities in the fall of 2008, SIPC has been at the center of the subsequent financial crisis. I would like to provide an overview of SIPC's role in the major events that have arisen from 2008 through the present day.

I.

Ongoing SIPA Liquidation Proceedings of Note.

A. Lehman Brothers Inc.

The Chapter 11 proceeding for Lehman Brothers Holdings Inc. ("LBHI"), and the Securities Investor Protection Act ("SIPA") liquidation of its subsidiary broker-dealer, Lehman Brothers Inc. ("LBI"), is the largest bankruptcy, of any kind, in history. SIPC is extremely proud of its role in protecting investors in that unprecedented case.

Distributions to Customers in the LBI Liquidation

On September 19, 2008, within hours of his appointment by the United States District Court for the Southern District of New York, the Trustee, James W. Giddens, applied for and received permission from the United States Bankruptcy Court for the Southern District of New York to transfer customer accounts to a solvent brokerage firm. The hearing in the Bankruptcy Court that afternoon, which extended into the early morning of the following day, was described in the American Bankruptcy Institute Journal as the most important bankruptcy hearing in history.[1] Over the vigorous opposition of some creditors, the Trustee, supported in court by SIPC, sought and obtained authority to transfer the accounts to Barclays Bank and Ridge Clearing. As a result, control of approximately **110,000 customer accounts** at LBI, containing approximately **$92.3 billion** in assets, was returned to customers, fully satisfying their claims, within days after the start of the SIPA proceeding. The Trustee and SIPC overcame substantial logistical problems to effect that transfer, and that achievement was critical to maintaining

[1] S. Lubben, The Sale of the Century and Its Impact on Asset Securitization: Lehman Brothers, American Bankruptcy Institute Journal, December/January 2009 ("Lubben"). Id., fn 4.

customer confidence in not only the American securities markets, but also the securities markets across the globe during the 2008 financial crisis.[2]

The satisfaction of claims in LBI addressed SIPC's primary mission...the protection of small investors... virtually immediately, and none of the related entities were nearly as complex as LBI.[3] Every investor with an account and a valid claim of less than $500,000 in assets owed in connection with the account has been fully satisfied.

Other Accomplishments in the LBI Liquidation

Some other significant facts and major achievements in the LBI case include:

- The magnitude and complexity of the LBI liquidation is apparent from the fact that the size of the estate marshaled and administered by the Trustee exceeds $117 billion.

- The Trustee has defended against, and pursued, high stakes litigation in the liquidation proceeding and he has done, and is doing, so successfully. As just a couple of examples -- the Trustee prevailed in his recovery against Barclays Bank of $2.3 billion in a dispute over margin assets seized by Barclays. That matter continues to be litigated on appeal. Likewise, the Trustee recovered $757.4 million cash, and $106 million in physical securities, in settlement of a dispute with JP Morgan Chase. Moreover, the Trustee has prevailed in other

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[2] Lubben noted as follows, fn 4: "See proffered testimony of Barry W. Ridings at Transcript, p. 146 – ("Any failure to consummate [the Barclays's sale] may potentially cause a major shock to the financial system") and the remarks of Judge Peck, Transcript at 171 ("in unrebutted testimony [Mr. Ridings] indicated through proffer that the markets, in effect, would tank [if the sale was not approved].")

[3] In enacting SIPA, Congress intended to protect the small investor. SIPC v. Morgan, Kennedy & Co., 533 F. 2d 1314, 1321 (2d Cir. 1976); McKenny v. McGraw (In re Bell & Beckwith), 104 B.R. 842, 855 (Bankr. N.D. Ohio 1989), aff'd, 937 F.2d 1104 (6th Cir.1991) (Congress was primarily concerned with protecting small investors).

litigation matters involving complex securities issues such as the proper valuation of short positions or the determination of tri-party set-off rights.

- The claims that remain for resolution by the Trustee are neither small nor easily resolved. Remaining claims involving the LBI U. K. firm, LBI's parent company, and numerous hedge funds will involve a dispute over approximately $42 billion.

Approval of the Chapter 11 Plan for LBHI

On December 6, 2011, the United States Bankruptcy Court for the Southern District of New York approved a liquidating Chapter 11 plan for LBHI. In doing so, Judge James Peck said that the case represented the most "overwhelming outpouring of creditor consensus in the history of insolvency law. What a difference three years makes." The packed courtroom applauded after Judge Peck's remarks.[4]

Judge Peck, who presided over the Lehman case, took a moment at the confirmation hearing to offer his views on the challenges in restructuring debts of this magnitude and complexity:

> My world changed when the Lehman cases were assigned to me and so did yours. For me, it has been a once in a lifetime experience. To have worked across the bench from so many outstanding professionals in promoting conflict resolution and helping to bring these truly extraordinary one-of-a-kind cases to this culminating substantive moment, superlatives abound. And we have heard them all and probably used them all. This is the biggest, the most incredibly complex, the most impossibly challenging international bankruptcy that ever was.
>
> But the greatest superlative of all is reserved for today. This largest ever unplanned bankruptcy that started in chaos, accelerated the financial crisis and eroded confidence in the global financial system also has yielded the most overwhelming outpouring of creditor consensus in the history of insolvency

[4] Lehman Closes a Chapter: As $65 Billion Bankruptcy Plan is Approved, Cheers and Tears Color Courtroom"
http://online.wsj.com/article/SB10001424052970204770404577082451546013514.html

> law. What a difference three years can make. Never before have divergent holders of 450 billion dollars in claims recognized the benefits of pragmatic compromise and come together as one in support of a single Chapter 11 plan. This is a monumental achievement in our field, awe-inspiring, really, that, to me, represents the highest and best use of Chapter 11 in the public interest.
>
> For myself, I'm extremely proud to have presided over this transparent, fair and the remarkably successful process that stands out as perhaps the finest example of the flexibility, power and utility of the United States bankruptcy system. Our system is not perfect. But together we have shown the world that it can work very well indeed. Lehman may once have been a too-big-to-fail systemically significant global financial institution. But it was not too big to resolve in Chapter 11.
>
> I congratulate each and every professional in every single law firm and advisory firm here and in foreign jurisdictions that contributed in ways recognized and unrecognized, large and small, to this historic confirmation of Lehman's plan. You should all feel great pride in what has been accomplished.[5]

SIPC concurs with Judge Peck's remarks and will continue to move the case to conclusion.

Litigation success in the United Kingdom

I am pleased to report that last week, the Supreme Court, the highest appellate court in the United Kingdom, has ruled in a way that greatly assists the customers of LBI, the United States SIPC member. The Court held that cash sent by customers to LBIE, a British entity, is deemed to be segregated for customers immediately upon receipt by LBIE, rather than at the point where LBIE actually placed the funds in a segregated account. Thus, if funds found their way to a "house" account, these funds will be deemed segregated. (This is the rule in cases under SIPA as well.)

[5] Weil Bankruptcy Blog: - http://business-finance-restructuring.weil.com/chapter-11-plans/confirmed/#axzz1l4PJ5URO

This result in this Lehman matter also has very positive ramifications for the American customers of MF Global.

B. Bernard L. Madoff Investment Securities LLC

While Lehman Brothers is the largest bankruptcy of any kind in history, the Madoff case, initiated three months later in December 2008, is the largest Ponzi Scheme in history. The Madoff case presented a completely different set of challenges.

Claims Determination and Satisfaction

The first major challenge for SIPC and Irving Picard, the Trustee in the Madoff case, was to determine who was eligible to share in "customer property" and advances from SIPC in this massive fraud. While the scope and duration of the Madoff fraud was unprecedented, SIPC had dealt with similar, albeit smaller Ponzi Schemes, in the past. SIPC and the Trustee took the same positions taken by SIPC and other trustees in prior SIPA cases involving fictitious pricing, and used a "net investment" methodology. This is also consistent with how virtually all other Ponzi Scheme claims are calculated. Persons who withdrew more than they deposited were thus ineligible to share in "customer property" or SIPC advances. The position taken by SIPC and the Trustee was affirmed by the United States Bankruptcy Court, and the United States Court of Appeals for the Second Circuit, and the latter Court refused to review the decision en banc. The matter is now the subject of three petitions for certiorari to the United States Supreme Court.

In other claims related matters, the Bankruptcy Court and the United States District Court upheld the Trustee's Determinations concerning persons who invested in hedge funds which, in turn, invested with Madoff. The Courts held that each of the hedge funds was a customer but the limited partners who owned the respective hedge funds were not entitled to "customer" status. That matter is on appeal to the Second Circuit.

Asset Recovery

The Trustee and his counsel have made enormous progress in recovering assets for ultimate distribution to the most impaired class of creditors, to wit, those claimants who have not recovered all of their original investments with Madoff. The Trustee's website summarizes the more than $9 billion in such recoveries to date, and that summary is attached as Exhibit A. This represents approximately half of the amount originally invested by claimants with Madoff.

This is an extraordinary result. The tools available to the Trustee under SIPA and the Bankruptcy Code made these recoveries possible.

Certain hedge funds had valid claims against the Madoff estate, but were required to return the proceeds of preferential and fraudulent transfers before sharing in any distribution. In entering into settlement agreements in these situations, the terms of the settlement agreements typically specify (at the insistence of the trustee and SIPC) that the proceeds of any subsequent distributions to the hedge funds flow directly to investors, without management receiving any of the money. Because SIPC knows this issue to be of concern to many members of the Subcommittee, a more detailed discussion of this issue is attached as Exhibit B.

C. MF Global Inc.

SIPC was called upon to initiate the liquidation of MF Global on virtually no notice. Unlike bank failures, brokerage firm failures typically take place with very little advance warning. The initiation of the liquidation for MF Global is very instructive. It provides insight into how SIPC responds immediately in a crisis situation.

On Monday morning, October 31, 2011 at 5:20 a.m., I received a telephone call from a representative of the SEC's Division of Trading and Markets who was then in New York. The purpose of the call was to inform SIPC that a SIPA proceeding was necessary for MF Global. This was the first notice to SIPC that such action was required to protect investors. I immediately telephoned SIPC's Chairman, Orlan Johnson, and sent the Chairman an email, indicating the need to start the case. The Chairman is authorized by SIPC's Bylaws to approve the initiation of a proceeding. I also telephoned other officers and senior members of the SIPC staff, who convened at SIPC's office at about 7:00 a.m. SIPC's legal staff drafted pleadings to begin the liquidation. SIPC received a formal written notification from the SEC that a liquidation proceeding was appropriate under 15 U.S.C. section 78eee(a)(1) via email from an SEC official at 7:29 a.m., stating the basis for commencing the case.

While four members of the SIPC staff flew to New York, the relevant personnel at SIPC made simultaneous inquiries to a number of professionals as to whether those persons, and the law firms with which they were associated, were presently engaged in the MF Global matter. This was done so as not to designate a person or firm with an irreconcilable conflict of interest which would have prevented their serving under the "disinterestedness" test. Approximately ten possible trustees and counsel having the requisite bankruptcy experience, skill and resources, were considered. Some were not called because it was public knowledge that those professionals were indeed involved in the MF Global case. Approximately five persons were contacted. Of the five, only two law firms were eligible to serve; three had conflicts. Of the two remaining law firms, one had never served in a previous SIPA case. MF Global presented the unprecedented situation of a large brokerage failure that did not only have a securities, but a multi-billion dollar commodities, business. Because this matter would not be the appropriate case for a firm with no prior experience, SIPC then determined that James W. Giddens, perhaps the most experienced individual in dealing with SIPA cases, having served as counsel or trustee in such cases since the early 1970s, was best suited for this complex case. After discussions with Mr. Giddens to assure SIPC that he and his firm had sufficient available resources and that they were disinterested, SIPC designated him as Trustee, with Hughes, Hubbard & Reed as his counsel. All of those decisions had to be made within hours; SIPC filed its legal papers in New York, obtained a court order in New York, and Mr. Giddens took control of the MF Global premises the afternoon of October 31.

SIPA places the responsibility for choosing a Trustee and counsel on SIPC. In the MF Global case, the wisdom of this statutory provision made it possible to have a fiduciary in place less than 12 hours after SIPC was notified of the necessity to protect investors. Further, I am pleased to report that the Trustee transferred over $1.5 billion in investor assets in the MF Global case within one week. Choosing a veteran Trustee made this possible.

Presently, the Trustee has distributed 72% of assets to 27,217 commodities account holders, and 60% plus up to $500,000 to 300 securities account claimants in the case. The trustee's most recent status update of the case, dated February 6, 2011, is attached as Exhibit C.

D. **Stanford Group Company**

SIPC declined to initiate a liquidation proceeding for the Stanford Group Company because the SEC had not demonstrated that any investors left assets at the SIPC member brokerage firm. The investors voluntarily purchased certificates of deposit issued by the Stanford International Bank in Antigua. In the words of the SEC those certificates of deposit paid "excessive and perhaps impossible" rates of return. Each investor, under SIPA, either (a) has his or her certificate or (b) is entitled to the delivery of that certificate or its value, namely, the value of a CD issued by a bank under the control of liquidators in Antigua.

Let me be very clear: in the forty year history of SIPA, SIPC has never been interpreted to permit SIPC to refund the purchase price of a bad investment. This is true even when the investment was induced by the fraud of a SIPC member firm. If there is to be a change in the law, Congress should change the law only after rigorous debate about the wisdom and implications of such a policy. The SEC should not usurp legislative authority and expand the role of SIPC far beyond Congressional intent or the plain words of SIPA.

If SIPC is to be revised to afford the protections of the SIPA statute to allow SIPC to pay claims based upon the rescission of fraudulent transactions, this is a task for Congress, after deliberation on the significant consequences of such a change.

II.

SIPC and the Dodd-Frank Act

The Dodd Frank Act made a number of changes to SIPA. First, the Act made changes to the minimum assessment charged to SIPC members. Ms. Bowen's testimony on the Task Force Report will mention a potential new amendment which should prevent an unintended result, to wit, that some SIPC members now pay no assessment.

Second, SIPC's credit line with the Treasury was increased from $1 billion to $2.5 billion.

Third, SIPC now protects cash up to $250,000 in each customer's account.

Fourth, the Dodd-Frank Act criminalized certain misrepresentations about SIPC membership, and increased criminal fines for misconduct.

Since the enactment of the Dodd-Frank statutory regime, there has been no instance where SIPC has been called upon to step in with respect to a financial conglomerate that would be wound down under that statute. While the Act authorized the FDIC to liquidate systemically significant financial firms, including those with broker-dealer subsidiaries, Congress set up the regime to be used sparingly. The fact that the Dodd-Frank statutory program was not brought to bear on the MF Global situation is a case in point. According to the filings in the Chapter 11 proceeding of MF Global' s parent company, the overall bankruptcy is the eighth largest bankruptcy in history, measured by assets. Yet the wind down of the business, and the satisfaction of claims, is proceeding under the Bankruptcy Code and SIPA, as Congress intended.

III.

H.R. 757

SIPC does not support H.R. 757. While SIPC is aware of the significant financial distress wrought by Madoff and that the intent of the bill is to provide for a more equitable distribution under SIPA, the provisions of the bill would actually:

(a) Result in a less equitable distribution,

(b) Have the unintended consequence of rewarding, encouraging, and perpetuating Ponzi Schemes,

(c) Allow a fraudulent actor to establish the distribution criteria in the subsequent liquidation proceeding.

(d) Pledge the assets of SIPC, and, indeed, the American taxpayer, to guarantee the fictional profits invented by fraudulent actors.

An analysis illustrating the inequality of distribution under the proposed legislation is attached as Exhibit D.

The bill would reverse long standing judicial precedents which are specifically designed to enforce equitable distributions. SIPC urges the Committee not to disturb the existing statutory scheme. By limiting the ability of a trustee to use preference and fraudulent transfer provisions of the Bankruptcy Code, the distribution to claimants is less equitable, by any objective standard. Further, the bill would reverse some of the salutary results achieved in the Madoff case, in that it would apply to ongoing cases. Such a result would cause chaos in the case, literally changing the law mid-stream.

H.R. 757 also removes SIPC's authority to designate a trustee and counsel in a SIPA case.

SIPC and trustees, in the words of the Second Circuit Court of Appeals, both vindicate important public interests. It would indeed be odd if trustees and SIPC disagreed often. That said, no one can make the remotest claim that SIPC chooses anyone other than extremely qualified fiduciaries. I submit that the track record of trustees in the courts demonstrates that trustees uphold the SIPA statute as Congress wrote it. That is the criteria upon which trustees should be judged.

It is true that SIPC has returned to proven experts when it is appropriate to do so. But SIPC does not choose from a "SIPC alumni" list. Out of 324 customer protection proceedings, only 2 former employees have served a total of 4 times as a trustee or counsel in a SIPA case. There is no revolving door.

IV.

H.R. 1987

SIPC does not support H.R. 1987. To the extent that bill seeks to limit the use of bankruptcy avoidance powers in a SIPA case, this bill presents the same problems as H.R. 757.

H.R. 1987 also changes SIPA by making a very broad category of individuals "customers" of a defunct brokerage firm, even where those individuals had no relationship whatsoever with the brokerage. Thus, individual limited partners in a hedge fund would be individual "customers" of a brokerage firm if the hedge fund itself held an account. This is at odds with the basic concepts of corporate ownership (that is, the hedge fund, not the partners, owns the account). To the extent H.R. 1987 would change this concept in ongoing liquidation proceedings, it would also reverse judicial opinions in the Madoff case, and reverse other precedents dating to 1976.

As Ms. Bowen indicates in her testimony, the SIPC Modernization Task Force considered this issue and proposed that only a very narrow subset of "indirect" investors be covered in future cases. Of course, the potential costs of such a legislative change requires further study.

The bill also makes a significant change in how "customer" accounts are evaluated by introducing an "inflation adjustment" concept which does not appear in SIPA as currently enacted. This would have the effect – demonstrable in the Madoff case – of increasing the return to claimants who have already received all of their own investment proceeds at the direct expense of persons who have not received less than they invested. SIPC does not support that result. A Ponzi Scheme is a "zero sum" situation. While well intended, this provision damages those who have lost the most.

V.

H.R. 4002

The bill appears specifically designed to deal with the Stanford Ponzi Scheme, discussed above.

For the following reasons, SIPC does not support the bill.

At the outset, let us stipulate that the victims of the Stanford Antigua Bank fraud are truly victims. Nevertheless, existing law does not protect them, and H.R. 4002 cannot be reconciled with the basic policy of the existing law. It is important to understand that his approach would fundamentally change the nature of SIPC.

The bill proceeds from a premise that radically alters the fundamental protection available under the Securities Investor Protection Act (SIPA).

As we discussed infra, the reason SIPC has declined to start a proceeding in the Stanford case stems from the essential nature of the dispute. SIPC protects the "custody" function brokerage firms perform. This means that customers are protected against the loss of the cash and securities held for them by their broker-dealer when the broker-dealer fails financially. In Stanford, after literally years of factual investigation, the SEC has not produced a single customer who left assets in the custody of the SIPC member brokerage at Stanford. Indeed the SEC's then General Counsel specifically concluded that SIPA protection did not extend to the Certificate of Deposit (CD) purchasers in the Stanford case.

The persons who bought CDs in Stanford purchased CDs issued by a bank chartered under Antiguan law for which two liquidators have been appointed. The CDs have declined in value. Fraud was involved. But SIPA does not permit SIPC to repay the original purchase price to other investors who purchase fraudulent investments in Enron, or any other security, including the CDs here at issue. SIPA does not permit SIPC to rescind transactions that result in losses. The investors have their CDs. The CDs have a value, but that value depends upon what the Stanford Antigua Bank liquidators can distribute to them. The risk of loss never leaves an investor just as the prospect of profit never leaves the investor.

Other facts bear out the Stanford CD purchasers' ineligibility for protection. In buying the CDs, the investors were required to open accounts at the Antiguan Bank, not at the brokerage. Moreover, in making the purchase, each investor was required to sign a subscription agreement/investor questionnaire in which the investor acknowledged having received a Disclosure Statement. More than once, the Disclosure Statement cautions the CD purchaser that the CDs are not protected by SIPC.

The only time SIPC would decline to initiate a customer protection proceeding is where SIPC has concluded that there is no investor who fits within the "customer" definition. That is what is apparent here. The reason the SEC did not immediately refer this matter to SIPC in 2009 is because the SEC knew then that there were no "customers" that fit within the SIPA statute. Indeed, there is only one instance in 42 years where SIPC has declined to start such a proceeding, to wit, the matter involving the Stanford Financial Group. Thus, although the bill refers to "customers" of a debtor firm, there are no such persons, as that term is statutorily defined in SIPA,

The bill presents SIPC with the worst of both worlds.

Payment of a settlement is typically designed to terminate legal proceedings, or the prospect of legal proceedings. Here, the bill contemplates that SIPC would proffer certain payments to persons SIPC believes are <u>not</u> eligible for SIPA's protections... and still proceed with a lawsuit. To extend a realistic hypothetical: <u>If SIPC wins the lawsuit initiated by the SEC, that would mean that the persons who had received funds were not customers entitled to receive anything</u>. The bill literally provides for payments....and the prospect of more payments, not the end of the proceeding.

There is a clear inconsistency in the amounts mentioned in the bill and SIPA protection.

Assuming solely for purposes of argument that it made sense for SIPC to name <u>any</u> "settlement proffer" to claimants, section 2(c)(3)(A) of the bill makes reference to a possible limit of $500,000 for such proffer, but section 2(c)(6) treats the CD claimants as claimants for cash. The limit of protection for cash claims is $250,000.

Unless and until Congress clearly assigns SIPC the task of paying fraud claims, both the bill, and the SEC's legal position, run counter to clearly established Congressional policy.

Consider the following hypothetical dialogue:

Salesman: My brokerage firm offers Certificates of Deposit issued by an offshore Bank in Antigua. The Bank pays extraordinarily high rates of return on CDs.

Investor: That sounds suspicious to me. What if this is a fraudulent investment that is discovered after I receive the CD?

Salesman: Not a problem. SIPC will pay you up to $500,000 in such an instance. That is more than the FDIC offers!

Under the SEC's legal position in SEC v. SIPC, and under the bill, the Salesman's last statement would be true. While the Stanford victims are sympathetic, this is a fundamental departure from existing law. The consequences for persons who buy legitimate investments, and the potential costs of rescinding all such fraudulent investments made through SIPC members firms have not been considered. Indeed, federal taxpayer funds are implicated because SIPC has a line of credit with the Treasury, through the SEC. Thus, taxpayer funds could be used to restore the purchase price of a bad investment. That is a very big departure from protecting the "custody," or "safekeeping" function performed by brokerage firms, as the law provides for today. Moreover, persons who invest in fraudulent investments would be better off than those who make legitimate investments. They bear no market risk, profit from the fraud until it is uncovered, and once the fraud is uncovered, they get their money back from SIPC.

VI.

The Adequacy of the SIPC Fund

The SIPC Fund currently stands at $1.4 billion. Under SIPC's Bylaws, most recently updated in 2009, the "Target Balance" for the SIPC Fund is $2.5 billion. Absent a decision by the SIPC Board to change the rate, SIPC will continue to assess its members ¼ of 1% of each member's net operating revenue until the Target Balance is reached between 2016 and 2017. This issue is always under review by the SIPC Board.

SIPC has sufficient funding to handle any foreseeable call on its resources under SIPA as currently constituted. I caution that if SIPC's mission is expanded by legislation to refund the purchase price of fraudulent securities transactions, judicial expansion of SIPC's clearly defined limitations, or otherwise, neither the SIPC Fund nor the Treasury line of credit will be adequate.

Conclusion.

In conclusion, the period from 2008 to 2012 has been unlike any prior experience in SIPC's history. I believe SIPC has responded effectively to the challenges presented. That is not to say that, as we look to the future, the SIPA program cannot be refined or improved.

I would be pleased to answer any questions you may have about SIPC's work.

Exhibit A

The Madoff Recovery Initiative

SUBSTANTIVELY CONSOLIDATED SIPA LIQUIDATION OF BERNARD L. MADOFF INVESTMENT SECURITIES LLC & BERNARD L. MADOFF

RECOVERY STATUS TO DATE

RECOVERIES AND SETTLEMENT AGREEMENTS

$9.067 Billion

AMOUNT UNAVAILABLE DUE TO APPEALS AND RESERVES

$6.444 Billion

AMOUNT IN CUSTOMER FUND

$2.297 Billion

AMOUNT DISTRIBUTED FROM CUSTOMER FUND

$325.7 Million

SIPC COMMITMENT

$798.4 Million

All amounts approximate

RECOVERIES TO DATE

As of February 15, 2012 and in the 38 months since his appointment, the SIPA Trustee has recovered or entered into agreements to recover more than $9 billion, representing approximately 52 percent of the approximately $17.3 billion in principal estimated to have been lost in the Ponzi scheme by BLMIS customers who filed claims. These recoveries exceed prior restitution efforts related to Ponzi schemes both in terms of dollar value and percentage of stolen funds recovered.

Significant Recoveries to Date

IRS

On December 21, 2011, a $326 million settlement with the United States of America, on behalf of the Internal Revenue Service, was approved by the United States Bankruptcy Court for the Southern District of New York. The SIPA Trustee determined that BLMIS falsely debited the accounts of 145 foreign accountholders for alleged income tax withholding and paid to the IRS such withheld amounts related to alleged dividends. However, because no securities were purchased on which the alleged dividends were paid, no taxes should have been withheld.

Mount Capital Fund

On October 4, 2011, the United States Bankruptcy Court for the Southern District of New York approved a settlement with Mount Capital Fund, a BLMIS Feeder Fund, which is in liquidation in the British Virgin Islands, which returned $43.5 million to the Customer Fund.

Tremont Group

On July 28, 2011, the SIPA Trustee announced a settlement with Tremont Group Holdings Inc. and related entities under the terms of which the Defendants will deliver cash payments into escrow totaling more than $1 billion, which will ultimately be placed into the Customer Fund and distributed, pro rata, to BLMIS customers with allowed claims. On September 22, 2011, the agreement was approved by the United States Bankruptcy Court for the Southern District of New York, but the settlement is currently under appeal.

Greenwich Funds

On May 18, 2011, a settlement agreement was announced with Greenwich Sentry L.P. and Greenwich Sentry Partners, L.P. (combined, the "Greenwich Funds"), domestic BLMIS feeder funds operated by the Fairfield Greenwich Group ("FGG") that were 100 percent invested in BLMIS. Terms of the settlement, which was structured very similarly to the settlement with the Fairfield Funds, included a reduction in the Greenwich Fund customer claims which will ultimately benefit BLMIS customers with approved claims. Under the agreement, the Greenwich Funds also agreed to assign all of their claims against FGG management companies, officers and partners to the Trustee and to the entry of judgment for the full amount of the Trustee's claims, approximately $212 million. The settlement was approved on June 21, 2011 by the United States Bankruptcy Court for the Southern District of New York.

Fairfield Funds

On May 9, 2011, a settlement agreement was announced with the Joint Liquidators of Fairfield Sentry Limited, Fairfield Sigma Limited and Fairfield Lambda Limited (collectively, the "Fairfield Funds"). Terms of the settlement include an immediate and permanent reduction – of nearly $1 billion – in the total amount of claims against the BLMIS Customer Fund by the Fairfield Funds, which would effectively increase future payments to customers with allowed claims. In addition, the settlement agreement aligned the interests of the SIPA Trustee and his counsel with the Joint Liquidators of Fairfield Sentry, strengthening both parties' abilities to pursue and recover billions of dollars in additional claims against the owners and management of the Fairfield Funds, as well as hundreds of subsequent transferees of stolen customer property. The United States Bankruptcy Court for the Southern District of New York approved this settlement agreement on June 7, 2011.

Hadassah

On March 10, 2011, the United States Bankruptcy Court for the Southern District of New York approved a settlement between the SIPA Trustee and Hadassah in the amount of $45 million.

Union Bancaire Privée

On January 6, 2011, the United States Bankruptcy Court for the Southern District of New York approved a pre-litigation settlement between the SIPA Trustee and Union Bancaire Privée that resulted in the recovery of $470 million.

Carl J. Shapiro, et al.

On December 21, 2010, the United States Bankruptcy Court for the Southern District of New York approved a pre-litigation settlement between the SIPA Trustee and Carl J. Shapiro, Robert Jaffe and related entities in the amount of $550 million. As part of the agreement, the Shapiros also forfeited $75 million to the U.S. government.

Estate of Jeffry Picower

On December 17, 2010, the SIPA Trustee and the U.S. Government announced a groundbreaking $7.2 billion recovery agreement with the estate of Jeffry Picower; $5 billion of the settlement to go to the SIPA Trustee for equitable distribution to BLMIS customers with allowed claims and $2.2 billion forfeited to the U.S. government.

On January 13, 2011, the United States Bankruptcy Court for the Southern District of New York approved this settlement, but the settlement is currently under appeal by third parties. The government forfeiture order also is being appealed.

Norman F. Levy, et al.
On February 18, 2010, the United States Bankruptcy Court for the Southern District of New York approved a pre-litigation settlement between the SIPA Trustee and the estate of Norman F. Levy. This settlement resulted in the return of $220 million (the "Norman Levy Settlement"). Certain customers moved to set aside the Court's Order approving the Norman Levy settlement. The Bankruptcy Court denied the motion, and the claimants filed an appeal in United States District Court on April 11, 2011. On February 16, 2012, the District Court upheld the Bankruptcy Court's earlier ruling approving the SIPA Trustee's settlement with the Levy family.

Optimal
On June 16, 2009, the United States Bankruptcy Court for the Southern District of New York approved a pre-litigation settlement between the SIPA Trustee and Optimal Strategic U.S. Equity Ltd. and Optimal Arbitrage Ltd. This settlement resulted in the recovery of more than $235 million.

Total Recoveries by Interim Report Periods
Amounts shown do not include Court-approved settlements under appeal or not yet collected

SIXTH INTERIM REPORT | FIFTH INTERIM REPORT | FOURTH INTERIM REPORT | THIRD INTERIM REPORT | SECOND INTERIM REPORT | FIRST INTERIM REPORT

SIXTH INTERIM REPORT
Period ended September 30, 2011
Total received $2.7 billion

DESCRIPTION	AMOUNT
Transfers from Debtor's Estate – Securities	$291,203,371.40
Transfer from Debtor's Estate – BNY account	$336,660,934.06
Transfers from Debtor's Estate – Chase account	$235,156,309.36
Transfers from Debtor's Estate – Other	$4,036,145.08
Interest and Dividends	$1,713,881.88
Closeout Proceeds – Broker Dealers	$37,273,877.23
Closeout Proceeds – NSCC	$21,783,082.40
Closeout Proceeds – DTCC	$17,304,329.91
Sports Tickets	$89,690.80
Bank Dept Participation	$4,755,690.63
DTCC Shares	$204,170.51
Market Making Business	$1,389,423.16
Abtech	$495,000.00
Administrative Subtenant Rent Revenue	$517,390.79
Adjusting Administrative Subtenant Rent Revenue	($517,390.79)
Refunds – BLM Air Charter	$752,963.00
Refunds – Deposits	$9,841.45
Refunds – Dues/Subscriptions	$177,247.15
Refunds – Car Registrations	$157.00
Refunds – Vendors	$61,567.20
Refunds – Transit Cards	$793.61
Refunds – Insurance/Workers Comp	$402,859.56
Refunds – Political Contributions	$144,500.00
Refunds – Other	$50.84
Recoveries – Customer Avoidances	$139,209,034.46
Recoveries – Pre-Litigation Settlements	$1,521,631,048.00
Recoveries – Litigation Settlements	$40,609,297.32
Recoveries – Donation Settlements	$500,000.00
Recoveries – Vendor Preferences	$804,850.39
Recoveries – Employees	$10,674.74
Recoveries – Taxing Authorities	$12,777.56

Recoveries -- Class Actions	$380,488.99
Recoveries -- NASDAQ	$308,948.49
Recoveries -- NYSE	$183,683.79
Recoveries -- Transaction Fees	$96,816.23
Recoveries -- Other	$296,298.73
Miscellaneous	$0.36
Earnings on Trustee's Investments	$15,239,625.47
Interest on Trustee's Savings Accounts	$473,893.50

Exhibit B

SIPC

SECURITIES INVESTOR PROTECTION CORPORATION
805 FIFTEENTH STREET, N.W., SUITE 800
WASHINGTON, D.C. 20005-2215
(202) 371-8300 FAX (202) 371-6728
WWW.SIPC.ORG

September 30, 2011

The Honorable Ed Perlmutter
Congress of the United States
1221 Longworth House Office Building
Washington, D.C. 20515

The Honorable Gary Ackerman
Congress of the United States
2111 Rayburn House Office Building
Washington, D.C. 20515

RE: Bernard L. Madoff Investment Securities LLC ("BLMIS");
Settlement Agreement Between Trustee and Tremont Group Holdings Inc., et al.

Dear Congressmen Perlmutter and Ackerman:

This is in response to your letter of September 26, 2011 to Chairman Shapiro and me regarding the settlement ("Settlement") between Irving H. Picard, Trustee for the liquidation of BLMIS under the Securities Investor Protection Act ("SIPA") and Tremont Group Holdings, Inc., ("Tremont") and a large number of other related defendants. You raised questions about the SIPA Trustee's Settlement with Tremont, including how the proceeds of the Settlement will get into the hands of the Tremont investors who in the BLMIS liquidation proceeding are indirect investors with BLMIS. You also requested comment on prospective amendments to SIPA regarding this topic.

This response will address your questions regarding the Tremont Settlement. I will defer on your requests for comment on prospective amendments to SIPA, as the SIPC Modernization Task Force has these particular issues under its review and will present its report to the SIPC Board later this year.

I am pleased to respond to your questions on the SIPA Trustee's Settlement with Tremont. First, the SIPA Trustee included a provision in the Tremont Settlement Agreement (at SIPC's suggestion) whereby Tremont Management agreed not to receive any money. That provision stated that the "Tremont Defendants covenant that they will cause all payments received from the Trustee in respect of the Total Allowed Claims Amount to be fairly and equitably allocated among Broad Market Fund, Portfolio Limited, Rye Insurance, and their respective partners and/or investors." As a result, all of the funds received by Tremont through any BLMIS customer fund distribution made by the SIPA Trustee will be available to the investors of the various settling Tremont funds. The SIPA Trustee had also included the same provision in the Fairfield Sentry and Greenwich Sentry settlements that were approved by the Bankruptcy Court.

Hons. Perlmutter and Ackerman
September 30, 2011
Page Two

Second, all of the funds received by Tremont through any BLMIS customer fund distribution by the SIPA Trustee is being placed in the Tremont Investor class action settlement fund to be distributed to the Tremont investors under a plan to be determined by U.S. District Judge Griesa in the Southern District of New York. At the hearing on the Tremont settlement before Bankruptcy Judge Lifland on September 22, 2011, the investors class counsel spoke in favor of the Settlement and made clear that there are conflicts among the Tremont investors as to the allocation of the class action settlement fund but that District Judge Griesa will determine how to resolve those conflicts after all the Tremont investors have had the opportunity to be heard in that court. In Fairfield Sentry and Greenwich Sentry, the funds are in liquidation or Chapter 11 and the allocation of funds received by each through any BLMIS customer fund distribution by the SIPA Trustee will be directed by the court overseeing the liquidation or Chapter 11 proceeding.

Third, as shown by the foregoing, the Trustee and SIPC are keenly aware of the importance of getting funds into the hands of so-called "indirect investors." But ultimately, the SIPA Trustee cannot control contractual relationships among parties which are not BLMIS customers.

Fourth, at the September 22 hearing on the Settlement, Bankruptcy Judge Lifland noted that the SIPA Trustee had acted to protect the indirect investors by preventing any payments from being used by management and further by requiring Tremont to allocate fairly and equitably any customer funds distributed by the SIPA Trustee among the investors in Tremont. Bankruptcy Judge Lifland also made it clear that the internal Tremont distribution process was an issue squarely before District Judge Griesa to be decided in the Tremont class action.

Fifth, the SIPA Trustee and SIPC are committed that, whenever possible, a similar equitable distribution process will be in force for all settlements with other feeder funds.

Finally, as I testified before the Subcommittee on Capital Markets, avoidance actions under the Bankruptcy Code and the Securities Investor Protection Act are designed to permit the most equitable distribution possible under the circumstances where a Ponzi Scheme has victimized investors. The results in the Madoff case to date demonstrate the wisdom of those legislative provisions.

Respectfully,

S. P. Harbeck

Stephen P. Harbeck
President and CEO

SPH/rec

cc: Chairman Shapiro

Exhibit C

Status Update from the Office of James W. Giddens, Trustee for the Liquidation of MF Global Inc., Concerning the Trustee's Investigation

Media Contact: Kent Jarrell, 202-230-1833

February 6, 2012 – New York, New York – James W. Giddens, the Trustee for the liquidation of MF Global Inc., today filed a preliminary report on the progress of his investigation into the failure of the broker-dealer with the United States Bankruptcy Court for the Southern District of New York, the Honorable Martin Glenn, presiding. The Trustee's investigation has preliminarily determined that MF Global Inc. had a shortfall in commodities customer segregated funds beginning on Wednesday, October 26, 2011, and that the shortfall continued to grow in size until the bankruptcy filing on Monday, October 31, 2011.

The Trustee's investigators have now traced a majority of the cash transactions, totaling more than $105 billion, made in and out of MF Global Inc. in the last week before bankruptcy and are completing the process of tracing the remaining transactions. MF Global also executed securities transactions totaling more than $100 billion during its final week of operations. These included liquidation of customer securities, proprietary positions and other items. The securities included complex instruments, such as off-balance sheet repurchase transactions involving sovereign debt securities and derivative structures.

"For three months our investigative team has worked to understand what happened during the final days of MF Global when cash and related securities movements were not always accurately and promptly recorded due to the chaotic situation and the complexity of the transactions," Giddens said. "With these preliminary investigative conclusions in hand, we will analyze where the property wired out of bank accounts established to hold segregated and secured property ultimately ended up. We will then determine whether there is a sound and legal basis for recoveries against third parties that will help make customers whole. These will be very complex legal and factual determinations, which we will make consistent with our duty as the advocate for the former customers of MF Global Inc."

The investigation to date has found that transactions regularly moved between accounts and that funds believed to be in excess of segregation requirements in the commodities segregated accounts were used to fund other daily activities of MF Global. In the past, such transfers were in amounts of less than $50 million, but as liquidity demands increased and could not be met from internal sources, much larger amounts were used, apparently with the assumption that funds would be restored by the end of the day. By Wednesday, October 26, as the result of increasing demands for funds or collateral throughout MF Global, funds did not return as anticipated. As these withdrawals occurred, a lack of intraday accounting visibility existed, caused in part by the volume of transactions being executed, and the 4(d) U.S.

segregated commodity customer account appears to have reached a deficit condition on Wednesday, October 26 that continued through to MF Global's bankruptcy.

The Trustee has identified most of the parties that were the immediate recipients of transfers from MF Global Inc. during the final days and weeks of operation. These transfers were largely effected through the clearing banks acting on behalf of MF Global Inc. The ultimate recipients of these transfers included banks, exchanges and clearing houses, MF Global Inc. affiliates, counterparties, and customers of the futures commission merchant and the broker-dealer.

The number of transactions executed by MF Global during the last week prior to the bankruptcy escalated to unprecedented volumes. The rush to meet funding needs for collateral, margin and customer liquidations led to billions of dollars in securities sales, draws on credit facilities, and a web of inter-company loans across affiliates, some foreign. The company's computer systems and employees had difficulty keeping up with the unprecedented volume of transactions. A number of transactions were recorded erroneously or not at all. So called "fail" transactions – where either the buyer or seller fails to deliver the cash or the security, respectively – were five times the normal volume during the firm's final week.

The investigation has revealed that a confluence of factors contributed to the deterioration of MF Global's liquidity position. The exposure to European sovereign debt, coupled with the announcement of disappointing quarterly results, triggered credit downgrades by Moody's, Fitch and S&P. This escalation in credit risk mandated substantial margin calls and increased demands from counterparties and exchanges for collateral. As an example, the additional margin paid to support only the sovereign debt positions exceeded $200 million during the final week of operations. This was a significant drain on available cash and securities. The sovereign debt investments undertaken on a repo to maturity basis allowed some immediate gains to be booked, but these were purely paper profits generating negligible cash while the underlying transactions resulted in calls for substantial additional margin.

The heightened risk and apparent loss of confidence drove customers to close their accounts and withdraw funds, resulting in even greater demands on a relatively limited amount of available cash. The Trustee's investigation has revealed that, while personnel may not have been immediately aware of it, MF Global Inc. experienced a shortfall in 4(d) customer funds beginning during the day on Wednesday, October 26. The MF Global parent company struggled to continue to operate and even to sell the business, but MF Global Inc. appears to have remained in a shortfall of commodity customer segregated funds virtually continuously until its parent filed for Chapter 11 protection on Monday, October 31 and the Securities Investor Protection Act (SIPA) proceeding was commenced against MF Global Inc. later that afternoon.

The Trustee's investigators, including the legal and forensic accounting teams, have conducted over 50 witness interviews, preserved secure access to thousands of boxes of hard copy documents, imaged over 800 computer drives, and are maintaining over 100 terabytes of data.

To understand where the money went during October 2011, the analysis conducted by the Trustee's professionals has included 840 cash transactions in excess of $10 million that total $327 billion, and an ongoing analysis of related securities transactions involving a value of over $100 billion. These large cash transactions alone span 47 bank accounts across eight financial institutions. An additional 20,000 cash transfers that total $9 billion involve transfers of less than $10 million.

The Trustee's investigation is continuing to correlate cash transfers to relevant movements of securities used as collateral or loaned to counterparties. To that end, the Trustee is now working with various third parties to further define these securities transactions and obtain more complete information about the extent and basis for transfers to select parties. The Trustee continues to investigate the complex factual and legal questions to determine how best to pursue possible recoveries and the extent to which applicable law would support claims against particular recipients of funds, affiliates, and possibly to other parties, including employees of MF Global.

The Trustee's investigation will continue, in coordination with the regulatory and law enforcement investigations that are being conducted by the Department of Justice, the CFTC, and the SEC on an ongoing basis. The Trustee will seek to release additional information related to his investigation in the future, but cannot prematurely release information that might compromise the integrity of those investigations or the Trustee's own efforts to recover funds for customers and the estate.

CLAIMS PROCESS AND ACCOUNT TRANSFERS

The Trustee's staff is continuing its analysis of customer claims after the claims filing period for commodities customers closed on January 31, 2012.

Once a claim is reviewed by the Trustee's staff on as expedited a basis as possible, a determination letter will be issued to the claimant. These determination letters are being issued on a rolling basis. The determination letter will acknowledge the claim and provide a determination as to whether the claim has been allowed, denied, reclassified, or is subject to further reconciliation or information requests.

The Trustee is eager to make additional distributions to former MF Global Inc. customers as soon as possible. However, the Trustee is required by law to hold an appropriate reserve of funds until disputed claims are resolved either through negotiation or by the Court. At this time, the Trustee anticipates significant disputed claims against the MF Global Inc. estate by MF Global Holdings Ltd., MF Global UK Limited, and other entities. The Trustee will move to attempt to resolve these claims as quickly as possible, but it is uncertain how long resolution will take. Therefore, it is not known at this time when the Trustee will be legally able to make additional distributions.

The Trustee has already distributed nearly $4 billion to former MF Global Inc. retail commodities customers with US futures positions via three bulk transfers:

- Within days of the bankruptcy, the Trustee received court approval for the transfer of 10,000 commodities customer accounts with three million open positions, along with approximately $1.5 billion in collateral associated with those positions at the time of the bankruptcy. These open positions had a notional value of $100 billion. It is estimated that 40% of all commodity futures exchange activity in United States markets came from MF Global Inc. trades and a serious disruption in markets was avoided by the transfer.
- A transfer of 60% of the cash attributable to approximately 15,000 customer commodity accounts with cash only in the accounts, totaling approximately $500 million, was completed in November.
- And in December and January a third transfer occurred that moved approximately $2 billion to restore 72% of US segregated customer property to all former MF Global Inc. retail commodities customers with US futures positions.

In addition, the Trustee has received Court approval to sell and transfer approximately 318 active retail securities accounts, which is substantially all of the securities accounts at MF Global Inc. Nearly all securities customers have received 60% or more of their account value and already 194 of former MF Global Inc. securities customers have received the entirety of their account balances because of a Securities Investor Protection Corporation guarantee.

The information in this statement does not apply to any other MF Global entity, including separate insolvency proceedings involving the parent company, MF Global Holdings Ltd.

Exhibit D

EQUITABLE TREATMENT OF INVESTORS: AN ANALYSIS

Prepared for the House Financial Services Committee
Capital Markets Subcommittee

Stephen P. Harbeck
President and CEO

The Securities Investor Protection Corporation

March 7, 2012

The Facts

DATE	INVESTOR A	INVESTOR B	INVESTOR C
01/01/10	Deposits $2 Million	Deposits $2 Million	Deposits $2 Million
01/01/12	Receives Statement $4 Million	Receives Statement $4 Million	Receives Statement $4 Million
02/01/12	Withdraws $3 Million	Withdraws Nothing	Withdraws Nothing
03/01/12	Receives Statement $1 Million	Receives Statement $4 Million	Receives Statement $4 Million

04/01/12 Ponzi Scheme Exposed and Investors Are Innocent of Knowledge
Broker's Assets and Other Customer Property Completely Dissipated on Filing Date

SIPC

WHAT DOES EACH CLAIMANT RECEIVE?

SIPC

Hypothetical 1: Assume total of $6 million deposited and nothing available to distribute.

Results Under the Equitable Treatment of Investors Act

	Investor A	Investor B	Investor C
Amount Withdrawn Pre Liquidation	$3,000,000	-0-	-0-
Amount Received From SIPC Advance	$ 500,000	$500,000	$500,000
Total Amount Received Based on $2 Million Deposit	$3,500,000	$500,000	$500,000

SIPC

Hypothetical 1: Assume total of $6 million deposited and nothing available to distribute.

Results Under Current Law

	Investor A	Investor B	Investor C
Customer's Net Equity After $3 Million Withdrawal by "A" Is Avoided	$2,000,000	$2,000,000	$2,000,000
Customer Property Distributed After Avoidance of Transfer to"A"	$1,000,000	$1,000,000	$1,000,000
Amount Received From SIPC Advance	$ 500,000	$ 500,000	$ 500,000
Total Amount Received Based on $2 Million Deposit	$1,500,000	$1,500,000	$1,500,000

SIPC

COST TO SIPC

- Identical in Each Instance
- Which is More Equitable?
- The Avoidance Powers Are Exactly What Makes the Distribution Equitable

Hypothetical 2: Assume Subsequent Recovery From Wrongdoer of $1,000,000

Results Under the Equitable Treatment of Investors Act

	Investor A	Investor B	Investor C
Customer's Net Equity Based on Last Statement	$1,000,000	$4,000,000	$4,000,000
Amount Withdrawn Pre-Liquidation	$3,000,000	-0-	-0-
From SIPC	$500,000	$500,000	$500,000
From Wrongdoer	$111,111	$444,444	$444,444
TOTAL AMOUNT RECEIVED BASED ON $2 MILLION DEPOSIT	$3,611,111	$944,444	$944,444

SIPC

Hypothetical 2: Assume Subsequent Recovery From Wrongdoer of $1,000,000

Results Under Current Law

	Investor A	Investor B	Investor C
Customer's Net Equity After "A's" $3 Million Withdrawal is Avoided	$2,000,000	$2,000,000	$2,000,000
Customer Property Distributed After Avoidance of Transfer To "A"	$1,000,000	$1,000,000	$1,000,000
From SIPC	$500,000	$500,000	$500,000
From Wrongdoer	$333,333	$333,333	$333,333
TOTAL AMOUNT RECEIVED BASED ON $2 MILLION DEPOSIT	$1,833,333	$1,833,333	$1,833,333

SIPC

SECURITIES INVESTOR PROTECTION CORPORATION

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SiPC

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NIAP

Network for Investor Action and Protection

TESTIMONY OF RON STEIN, CFP

President, The Network for Investor Action and Protection

Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services

United States House of Representatives

March 7, 2012

www.investoraction.org
P.O Box 2159 Halesite NY 11743 Phone (800) 323-9250 Fax (631) 421-5701

Chairman Garrett, Ranking Member Maxine Waters, Vice Chairman David Schweikert, Members of the Subcommittee, and Fellow Congressional Members:

My name is Ron Stein, President of the non-profit Network for Investor Action and Protection ("NIAP"). I am both a registered investment adviser and Certified Financial Planner and over the years have seen all too often how a fraud such as Madoff's can ruin the lives of thousands of innocent victims.

On behalf of NIAP and myself, I appreciate the opportunity to appear before this Committee and explain why it is essential that Congress enact H.R.757, legislation that reaffirms and restores the vital investor protections that Congress intended for investors under SIPA and that until recently, investors rightfully understood was already provided to them.

Since its formation, NIAP and its membership of over 1200 individual investors have worked diligently to preserve and expand investor protections against the wide array of potential investor frauds any one of which could financially devastate the victims and their families and turn their lives upside down. Our primary constituency and concern is the individual non-institutional investor, the person most in need of assistance. Unlike the large hedge funds and other institutional investment entities, these individual investors are frequently unable to fend for themselves in the wake of a fraud and lack the awareness and tools to obtain relief that is, or at least should be, available to them as investor fraud victims.

Although NIAP was formed in response to the Madoff scandal and the devastation it has caused, our mission and our focus is not limited simply to the Madoff fraud, but enhancing protections for all investors. We have devoted significant time and effort working toward meaningful regulatory reform. The regulators, whether they be governmental agencies such as the SEC or quasi-governmental self-regulatory entities such as SIPC or FINRA are the threshold gatekeepers; unless they do their jobs diligently and vigorously, the likelihood of future wide scale fraud is increased. NIAP is therefore deeply involved with reform efforts and measures designed to enhance proper regulatory functioning. Our work thus includes oversight and investor education to prevent the erosion of existing investor rights by those such as SIPC which should be working vigorously for the victims but all too frequently operate instead in their own self-interest.

It is widely known that the regulatory oversight and investigatory functions failed abysmally in the Madoff fraud, which should have been stopped years ago. But even after it was discovered, during the inordinately lengthy SIPC Liquidation process that has followed, there has been a continuation of the past failures to protect the victims of this massive fraud.

For these and other reasons, we fully support H.R.757. It is a vital reform measure and reaffirmation of core investor protections. It must be enacted to protect the reasonable and legitimate expectations of Madoff victims and as a necessary step toward rebuilding investor confidence in our capital markets, already shaken by the events of recent years.

In considering H.R.757, it cannot be over-emphasized that the Madoff firm – BLMIS – was not an un-regulated, fly-by-night investment firm, offering outrageous returns. It wasa high profile, highly regarded broker-dealer, and SIPC member, led by a scion of Wall Street, theoretically subject to the full range of regulatory scrutiny, and offering, at times, below-market, albeit steady returns. As documented in great detail in the Report of the SEC's Inspector General, however, during the lengthy period that the fraud persisted, the SEC failed, for many years, to identify and stop the massive investor fraud despite repeated opportunities to do so, and despite possessing full authority and the necessary tools to do so.[1] Compounding the SEC's regulatory failures, the SEC Inspector General's report also documents the shocking fact that despite learning information strongly suggesting to them that Madoff was engaged in a fraud, highly regarded financial institutions and insiders chose to keep silent and not report that information or their suspicions to the regulators. In essence, the failed oversight of the SEC, NASD, and the blind eye of other professionals in the field is what fueled the explosive growth of this crime, perhaps more even than the fraudster.

Unfortunately, the failure to inform or protect investors has continued even now, three years even after Madoff was caught. The manner in which the Madoff Liquidation has been mishandled reveals with painful clarity the gross inadequacy of the current SIPC liquidation process and the vital need for reform. Throughout the liquidation process, SIPC and its hand-picked trustee have been allowed to make crucial decisions which favored their own substantial financial interests to the detriment of the Madoff victims, even though the statute -- entitled, ironically for many investors "The Securities Investor Protections Act"-- was specifically enacted to *protect* investors. The core failures arising from SIPC's conflict-based, self-interested decision making could not have continued but for the parallel failure of the SEC to exercise in any meaningful way oversight over SIPC's operations, as mandated by the SIPA statute. Rather than exercising its authority, the SEC has abdicated its responsibility and allowed SIPC and its Trustee free rein to twist and mangle the statute almost beyond recognition. The consequence is that vital investor protections enacted by Congress have been compromised or ignored, in flat defiance of the clearly expressed Congressional intent to the contrary.

It is undisputed, for example, that the majority of Madoff victims will receive none of the monetary relief promised them in the SIPA statute -- not one penny in SIPC advances[2]. Moreover, and in devastating fashion, SIPC and its Trustee have dramatically added to investors'

[1] INVESTIGATION AND FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, OIG Report No. 507. August 31, 2009

[2] According to the Trustee's web site, 2,703 claims were denied entirely and 2,426 claims were at least partially allowed.

financial and emotional distress by bringing almost 1,000 individual clawback lawsuits against victims although each of these defendants, according to the Trustee, are innocent victims with no knowledge of the Madoff fraud. Thus, not only have these innocent victims been deprived of their SIPA benefits but they have now been forced, at considerable cost, to defend themselves against clawback actions in which the Trustee seeks to compel victims to pay SIPC monies legitimately withdrawn from their own Madoff accounts over decades -- money long spent to pay taxes, mortgages, education expenses, and all of their other costs of living incurred over the course of many years. Investors took redemptions in good faith, reasonably believing that they were taking their own funds based on statements that reflected positive account balances. For SIPC and its Trustee now to seek to take those monies from already devastated victims of this fraud is, quite simply, unconscionable – as is the failure of SEC to exercise its oversight powers to prevent it – even though the SEC had been told previously that there would not be clawback against innocent victims.[3]

In the process, the SIPA statute has been a total failure and fraud for these innocent Madoff victims. It has been transformed from a remedial, investor protection statute, into an instrument of investor oppression and harm. Most of these victims are small non-institutional investors who were devastated by the Madoff fraud to begin with. It is morally indefensible that these victims should now also be subjected, to further victimization by SIPC through the misapplication of the SIPA statute.

The historical context makes obvious both Congress' intent and SIPA's meaning. SIPA was enacted in 1970 in the wake of massive insolvencies that had rocked the broker-dealer industry and seriously undermined investor confidence.[i] [ii]At the time, the securities industry operated on the basis of registered physical stock certificates rather than the current book entry-street name system. Each time stock was bought or sold, the seller's shares had to be physically delivered to be cancelled and a new certificate had to be issued by the Company in the name of the buyer, to be physically delivered to that buyer. The back office logjams – often referred to as the "paper crisis" -- were monumental as were the attendant costs and delays, particularly as the number of shares traded exploded throughout the 60's. Stock certificates literally piled up in back offices from floor to ceiling waiting to be transferred. Certificates were frequently lost and theft of securities, and even counterfeit was rampant.[iii] Brokerage firms resorted to all types of devices, including fraudulently "cooking their books" to mask their deteriorating financial condition from the regulators and their customers. [iv] Embezzlements and Ponzi schemes were routinely in the headlines. Chaos was the norm.

It was in that context that Congress sought to reform the system in order to assist the

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3 The SEC's Inspector General's report on the David Becker conflict issue quotes Chairperson Mary Shapiro to the effect that she (and presumably the other SEC commissioners and staff) understood from SIPC and the trustee that no clawback actions would be brought against innocent victims of the Madoff fraud. But even when that proved to be false-when such actions were later brought by the trustee in the name of SIPC- the SEC remained silent and took no action to prevent this obvious wrong from continuing.

industry, while at the same time protecting the investing public and maintaining the integrity of the capital markets. Following extensive hearings through 1969 and 1970, legislation was introduced[v], patterned on the FDIC model to provide necessary structural change and investor protection. Although initially the financial industry stalled the legislation, as broker-dealer insolvencies mounted (including several major firms that threatened the very existence of the NY Stock Exchange), and commission income plummeted with the increased loss of investor confidence, the industry soon reversed course and urged the creation of a federally-based insurance entity that could help stave off financial disaster. Thus SIPA was enacted and SIPC was born. The old system of registered investor possessed stock certificates migrated to the book entry-street name system and in 1975 Congress enacted modifications to the Securities Exchange Act of 1934 and additional changes to SIPA in 1978 to continue to improve protections, and affirm that investors would know that they were protected (up to the statutory limits) if the shares they owned were not available to them from the brokerage firm for whatever reason.

Through the enactment of SIPA, Congress created a multi-legged investor protection regime that dramatically stepped up oversight of broker-dealers and exchanges, and further empowered both NASD (now FINRA) and the SEC. It also mandated that the securities industry form and fund SIPC, a not-for-profit entity, to act as the funding vehicle to insure customer accounts against brokerage firm failure up to the statutory limits (currently $ 500,000).[4] In doing so, Congress looked to the structural protection offered by the banking industry through FDIC, with necessary modifications to accommodate for the industry differences. With the change to a book entry/street name system, securities ownership would be demonstrated by trade confirmations and account statements in the same manner as the banking industry's customers knew what they were owed by their bank account statements and pass books. Under both systems -- FDIC for bank customers and SIPC for brokerage customers -- there were specific dollar protection limits providing customers with clarity and, most critically, the certainty so central to a pillar of the economy. Just as all FDIC bank depositors, whether net savers or those now withdrawing savings for living income, enjoy equal status and FDIC protection, Congress sought to provide similar certainty for all brokerage customers. While bank and brokerage customers could choose to exceed those protected limits, they would do so knowing that those excess balances were at their own risk.[5] But they were never told that even the basic SIPC coverage would be withheld from them by a rogue quasi- governmental agency and its designated Trustee.

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4 Richard Nixon, "STATEMENT ON SIGNING THE SECURITIES INVESTORPROTECTION ACT OF 1970", December 31, 1970.

5 To the banking industry, which during the Great Depression had seen innumerable failures, had even witnessed the Hanover Trust Banking Ponzi theft, FDIC insurance coverage based on the customer's account statement was seen as an essential component of restoring customer faith in the banking system and to encourage investor to feel confident leaving their money on deposit in banks. That same need existed in the Securities system and with the change from registered physical stock certificates to book entry street name, the same need existed for the account statement representations to be given full force and effect. Otherwise, customer confidence could not be restored and our capital markets would have suffered.

While the SEC and industry pressed intensely for the keeping of securities in street name, the public was not in full support. As one study indicated, "the public appears to lack confidence in street name registration as a substitute for the customer named certificate." [vi] It made sense, therefore, that Congress, the SEC and the industry, given the already dismal public opinion, would do nothing further to undermine investor confidence, or weaken the new protections.

But SIPA's laudable goals and protections have now, for all practical purposes, been eviscerated by SIPC and its Trustees, as the following undisputed facts from the Madoff liquidation all too clearly demonstrate.

FACT: A majority of the Madoff customers have been denied any SIPC coverage or advances, will receive none in the future, and will not be entitled to participate in the distribution of the SIPC customer property;[6]

FACT: Many investors who have received some SIPC relief under the Trustee's Net Investment method, have received less in SIPC advances than they should have based on their account statements and the amount of their allowed claim has similarly been improperly reduced.[7]

FACT: According to the Trustee, at least 75% (and perhaps as much as 90%) of the anticipated pool of SIPA customer property will be distributed to institutional entities -- hedge funds and the like -- leaving only a small percentage for the small, non-institutional individual investor, the person who was supposed to be the primary beneficiary of SIPA protection. Included in this group of large institutional customers are some of the very hedge funds and other professionals whom the Trustee says facilitated the rapid expansion of the fraud by virtue of their substantial funding of Madoff's investment cash and lack of due diligence.[8]

FACT: For more than 40 years, SIPC has aggressively marketed the familiar SIPC Logo to investors and to the industry, to persuade the investing public that their investments are protected even if the brokerage firm should fail or be unable to deliver what should have been in an investor's account. During this same 40 year period, the industry experienced explosive growth due, in part to the ability of a brokerage firm to advertise its SIPC membership and the fact that their customer accounts would be protected by SIPC as a result of that membership.

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6 See Footnote 2.

7 This occurs because under the Trustee's methodology, all investors have their allowed claims reduced by the amount of so-called fictitious profits. This results in a reduced allowed SIPC claim which impacts on the size of the SIPC advance and the participation in the distribution of customer property.

8 Included in this group of large institutional customers are some of the very hedge funds and other professionals who the Trustee himself has stated allowed for the rapid expansion of the fraud by virtue of their substantial funding of Madoff's investment cash flow; See SIPC responses to Rep. Kanjorksi and Rep. Garrett on 9/7/2010 and 1/24/2011 respectively.

Until SIPC's recent arbitrary revision of the statute, the investing public understood that there was only one meaningful exclusion from SIPC coverage: SIPC would not protect against market place loss (i.e. if an investor purchased stock which then declined in value in the marketplace, that loss belonged to the investor, not SIPC and properly so). But other than that, investors were informed of the coverage, and of no other exclusions to that coverage. Theft, embezzlement or other theft fraud (including "Ponzi" theft) were *never* perils exempted from SIPC protection. Critically, the financial services industry, with SIPC's support, including thousands of trained practitioners in my field, repeated these same assurances of SIPC insurance protections to millions of investors for these past forty years. To change the rules now, just when the SIPC coverage is so needed amounts to a bait-and-switch campaign, having deliberately misled the American investing public, and abandoning them during their time of greatest need. Frankly, it should be dealt with as such.

FACT: The Trustee has already received legal fees in the hundreds of millions of dollars and has publicly projected that these legal fees and expenses ultimately exceed **$1 billion**.[9] Ironically, if that same amount of money had instead been allocated to paying SIPC advances to innocent Madoff victims, based on their final account statements, every Madoff victim -- so called net winners and net losers alike -- would have received a full SIPC advance, without diminishing by even one penny the amount of customer property available for distribution to Madoff victims with allowed SIPC claims. Instead, more than three years after the Madoff fraud surfaced, the Liquidation process remains bogged down interminably in complex litigation, and victims remain without their SIPC financial relief, despite the explicit SIPA requirement that relief to victims be paid "promptly".

FACT: Although acknowledging that each victim was factually innocent and unaware of the Madoff fraud, the Trustee has nevertheless brought almost 1000 clawback actions against Madoff victims to recover withdrawals they made years and even decades earlier. They did so from their own Madoff accounts in good faith, with every reason to believe it was their own money. Although couching these clawback actions as necessary to accomplish an equitable result, it is hardly fair or equitable to require people to pay moneys they have long since spent believing -- for good reason -- that they were spending their own money.

FACT: Despite repeated representations to the contrary, under the Trustee's Net Investment Methodology, SIPC will be being reimbursed for all SIPC advances and for all legal fees and expenses before the majority of the Madoff victims receives even first dollar from the Madoff bankruptcy estate.

FACT: The Trustee's Net Investment methodology will save SIPC approximately **one billion dollars**, the additional amount that SIPC would have paid out to victims in SIPC advances under the final account statement method (the historical norm). This financial windfall

9 As reported in above reports to Kanjorski and Garrett.

for SIPC comes at the direct expense of the innocent Madoff victims.

FACT: Moreover, the Trustee's Net Investment methodology, while saving SIPC nearly $1 billion as stated above, has transferred the cost instead to all US taxpayers. Had SIPC paid the Madoff victims their proper SIPC advances as Congress intended, that would have reduced the amount of the allowable theft loss deduction and would have reduced the tax refunds the IRS would have paid out based on the theft loss. Conversely, when SIPC withheld SIPC advances from these Madoff victims which increased the deductible theft loss, and increased the amount the IRS had to pay in refunds on the allowed theft loss. In other words, under SIPC everyone loses -- except SIPC and the financial services industry -- which get a $1 billion windfall and reduced fees (amounting to a bailout) respectively.

FACT: Although SIPA, by its express terms, requires the registered brokerage industry to fund SIPC at sufficient levels to enable SIPC to pay all required statutory advances and benefits, for many years each brokerage firm paid only $150 dollars per year for the privilege of proclaiming SIPC membership by the firm and protection for the customers, despite the enormous increase in the size (and risk to clients) of brokerage firm failure. This left the SIPC fund woefully underfunded when the Madoff fraud surfaced and led the Chairperson of the SEC Mary Shapiro to acknowledge in her Congressional testimony that the "problem" was that there was just not enough money to provide SIPC relief for all of the Madoff victims as SIPA required.[10] This, however, should not have been a surprise to anyone, least of all the SEC. SIPC's underfunding has been questioned for years by Congress, with no remedial actions taken until the Madoff scandal came to light.

FACT: SIPA expressly requires SIPC to make advances from the SIPC Fund "promptly" to relieve the financial distress of customers while the Trustee seeks to recover customer property from complicit third parties. But in addition to denying any protection, whatsoever, to over half of BLMIS' customers, the actual disbursement of funds to even eligible customers has been delayed more than three years, with no end in sight -- and without any hint that compensatory interest will ever be paid to compensate for the delay.

FACT: The SIPA statute contains a specific definition of Net Equity and further provides it may not be changed by SIPC, reserving that right exclusively to Congress.[11] Despite this Congressional prohibition, SIPC and the Trustee have acted as though they have Carte Blanche to adopt whatever "definition" of Net equity suits their interests. This not only violates the statute but is inherently dangerous. Since SIPC chooses the trustee and SIPC alone decides how much to pay that Trustee, it is hardly surprising that, as in Madoff, a trustee will, consciously or otherwise, choose a definition that benefits and protects the interests of SIPC (and

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[10] . The OIG report also reported the Chairman's concern about the ability of the SIPC fund to handle the impact of the Madoff insolvency. Left unexplained by Chairperson Shapiro is how then there was enough money to pay the Trustee and his law firm a projected BILLION DOLLARS in fees and expenses

[11] *See*, 15 U.S.C.§78ccc(b)(4)(A) & 15 U.S.C.§78lll.

the securities industry), relegating the needs of the victims to secondary status. This is a universal problem and what has happened to the Madoff victims here can happen to other victims of future brokerage firm failures and fraud.

FACT: The Congressional history of SIPA confirms that it was intended to provide protection for brokerage customers when their securities "have been lost, improperly hypothecated, misappropriated, never purchased, or even stolen".[12] However, in its zeal to protect the SIPC fund in the Madoff debacle, SIPC and the Trustee have effectively written this core protection out of the law and, in the process, have defied the will of Congress.

FACT: Despite what will invariably be SIPC's protestations to the contrary, SIPC has a longstanding history of denying valid customer claims, forcing victims to undertake years of costly and contentious litigation. The SEC, despite statutory responsibility for overseeing SIPC, has essentially allowed SIPC free rein to do as it pleases, without restraint or effective oversight.[vii]

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With these facts as a backdrop, no investor can ever comfortably feel protected by SIPA; they should no longer believe that if their brokerage firm fails, they will at least receive their promised SIPC coverage to partially reduce their loss. If the Madoff liquidation is any indicator, SIPC coverage will effectively be non-existent for most securities fraud victims, a result which is antithetical to fostering investor confidence.

After Madoff, what informed or prudent investor can ever feel safe withdrawing any money from a brokerage account for fear that years, or even decades, later, a future SIPC trustee will sue to take back those funds. How can anyone be expected to invest with any degree of confidence under such circumstances?

And who is most affected by this? Clearly, it is the small non-institutional investor -- the elderly, the retiree, the sick – all of whom need to access their brokerage account profits regularly in order to live and pay their bills. These victims have already lost their life savings to a fraudster. It is unthinkable to subject them to yet another devastating confiscation. [13]

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12 H.R. Rep. 95-746, 95th Cong., 1st Sess. (1977) at 21. *See also*, S.Rep. 95-763, 95th Cong.2d Sess. (1978) Sess.(1978) at 2

13 Imagine if similar procedures were adopted by the banking industry under FDIC? Imagine the uproar if after years of living on interest earned from a bank account, the bank suddenly became insolvent due to the bank president's Ponzi scheme fraud and instead of receiving FDIC coverage, customers were told they had to repay the bank the interest previously withdrawn. As inconceivable as that sounds, that is precisely the underlying rationale for denying Madoff victims SIPC coverage and for the reprehensible clawback actions brought against these innocent victims.

If SIPC's current self-serving approach is left in place, a further loss of investor confidence will inevitably follow. Responsible financial advisors and brokers will have to explain to their clients that SIPC protection is replete with caveats that will not be known to the investor until their investments may be in jeopardy. They may be informed that SIPC has recently decided that profits may not be protected, that funds withdrawn from an account may reduce SIPC protection, or worse, they may be clawed back. A responsible practitioner may tell their customer what their true account value – their net equity – really is, and that it may be far lower than their account statement values. The public hazard, particularly to those living on income and thereby reducing their potential SIPC protection, is clear and beyond belief.

No one is asking SIPC to provide insurance against a market place decline in a customer's investment. That is an investment risk that is not covered by SIPA, and properly so. Again, it is the primary factor distinguishing SIPA coverage from FDIC coverage; in all other material respects, SIPA was patterned after FDIC coverage and was intended to provide that same degree of comfort and protection against institutional failure, despite recent insistence by SIPC and its supporters to the contrary. But what is needed is the basic SIPC coverage promised to investors for more than forty years.

As applied in Madoff by SIPC and its Trustee, we are left with a statute enacted by Congress to *protect* investors and foster investor confidence accomplishing precisely the opposite result. Coverage is riddled with uncertainty and without any clarity as to what SIPC will, or will not, protect. Further, investors are now faced with the prospects of staggering clawback actions against them, ostensibly under the guise of SIPA itself. This is a perverse and untenable circumstance. It brings into sharp focus the urgent need for Congress promptly to pass H.R.757, to restore SIPA to what Congress intended and to eliminate the ability of SIPC or any future trustee to craft artful techniques to deprive investors of the protections mandated by Congress.

H.R.757 addresses squarely and unambiguously a number of the more glaring deficiencies that have emerged during the process of SIPC's mismanagement of SIPA and the SEC's failure to rein in SIPC's wrongful activities.

- First, it will require SIPC and all future Trustees to determine Net Equity of an innocent non-institutional customer using the customer's final account statement, i.e. on the basis of what the customer reasonably understood and expected he is owed by the brokerage firm. At the same time, it will provide no comfort or protection to any customer who is found to have been complicit with the broker's fraud since those customers will clearly not qualify as "innocent".

- It will also protect an innocent non-institutional customer from the costs, emotional toll and potential financial devastation of clawback actions. Again, H.R.757 will not shelter those who acted with wrongful knowledge of or complicity in the fraud. Again, they will not qualify as "innocent" and will thus fall outside of the safe harbor of H.R.757.

- H.R.757 will impose a more stringent standard for registered professionals relating to what they knew or should reasonably have known and will provide meaningful and practical incentives for them to report perceived fraudulent conduct to the appropriate regulators in order for them to be protected from liability.

- It will eliminate the unseemly practice -- and the obvious conflicts of interest- inherent in allowing SIPC to choose the Trustee and then to determine how much that Trustee can charge for his and his law firm's services. Under H.R. 757, the SEC will create an panel of independent potential trustees and the Court will select the trustee from that panel. Moreover, the Court, not SIPC will determine the trustee's compensation consistent with the manner in which non-SIPC bankruptcy trustees are compensated

- Critically, H.R. 757 will make clear to **all** investors already shaken by the events since 2008, and further frightened by the high-profile failures of major brokerage firms, that account statements will be honored in the event of a brokerage firm failure and will not be ignored at the whim of some future SIPC Trustee based on some amorphous and subjective view of fairness. At this critical juncture, certainty and clarity is needed, now more than ever, if our capital markets are to continue to grow and if investor confidence is to be restored and nurtured.

Passage of H.R.757 will reaffirm the type of protections Congress mandated for victimized brokerage customers when SIPA was enacted. It will end the insanity of allowing clawbacks against innocent victims -- a process that virtually criminalizes the victim and dramatically erodes investor confidence. H.R.757 will also correct some of the more significant deficiencies in the administrative operations of the current SIPA statute, including, most significantly ending the conflict of interest inherent in allowing a quasi-governmental agency to hand-pick its own trustee, a person who has a vested interest in catering to the needs and wishes of the paymaster. It will help restore investor confidence in the securities markets and, hopefully eliminate -- or at least minimize -- the extreme investor cynicism that currently exists. It will provide necessary clarity and certainty in place of the uncertainty and chaos which currently exists. It will reiterate to investors, that Congress intends to stand by its promises of investor protection now, and in the future.

In sum, H.R.757 is desperately needed to restore the protections mandated by Congress to victims of frauds such as Madoff and the desired confidence in our capital markets that our economy needs and requires to grow. We urge the swift passage of H.R.757[14]

[14] Passage of H.R.757 is the beginning not the end of a necessary reform process Further improvements and changes to our investor protection system are needed. My prior testimony submitted to this committee, along with materials submitted to the SIPC Modernization Task Force articulate some of those thoughts. Clearly, protections are needed for other victims of this type of fraud as well, including victims in qualified plans and other indirect investors. But a first step is essential. Future promises will mean nothing, if we don't follow through on the promises already in place.

- ENDNOTES

[i] Joel Seligman, *The Transformation of Wall Street*, Third Edition, p450 +

[ii] Wyett Wells, *Certificates and Computers: The Remaking of Wall Street, 1967-1971; Harvard Business History Review, 2000; p 204+*

[iii] SEC, *Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations;* pursuant to SIPA Act of 1970; for Committee on Insterstate and Foreign Commerce, Washington, D.C. 1971; p20, 44, 145-146.

[iv] I.e. Ira Haupt & Co, a mid-sized Wall Street brokerage was closely tied to the Tino DeAngelis "Salad Oil Man" Ponzi theft scheme; Robert Vesco, and his financial scandal and political connects was major news through 1970.

[v] Legislation introduced, S 2348, *The Federal Broker-Dealer Investment Corporation Act,* 1970. This was stalled and subsequently superseded by HR19333, which became the SIPA law.

Joo, Thomas W., *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure,* Southern California Law Review, Vol 72:1071, 2000; p1080+

[vi] Sidney Robbins, *The Paper Crisis in the Securities Industry,* Lybrand, Ross, 1969; p6

[vii] Gretchen Morgenson, *Investor Beware; Many Holes Threaten Safety Net for Investors of Failed Brokerages,* NY Times, Sept 25, 2000

Richard Nixon
XXXVII *President of the United States: 1969-1974*

481 - Statement on Signing the Securities Investor Protection Act of 1970. *December 30, 1970*

I AM SIGNING today the Securities Investor Protection Act of 1970. This legislation establishes the Securities Investor Protection Corporation (SIPC), a private nonprofit corporation, which will insure the securities and cash left with brokerage firms by investors against loss from financial difficulties or failure of such firms. Protection is provided up to an aggregate of $50,000 per account, with a limit on coverage of cash of $50,000.

In my message on economic policy and productivity on June 17, 1970, I urged the formation of a corporation to afford protection to small investors, backed first by industry payments and then by funds from the U.S. Treasury. The bipartisan efforts of the Congress, the administration, and the industry have now resulted in this legislation--a vitally important advance in the consumer-protection field.

Just as the Federal Deposit Insurance Corporation protects the user of banking services from the danger of bank failure, so will the Securities Investor Protection Corporation protect the user of investment services from the danger of brokerage firm failure.

This act protects the customer, not the broker, since only the customer is paid in the event of firm failure. It does not cover the equity risk that is always present in stock market investment, but it will assure the investor that the solvency of the individual firm with which he deals will not be cause for concern. It protects the small investor, not the large investor, since there is a limit on reimbursable losses. And it assures that the widow, the retired couple, the small investor who have invested their life savings in securities will not suffer loss because of an operating failure in the mechanisms of the marketplace.

Virtually all brokers and dealers in the securities industry will be members of SIPC. These members will provide $75 million from assessments, trust fund transfers, and lines of credit from commercial banks within 120 days. The industry will continue to pay assessments based on a percentage of their gross revenues until the fund reaches $150 million. If, contrary to expectations, this fund at any time should prove inadequate, SIPC may also call upon a $1 billion line of credit from the U.S. Treasury. Any funds provided by the Treasury will be recovered from subsequent assessments.

This legislation contains a specific statutory mandate to the Securities and Exchange Commission to promulgate rules and regulations with respect to the financial responsibility and related practices of brokers and dealers. The SEC is given flexibility in establishing those rules and regulations.

The functioning of the securities industry is a key element in providing the means for continued growth of American business and the economy of this country. Protection for the customer is essential, and has been provided here, as in the mutual fund bill [Public Law 91-547] which I recently signed. The Government and the industry must work together on seeking prompt solutions to the problems of the securities business. While those problems are being defined and resolved, the user of investment services, the small investor, will be protected.
Note: As enacted, the bill (H.R. 19333) is Public Law 91-598 (134 Stat. 1636).

Citation: Richard Nixon: "Statement on Signing the Securities Investor Protection Act of 1970.," December 30, 1970. Online by Gerhard Peters and John T. Woolley, *The American Presidency Project*. http://www.presidency.ucsb.edu/ws/?pid=2870.

Statement of
United States Senator David Vitter
Before the Capital Markets and Government Sponsored Enterprises Subcommittee
of the House Financial Services Committee
March 7, 2012

Thank you, Chairman Garrett and Ranking Member Waters and members of the Capital Markets and Government Sponsored Enterprises Subcommittee, for inviting me to testify here today. Congress has given the Securities Investor Protection Corporation (SIPC) incredible responsibility for protecting investors, and for that reason, it's vitally important and appropriate that we point the spotlight at SIPC to understand the ways that it is and is not working.

If there is one common cause between Stanford and Madoff investors, it's the way SIPC fought investors every step of the way and has absolutely refused to protect the victims of fraud. For three years the Stanford victims have been fighting just to have their day in court – and unfortunately, it's SIPC that they have to fight.

I fear we are in a situation where, if SIPC were a true financial regulator, we would call it regulatory capture. The actions of SIPC are dictated by the member companies rather than by the law. SIPC is functioning more like a trade association and advocate than a quasi-regulator.

I first became involved in the Stanford case because it has affected thousands of victims in the United States, and many of them live in Louisiana. Allen Stanford was adept at preying upon the savings of retired oil and gas workers in Louisiana in particular. Many of the victims have told me their entire savings has been lost because of the Stanford fraud, and that they have been forced to sell their home and re-enter the work force.

I want to be absolutely clear. I don't believe there is any need to change to the Securities Investor Protection Act in order to provide coverage for the Stanford victims. These victims are entitled to coverage under the law as it is currently written.

In the actual criminal case against Allen Stanford, he is accused of stealing customer funds. Instead of purchasing Stanford International Bank (SIB) "certificates of deposit" (CDs), the Stanford Group Company (SGC) which was a SIPC member, acquired control of its customers' funds and the funds were stolen by Allen Stanford. The Securities Exchange Commission (SEC) and courts have taken the position in litigation related to the receivership of Stanford's estate, that the Stanford companies operated as a Ponzi scheme and, "a Ponzi scheme is, as a matter of law insolvent from its inception." And, just yesterday, a jury convicted Allen Stanford on 13 of 14 counts related to this case.

In *Old Naples Securities, Inc.* the U.S. Court of Appeals for the 11th Circuit held that customers of an introducing broker-dealer who thought they were purchasing bonds through the broker-dealer were "customers" of an introducing broker-dealer within the meaning of SIPA and entitled to coverage under the statute. The court held whether a claimant deposited cash with the debtor "does not… depend simply on to whom the claimant handed her cash or made her check payable, or even where the funds were initially deposited." Rather, the issue was one of "actual receipt, acquisition or possession of the property of a claimant by the brokerage firm under liquidation."

Previously, the SEC has argued that "a customer's legitimate expectations" ought to be protected "regardless of the fact that the securities were fictitious." It is impossible for an insolvent entity issue legitimate securities. In *re New Times Securities Services, Inc.*, the owner sold fictitious mutual funds, as well as bona fide mutual funds to investors via a register broker dealer that was a SIPC member and a non-broker-dealer entity.

Forensic accounting, which was done by the court appointed receiver, shows that the SIB CDs were not purchased by SGC for its customers, and therefore they are not worthless securities with zero value as argued by SIPC. Instead, these CDs are fictitious. The SGC customer funds were never transferred to the Antiguan bank and there was never any money standing behind the CDs.

On June 5, 2011, the SEC Commission voted on a determination that SIPC should provide coverage for the Stanford victims. In the analysis of the case provided by the SEC to SIPC, the SEC explains that on the specific facts of this case, investors with brokerage accounts at SGC who purchased the CDs through the broker-dealer qualified for protected "customer" status under SIPA.

In reaching its determination, the SEC cited the conclusions in the report of the court appointed-receiver for SGC, who noted that the many companies controlled and directly or indirectly owned by Stanford "were operated in a highly interconnected fashion, with a core objective of selling" the CDs. Among other things, the receiver also noted that "[c]orporate separateness was not respected within the Stanford empire... Money was transferred from entity to entity as needed, irrespective of legitimate business need. Ultimately, all of the fund transfers supported the Ponzi scheme in one way or another, or benefited Allen Stanford personally."

A SIPA liquidation proceeding would allow investors with accounts at the SGC to file claims with a trustee selected by SIPC. The trustee would decide whether the investors have "customer" claims that are protected by the statute, and an investor who disagreed with the trustee's determination could seek court review.

However, the ultimate roadblock to the victim's day in court is SIPC.

During the eight months since the SEC made its determination instructing to provide protection to the Stanford victims, SIPC has tried every conceivable idea to drag out making a final determination.

After the SEC's determination, SIPC ran up $200,000 of charges in June and July of last summer in reviewing the court appointed receiver's documents – a cost that will be ultimately be paid for with the money set aside for the victims. When asked about these charges, SIPC claimed that it was in order to do research into a settlement offer to the victims. However, an official settlement offer never materialized.

During the time between the SEC's determination and the SEC ultimately filing an application with the DC Circuit Court to compel a SIPA liquidation, I had many calls and meetings with Orlan Johnson, then Chairman of SIPC and his staff, including Stephen Harbeck. Concerns were raised by both Mr. Johnson and his staff on a reoccurring basis, as far back as our first meeting on this issue, about the cost to the SIPC fund of covering Stanford victims and how SIPC member companies would react to the need for SIPC to increase its assessments. I stressed in our discussions that I believe the only focus should be on providing the victims with swift resolution under the law in a manner that takes into account the complex nature of the fraud and uses the forensic accounting that had already been undertaken.

In these meetings and on these calls, it seemed to me, that SIPC was more interested in the cost of the resolution and protecting its Wall Street member companies than it was in doing their duty, doing the right thing, and immediately initiating a formal liquidation proceeding in the Stanford matter as ordered by the SEC. In fact, I was told that SIPC felt they would be sued no matter what they ultimately decided to do. SIPC was certain they would either be sued by the SEC or sued by their member companies

During the course of these meetings and phone calls it also became obvious that SIPC hired lawyers to defend itself from the SEC while still negotiating a settlement offer, and SIPC has shown every indication it will continue to litigate this matter in court.

Currently, SIPC is fighting the SEC in court trying to avoid being compelled to file a protective order which would ultimately allow individual victims to get a judicial review of the merits of their claims against SIPC. While this judicial review is certainly part of the SIPA process, it was intended to be more of a summary proceeding, and I think everyone would be surprised at some of SIPC's tactics they are willing to use in order to avoid compensating the victims.

In a filing on February 16th, despite the fact that SIPC has run up a charge of $200,000 dollars with the court-appointed receiver, SIPC asked the judge to allow a discovery of documents related to who the customers were, the certificates of deposit and the corporate structure of the Stanford Companies. In addition, on Monday of this week, SIPC asked the judge for approval to review all of emails and documents of the SEC's legislative affairs team in a fishing expedition in an attempt to find a past instance where a staffer at the SEC might have said something that disagreed with what the SEC ultimately voted on months or years later.

The SIPA statute is 41 years old, and SIPC has never challenged the authority of the SEC in court the way it is now. SIPC has decided to test the SEC's authority to compel SIPC to protect investors. If SIPC persists on this pat, SIPC will undermine the faith investors have in markets and in SIPC coverage itself. Although I hope SIPC will see the error of their logic, I realize that ship has already sailed. I will continue to work on behalf of Stanford victims and all of Louisiana victims of securities fraud.

Chairman Garrett, I want to close by once again commending you on this timely hearing. I hope that my testimony shows that though no additional legislative action is needed to provide SIPC coverage for the Stanford victims, they are facing what amounts to regulatory capture and are in a desperate search for ways to hold SIPC accountable. Hearings like this one are a very important step in that process. I encourage you to bring them back before this committee on a regular basis to answer for their actions.

I hope at some point to hear Mr. Harbeck and Ms. Bowen tell the victims why they feel comfortable running up a $200,000 tab at the expense who have lost everything.

Thank you again Chairman Garrett, Ranking Member Waters and Members of the Subcommittee for the opportunity to speak on behalf of the victims.

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Statement of William Daly
Senior Vice President, Government Relations
Bond Dealers of America

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

The Securities Investor Protection Corporation: Past, Present, and Future

March 7, 2012

Chairman Garrett, Ranking Member Waters and members of the Capital Markets and Government Sponsored Enterprises Subcommittee, thank you for the opportunity to submit this statement from the Bond Dealers of America (the "BDA").

The BDA is the only trade association exclusively focused on U.S. fixed income markets and represents middle-market brokers and dealers who are headquartered in cities all over the country, doing business throughout the United States coast to coast.

Our members are the "Main Street" firms, not the Wall Street firms. They help communities around the country finance their schools, roads and bridges. They also provide investment opportunities and liquidity for the investors in those communities.

The Securities Investor Protection Corporation (SIPC) plays an important role in the American financial markets, providing investors with the assurance that if their broker gets into financial difficulty the investor's cash and securities in possession of the broker will not be lost.

We appreciate this opportunity to comment on the Report and Recommendations of the SIPC Modernization Task Force. The Task Force clearly spent a great deal of time on this project and gave serious thought to the issues before it. We commend them for their efforts.

We believe, however, that the challenges to modernizing SIPC go far beyond the incremental recommendations of the Task Force and that some of the recommendations would increase the challenges. As the Task Force recognizes, several of its recommendations will have the effect of increasing claims.

SIPC was created approximately 40 years ago and for most of its history the demands on its resources were relatively low. However, since 2008 the demands have become larger by several orders of magnitude. Its expenses increased from virtually zero in 2007 to over $1.3 billion in 2008 and have remained very high by historical standards ever since. Obviously, the liquidation of Lehman Brothers was due to the financial crisis, but other liquidations – notably the Madoff ponzi scheme and the liquidation of MF Global – were not. There is also the case of the Stanford International Bank Ltd., where SIPC and the SEC differ over whether the case is covered by the Securities Investor Protection Act (SIPA). As with the other very large cases, the Stanford case would involve major claims on SIPC's resources if the SEC's view prevails. And it would clearly represent an expansion of SIPC's role as currently interpreted by the SIPC Board.

It does not appear that after a short period of time, SIPC will return to "business as usual" as it was before 2008 and any discussion of modernization should take that into account.

As a result of the demands put on SIPC, member assessments have had to increase dramatically, and will increase further if the SEC prevails in the Stanford case. In 2007 and 2008 (and for many years previously) members' assessments were virtually zero. They now exceed $400 million a year. The effect on individual firms has been dramatic, with the assessments for some BDA members increasing 1000 fold. Increases of that magnitude in a short period can and do affect firms and the services they provide to investors. Such a sudden and large increase in assessments strains firms' budgets and forces adjustments and curtailments in plans and projects to provide services and investment opportunities to the firms' clients.

In this context, the recommendations of the Task Force, while perhaps good policies, seem to us to have missed the mark. In a situation where the scope and activity of SIPC have dramatically changed and may change further, there is no recognition of that fact in the Task Force's report or recommendations. The challenges facing SIPC and how it can fulfill its role in the financial system going forward is simply not recognized nor dealt with in the report's recommendations.

In fact, the Task Force makes a number of recommendations that would increase the claims on SIPC without any discussion of the magnitude of the increases nor any cost/benefit analysis.

The Task Force does recommend that the SIPC Board undertake its own examination of the recommendations. We would go farther. We believe that the SIPC Board should examine SIPC's role in a more fundamental way. We believe that before the SIPC Board takes up these recommendations that it should examine SIPC's role currently and what it likely will be in the future, what the magnitude of claims will be, whether the current increase in claims is solely due to the financial crisis and will abate or whether there may be a permanent increase in SIPC claims, what the capital needs of SPIC will be and finally, how to equitably finance those capital needs.

Thank you again for the opportunity to present our views.

FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

STATEMENT FOR THE RECORD

On

The U.S. House Committee on Financial Services,
Subcommittee on Capital Markets and Government Sponsored Enterprises

"Securities Investor Protection Corporation: Past, Present, and Future"

March 7, 2012

FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

Statement of the Financial Services Institute
To the Subcommittee on Capital Markets and Government Sponsored Enterprises
For Oversight Hearing on the Securities Investor Protection Corporation

The Financial Services Institute (FSI) represents independent financial services firms and the independent financial advisors affiliated with them. We are pleased that the Subcommittee is holding this hearing to explore the issues facing the Securities Investor Protection Corporation (SIPC). We wish to register our concerns regarding proposed changes to the structure of SIPC assessments, particularly our strong opposition to the disproportionate financial impact that independent broker-dealer (IBD) firms will be forced to bear under revised SIPC assessments and the SIPC Modernization Task Force's recommendations.

<u>Independent Broker-Dealer Firms were not part of the problem and are Disproportionately Impacted by Increased Assessments</u>

It is clear that IBD firms were not part of the problems that created the most recent financial crisis. Yet, these same firms are disproportionately bearing the burden of the failures that resulted in the crisis through the imposition of significant and unanticipated increases in SIPC assessments. The failure of Lehman Brothers and the Ponzi scheme of Bernie Madoff, as well as others, have placed an enormous burden on IBD firms. Prior to 2009, SIPC assessments were at the very minimum, $150 per year. In fact, this had been the practice for so long that our members had developed a reasonable expectation that the cost would remain at that level for the foreseeable future.

Instead, since 2009 SIPC assessments have increased exponentially and without warning. The result has been a significant blow to IBD firms, making already difficult economic circumstances even more challenging. To wit, the following is a brief list that demonstrates the impact:

- A small FSI member firm located in the Southeastern United States, with approximately $20 million in revenues in 2011, had the following SIPC assessments from 2008 to 2011:
  - 2008 - $150.00
  - 2009 – Approximately $10,000 – a 6566.67% increase from the prior year
  - 2010 - $22,417 – a 124.17% increase from the prior year
  - 2011 - $34,891 – a 55.65% increase from the prior year
- A mid-size FSI member firm in located in the Southwestern United States, with approximate revenues of $65 million in 2011, had the following SIPC assessments from 2008 to 2011:
  - 2008 - $150.00
  - 2009 - $32,107 – an increase of 21,304.67% from the prior year
  - 2010 - $84,660 – an increase of 163.68% from the prior year
  - 2011 - $71,595
- A large FSI member firm in the Northeastern United States with approximately $170 million in revenue in 2011, had the following SIPC assessments from 2008 to 2011:
  - 2008 - $150.00
  - 2009 - $486,714 – an increase of 324,376% from the prior year

- 2010 - $795,174 – an increase of 63.38% from the prior year
- 2011 - $835,763 – an increase of 5.1% from the prior year
- 2012 - projects near $1,000,000

Profit margins for IBD firms are generally very small. From 2004 to 2010, the average annual profit margin for IBD firms was 1.7%. SIPC assessments are likely to remain high for the foreseeable future, especially with recent developments involving a court battle between the SEC and SIPC to determine coverage for victims of the R. Allen Stanford Ponzi scheme and the failure of MF Global currently progressing through SIPC liquidation.

These assessments are having a disparate impact on small IBD firms which don't have the resources to absorb the large and unexpected increase in fees. Furthermore, many IBD firms operate as dual registrants conducting both investment advisory and securities brokerage operations under a single corporate entity. Small firms are organized in this manner to reduce costs and simplify their business operations. This structure results in additional complications due to the fact that when investment advisory services are segregated into a separate corporate entity they are excluded from SIPC assessments, but are included when they occur under the same corporate entity as the brokerage services. IBD firms should not be penalized simply for choosing a more efficient business structure that helps lower their costs.

Another reason IBD firms are shouldering a disproportionate share of the burden is that IBD firms present a significantly lower risk of causing SIPC payouts due to the fact that they operate as introducing brokers. As such, they are prohibited from obtaining custody of investor funds and securities, and therefore receive no cash or securities from investors other than for transmittal purposes. Instead checks are made payable directly to the product sponsor and accounts are held, and securities transactions are processed, through clearing firms. The risk to investors is significantly less in this model and, thus, the risk of an adverse event requiring SIPC liquidation is also lower.

In addition, the vast majority of IBD firms do not sell proprietary securities or insurance products. Those IBD firms who do engage in proprietary product sales are usually subsidiaries of large, heavily regulated insurance companies and typically do not offer their financial advisors preferential compensation for the sale of those products. Proprietary products are often the vehicle through which those who perpetrate financial fraud, like R. Allen Stanford, gain access to investor funds. Once again, the structure of the typical IBD firm lowers the risk of SIPC payouts.

Effects of Increased SIPC Assessments to IBD Firms

The results of excessively high SIPC assessments will continue to be predictable: failure of small IBD firms. In 2008 there were more than 5,000 broker-dealer firms. By 2012 that number has fallen to just over 4,500, with approximately 175 broker-dealer firms failing in 2009 alone, the first year of the increased assessments.

The failure of small IBD firms will have a significant impact on the securities industry. Smaller IBD firms are a significant source of industry innovation. With profit margins generally very slim, small IBD firms have incentives to consistently develop new methods of efficiently and effectively meeting their regulatory obligations, while at the same time providing the financial advice and services that Main Street Americans need and demand. These innovations often are adopted by others in the industry and become industry best practices. The excessively high SIPC assessments will lead to not only failures of small IBD firms, but also to reduced investment in new resources and innovation – including the hiring and training of new employees, acquisition of new equipment and development of software – among remaining IBD firms.

Beyond industry innovation, there is a more significant impact that the loss of IBD firms will have: decreased access to financial advice, services and products for Main Street Americans seeking to save for retirement and their children's education. Small IBD firms and the independent financial advisers associated with them typically provide financial services and products to middle-class investors that are not served by larger firms. These investors need access to quality financial advice, products and service every bit as much as wealthier investors. However, many of these investors are unable to access these products and services through large wire house firms, which often find servicing smaller accounts unprofitable. Without the small IBD firms and their associated independent financial advisors providing local access to financial advice, less affluent investors will be left to their own devices to achieve their financial goals.

Implementation of the SIPC Modernization Task Force Recommendations will perpetuate these problems

Should the recommendations of the SIPC Modernization Task Force be adopted, the problems outlined above will only be perpetuated. The Task Force has recommended, among other things, the following:

- Increase the minimum assessments,
- Increase the caps on coverage to $1.3 million indexed for inflation, and
- Eliminate the distinctions between cash and securities to allow larger recoveries.

Unfortunately, the Task Force failed to make major reforms that would more equitably distribute the costs. We believe that this is a result of failing to include small firm representation on the Task Force.

A Better Approach

FSI believes that true SIPC modernization requires a system that provides recovery to defrauded securities investors in a smooth and orderly process. In order to be equitable, such a system should impose the greatest cost for maintaining the system on those that present the greatest risk. This system must also provide broker-dealers with greater predictability so that they can budget appropriately for the costs. Finally, the system must avoid imposing a disproportionate impact on IBD or other firms.

We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues. Please contact David T. Bellaire, Esq., FSI's General Counsel & Director of Government Affairs at 770 980-8488 or david.bellaire@financialservices.org if you would like more information on the Financial Services Institute and our position on this important issue.

Background on FSI and the Independent Broker-Dealer Community

The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees of their affiliated broker-dealer firm.[1] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market for advisors affiliated with IBDs is clients who have tens and hundreds of thousands, as opposed to millions, of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[2] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. Our mission is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. We also provide our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

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[1] Cerulli Associates at http://www.cerulli.com/.

[2] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

AGILE FUNDS INVESTOR COMMITTE

March 2, 2012

Members of the Capital Markets, Insurance and
Government Sponsored Entities Subcommittee:

Chairman Garrett, Ranking Member Maxine Waters, and members of the Capital Markets and Government Sponsored Entities Subcommittee of the Committee on Financial Services (the "Committee").

This letter is submitted for the official record of the Committee's March 7, 2012 hearing "The Securities Investor Protection Corporation: Past, Present, and Future"

My name is Peter J. Leveton. I live in Lakewood, Colorado, a Denver suburb in Congressman Ed Perlmutter's 7th District. I am an indirect investor victim of the Bernard L. Madoff Investment Securities, LLC ("Madoff"or "BLMIS") Ponzi scheme, and a Co-Chairman of the Agile Funds Investor Committee of the Agile Group, LLC, Boulder, Colorado ("Agile" or "Agile Group"). In December 2008, Agile had 205 investors and managed three primary hedge funds. The Group and its funds are currently in liquidation.

A large portion of Agile's funds under management were invested by Agile in the Rye Select Broad Market Prime Fund (the "Prime Fund") managed by Tremont Group Holdings, Inc. ("Tremont" or "Tremont Group"), and invested by Tremont with Madoff/BLMIS. Tremont is a subsidiary of Oppenheimer Funds, itself a subsidiary of Massachusetts Mutual Life Insurance Company.

This letter is written on behalf of Agile's 205 Indirect investors, several hundred Ponzi Victims Coalition Indirect investors from more than 20 states; and, by extension, all Madoff Indirect investors who filed approximately 11,000 Securities Investor Protection Corporation ("SIPC") claims on or before the bar date of July 2, 2009.

When I testified before this Committee on December 9, 2009, I believed Congress would resolve the Madoff matter before the end of 2010. Unfortunately, we are not much further along now than we were then.

For many people, Bernie Madoff and BLMIS are yesterday's news. I believe that unless this Committee takes action quickly, the 11,000 Indirect investors will end up holding the same empty bag we have held since Madoff's arrest in December 2008, almost three and one-half years ago. Because the scandal broke so long ago, we are worried that except for a few Members of this Committee, the only people who still have a passionate concern for the Indirect investors are the investors themselves.

We need your help now more than ever and we implore you to take action soon!

"Indirect" Madoff/BLMIS investors are those individuals and entities who did not invest directly with Madoff and did not have their own BLMIS account. The individual Indirect investors placed their money in hedge funds, family partnerships, pension funds, retirement funds and other intermediaries that then invested with Madoff/BLMIS, or a feeder fund which in turn invested with Madoff and had their own BLMIS account.. Many Indirect investor victims did not know their money was being invested with Madoff/BLMIS and many, if not most, of us had never even heard of Madoff until the day we learned he had stolen our life savings.

"Direct" Madoff/BLMIS investors are those individuals and entities who invested directly with Bernard L. Madoff, had their own BLMIS account and knew exactly who Madoff was.

We Indirect investors are Americans from all walks of life and include farmers, teachers, engineers, doctors, lawyers, entrepreneurs, business owners, corporate executives, and others who have worked hard, saved wisely, paid our taxes, educated our children, contributed to charities, benefited society in many ways and essentially tried to do "everything right" our entire lives.

- Many of us are your constituents.
- Many of us placed a lifetime of savings in what we believed were safe investments but which were ultimately invested with BLMIS, often without our knowledge.
- Many of us are now devastated, financially and psychologically.
- Many of us have sold or are trying to sell our homes just to obtain money to live on without becoming wards of the state.
- Many of us in our 60s, 70s and 80s have been retired but have had to, or are attempting to, .go back to work, often accepting menial jobs to obtain money for food and shelter.
- Some of us have had to beg for support from our siblings, children and friends

Because nothing for Indirect investors has changed, the above description is substantially the same as I submitted for the 2009 Committee hearing.

The Madoff/BLMIS matter has been covered extensively by the media, has been investigated extensively by the Securities and Exchange Commission and has been discussed many times by this Committee. I believe the Committee members are fully aware of the background, and don't plan to reiterate it in this letter.

The letter focuses on the current status of BLMIS Indirect investor victims, H. R. 1987, H.R. 757, and the February 2012 SIPC Modernization Task Force Report (the "Task Force Report").

My objectives are:

1. To gain financial relief for all Indirect investors via Madoff-related legislation which we hope will be ultimately approved by this Committee and sent to the House Committee on Financial Services during the 112th Congress. Without the passage of such legislation, Indirect investors will remain on the "outside looking in" and will have received only platitudes and conversation, but no financial relief;

2. To encourage the principal sponsors of H.R. 757 and H.R. 1987 to consolidate the two Bills into one straightforward and powerful Bill that will assist all Madoff investors and be passed by this Committee, the House Committee on Financial Services, the House of Representatives and the Senate;

3. To clarify the incorrect assumption that all Tremont Group Indirect investors will receive their pro rata share of monies that Irving H. Picard, the BLMIS Bankruptcy Trustee ("Picard" or the "Trustee") recovers from third parties and distributes to the Tremont Funds pursuant to the Trustee/Tremont Settlement Agreement. This assumption is incorrect because even though Agile and other Prime Fund investors were "net losers", the Fund itself was determined by the Trustee to be a "net winner" and therefore not eligible to receive the Trustee's distributions. We hope this matter will be worked out within Tremont, but at the moment there is no assurance that the Prime Fund investors will receive anything at all from the Trustee/Tremont Settlement of more than $2 billion. This situation is grossly unfair, and once again we need your help to protect the Indirect investors

4. To correct the discrimination of non-ERISA plan Indirect investors as proposed in the Task Force Report. .

Comments Related to the Task Force Report

My Task Force Report comments are limited to those few sections on pages 12 and 13 that are specifically applicable to Indirect investors.

In summary, despite all the fanfare, I and many other Indirect investors are extremely displeased and disappointed in the Report because the Task Force elected to continue "business as usual" for non-ERISA plan Indirect investors. Instead of helping such Indirect investors, the Task Force recommendations have actually made things worse for us.

We believe this is not at all what Chairman Kanjorski and the 111th Congress Capital Markets Subcommittee had in mind in the spring of 2010 when the Committee directed SIPC to create a Task Force. In providing this direction the Chairman stated: "The recent colossal failure of Bernard Madoff's firm and its effect on investors has highlighted the need for Congress to enact modification to SIPA and for SIPC to pursue regulatory, policy, and organizational changes."

We further believe that SIPC's hand-picked Task Force, which to my knowledge excluded any Indirect investor representation, did not address the discrimination against hedge fund, fund of funds and mutual fund Indirect investor because of its desire to protect SIPC's Board and Management, limit the financial responsibility of SIPC's broker-dealer members, and limit the amount of work required of the SIPC staff.

The Report, on page 13, recommends "no change to their treatment", i.e., no pass-through participation, for "Investors who own shares of a hedge fund, fund of funds, or mutual fund, where the fund is the account holder".

However, two paragraphs later the Report notes that the following Indirect investor categories "are currently not eligible for pass-through protection and the Task Force is recommending that treatment of these individuals be changed:

1. Individual participants of a defined benefit pension plan, where the plan is the account holder;
2. Individual participants in a defined contribution plan, where the plan is the account holder; and
3. Individual participants in a deferred profit sharing plan, where the plan is the account holder" should receive pass-through protection.

Although the money from both ERISA and non-ERISA investors was placed indirectly in the Madoff fraud, these recommendations separate Indirect investors into two classes (those in ERISA plans and those not in ERISA plans), and worsen the inequities of the original SIPA.

It is impossible to fathom why the Task Force would differentiate between the ERISA plan Indirect investors and all other Indirect investors, unless the differentiation resulted from extensive third party lobbying. While the demographic and financial profiles of the two classes are most likely quite similar, the differentiation elevates the ERISA plan Indirect investors to a substantially preferred position over all non-ERISA plan Indirect investors.

The Task Force's feeble rationale that pass-through participation for non-ERISA Indirect investors is not feasible because "much of the information concerning the underlying investors and the size of their investment is proprietary and generally unavailable to the broker" is bogus.

It is hard to imagine that any Indirect investor would refuse to provide information if it meant the difference between SIPC relief to recover a portion of their investment and no SIPC relief.

The Report, referring to non-ERISA Indirect investors, goes on to state that "Without access to the books and records of the underlying funds, it is impossible to ascertain the amount of additional exposure to the SIPC fund if protection is extended to this group." Again, this is a bogus rationale because such information is relatively easy to obtain through the discovery process and review of the books and records of the underlying funds and feeder funds.

I submit that the needed information is just as easy to obtain for non-ERISA Indirect investors as it is for ERISA Indirect investors. Additionally, the Trustee and SIPC have a large portion of the information already in their records.

Trustee Picard knows exactly who we are, our street and email addresses, and the hedge funds, funds of funds, and mutual funds in which we invested. In fact, all Indirect investors who filed SIPC claims before the July 2, 2009 bar date routinely receive the Trustee's Bankruptcy Court filings that request approval of legal fees and expenses, which now total more than $273 million.

We believe the above matter deserves serious investigation. We strongly recommend that the Committee interview Task Force members, require them to explain the rationale and logic for their recommendations, and require that they fully disclose all information with respect to third party influence.

We would also like you to know that our efforts to mobilize the Indirect investors were consistently blocked by SIPC and the Trustee. Our many written and verbal requests of SIPC and the Trustee to provide us with the Indirect investors' states of residence (which would have helped us contact Indirect investors and their elected officials) were all refused based on assertions of "privacy". A blatant contrast with the Direct investors' names which were published in the national press and picked up by numerous other media early in the Madoff process.

To eliminate this discrimination between classes of Indirect investors, we request that the Committee disregard the Task Force "pass-through participation" recommendations for ERISA-only accounts, and approve legislation that will instead provide true and equitable "pass-through participation" for all Indirect investors.

General Comments Related to Indirect Investor Victims, H.R.757 and H.R. 1987

According to the Trustee's most recent report, as of February 15, 2012, Trustee Picard recovered for the sole benefit of Direct investors approximately $9.1 billion (52%) of the approximately $17.3 billion in initial BLMIS principal investments. The same report states that SIPC has advanced the Trustee approximately $800 million to distribute to 2,426 Direct investor "allowed claims" -- an average of about $330,000 per claim.

Over the same period, because SIPC, the Trustee, and certain Federal judges have determined that Indirect investors are not "Customers" under SIPA, neither SIPC nor the Trustee has done anything to assist the approximately 11,000 Indirect investors.

H.R. 1987, introduced by Congressmen Gary Ackerman, provides for SIPC reimbursement up to $100,000 per Indirect investor. We are working closely with Congressman Ed Perlmutter and his staff, and Congressman Ackerman's staff to increase this amount to something closer to the $500,000 per account SIPC relief provided Direct investors, and to modify other important aspects of H.R. 1987. In fact, because Direct and Indirect investor monies were stolen in the same fraud, we believe that all investors should be treated the same way.

HR 757, introduced by Chairman Scott Garrett, has received broad-based support from Direct investors because it proposes to eliminate investor "clawbacks" and calculate SIPC's reimbursement of up to $500,000 per account based on the "final statement balances", instead of the "cash in /cash out" method used by the Trustee. At this point neither provision of H.R.757 helps Indirect investors because, as noted above, we are not considered "Customers" and therefore, we are not currently eligible for SIPC relief.

Accordingly, our only realistic hope to gain SIPC relief is through new legislation initiated by this Committee.

For the benefit of all Madoff victims, I strongly urge Chairman Garrett, Congressman Ackerman, and this Committee to combine the most equitable measures of H.R. 757 and H.R. 1987, pass the combined Bill, and work with the Leadership and Members of the Committee on Financial Services to pass and send the Bill to the House of Representatives and subsequently to the Senate.

I am very familiar with many of the issues surrounding H.R. 757 and H.R. 1987 and to provide a much-needed Indirect investor-perspective request that I be invited to participate in the mark-up sessions for a final Bill.

Closing

We look to you and your congressional colleagues as our last and only hope to carry out what we believe was Congress' original intent of protecting all investors when it enacted SIPA.

I will be in town the remainder of this week and would welcome the opportunity to discuss these matters in person with you or your staffs.

Peter J. Leveton

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