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ASSESSING THE LIMITATIONS OF THE SECURITIES INVESTOR PROTECTION ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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ASSESSING THE LIMITATIONS OF THE SECURITIES INVESTOR PROTECTION ACT

Thursday, September 23, 2010

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

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Hinojosa, Baca, Klein, Perlmutter, Carson, Childers; Garrett, King, and Jenkins.

Also present: Representative Moore of Kansas.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Pursuant to committee rules and prior discussions with the ranking member, each side will have 10 minutes for opening statements.

Without objection, all members' opening statements will be made a part of the record; and I yield 5 minutes to myself.

Nearly 2 years have passed since the massive $65 billion Madoff Ponzi scheme came to light. Since then, we have enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among many other things, this law amended the Securities Investor Protection Act, the statute that works to return money and securities to customers of failed brokerages.

To better protect the customers of failed brokerages going forward, the Dodd-Frank Act increases cash protection limits and bolsters the resources of the Reserve Fund used to replace customers' missing cash and securities. This new law also triples penalties for misrepresentations of membership in or protections offered by the Securities Investor Protection Corporation. Moreover, the statute makes important changes to prevent rather than simply replace the loss of customers' property, including new custody safeguards for customers' assets held by certain financial professionals.

The Dodd-Frank Act additionally requires the auditors of broker-dealers to register with the Public Company Accounting Oversight Board, and this body has the authority to regulate these market gatekeepers. This change ought to put incompetent and unscrupu-

lous one-man-auditor shops like the one which blessed the books of the Madoff brokerage out of business before investors get harmed.

Much more, however, remains to be done to protect investors. The victims of the Madoff Ponzi scheme and the Stanford Financial fraud include many hard-working families and frugal retirees who invested their hard-earned money with now imprisoned or indicted con artists. Numerous press stories have related accounts about how these victims who sought to play by the rules have now had to greatly modify the ways they live. The victims of these frauds believe that SIPC has fallen short in meeting the responsibilities, and they want change. I do, too.

We therefore have many questions to explore today. For example, although SIPA's protections do not currently extend to customers of investment advisers, we must explore the issue of expanding SIPA's coverage, as investment advisers may also commit fraud.

In any serious efforts to reform SIPA, we must also consider what responsibilities SIPC has to honor the broker statements that customers receive. SIPC has denied the claims of customers based on seemingly legitimate paperwork provided to them by the brokers. Yet SIPC expects customers to use those very same statements to report unauthorized trading in their accounts. This inconsistency is unacceptable, and we must work to resolve it.

Investor trust, for which SIPA was designed to preserve, has been seriously eroded by SIPC's narrow interpretations of its statutory mandate. While SIPC's actions may follow the letter of the law, many would argue that SIPA has ignored the spirit of the law. We therefore must consider the best way to change the tone of SIPC and refocus this body on maintaining confidence in the financial system and promoting investor protection.

To the extent possible, we ought to also explore how SIPC could learn from the success of the Federal Deposit Insurance Corporation in maintaining the public's trust. To address these questions and many others, SIPC has focused on the Modernization Task Force, and several members of this panel will appear before us today in their personal capacities. I expect this Task Force to complete its work with great transparency, considerable outreach, and much speed. Moreover, this Task Force must view its mission as broadly as possible and work to provide Congress with a comprehensive plan for reform.

In closing, we can further improve SIPA by building on the reforms of the Dodd-Frank Act. The witnesses before us today are recognized securities experts. Their recommendations, along with those offered by the Madoff victims at our hearing last December, will undoubtedly help us in our work to update SIPA and better protect investors.

The Chair recognizes the gentleman from New Jersey for 10 minutes.

Mr. GARRETT. Thank you.

"As mad as I am at Madoff, I am even more upset at my own government over the way I have been treated in the aftermath of this fraud." That is the gist of a quote from one of my constituents who was defrauded by Bernie Madoff and who feels failed by the FCC and FINRA in protecting him while the fraud was going on and who now faces a specific trustee who is threatening to claw

back funds he withdrew from his made-up account over the course of the last 15 or 20 years.

In a sense, these innocent investors are being held to a higher standard than both the government that was supposed to protect them and that gladly took their tax payments and the organization, SIPC, that was supposedly set up to protect them while installing and instilling greater confidence in our securities market.

We are holding today's hearing to assess the limitations of the Securities Investors Protection Act (SIPA), and the Securities Investors Protection Corporation (SIPC), and to identify whether there are potential reforms that would better protect the investors.

It would seem to me that one major and fundamental reform would be for them, through the actions of the trustee as appointed, to see itself as an advocate for, rather than an adversary against innocent defrauded investors so that they feel as though they are being assisted by the SIPC process rather than hunted down and accused somehow of them doing some sort of wrongdoing.

So there is one piece of legislation that is out there that could go at least part of the way in making things right for once and potentially twice victimizing the Madoff investors. A colleague of mine in New Jersey, Bill Pascrell, has introduced a bill, H.R. 5058, called the Ponzi Scheme Victims Tax Relief Act. What it would do is liberalize the ability of those who are victims of theft to receive a refund for taxes that they paid on gains that the SIPC trustee is now trying to take back from them. I am a cosponsor of this bill, which actually should go a little further than the 10-year look-back since their trustee is going back further than 10 years in calculating the so-called net winners and losers.

Another aspect of the trustee's handling of this case is now in the process of working the way through the court systems in which matters will be decided. I am concerned, though, about a looming deadline that is coming up, and that is in December, when the trustee will decide whether to go forward with potentially thousands of claw-backs from these innocent defrauded investors.

SIPC leadership and the trustee have indicated that they will not be going after the so-called ordinary people, people who are not leading a lavish lifestyle and who had no knowledge of the fraud. But if you hear from my office or my staff, that is not what I am hearing from my constituents and others and the people I talk to when I go back at home.

I spoke with one gentleman who years ago withdrew money to pay for college and who lives a very modest lifestyle now. He contacted the trustee's firm to get clarification that he wouldn't be clawed back, but he was told that, other than forgiving a small percentage of what the trustee had calculated that he owed, he otherwise looks like he would be on the hook for the rest. In addition, he was told that anything he might recover in the form of tax refund, that, too, might be subject to seizure by the trustee.

So I am also concerned that while these court cases are under way, the SIPC trustee has denied access to Madoff's records for their victims and attorneys. Access to these records is important for several key aspects of the case, including whether or not all transactions reported by Madoff over the years were actually fraudulent

transactions. If some of them weren't, then the trustee's net equity formulation would completely be called into question.

Inequitable access to these records results in a fundamental imbalance of the scales of justice in this case and also calls into question whether ultimately there will be a fair trial at the end of the day in this case.

So all of this, when you think about it, should make all of us feel very uncomfortable. The SIPC decal is supposed to mean protection. The SEC was supposed to provide protection. The IRS, taking the tax payment, also serves as a government imprimatur. SIPC is supposed to provide up to $500,000 in protection based on "reasonable expectation of customers." In fact, SIPC was created at the behest of the securities industry to encourage confidence in a more efficient paperless process, where investors would no longer have the piece of mind one gets from holding on to the actual stock certificate like we used to do in the old days. In their place, customers grew accustomed to depending on trade confirmations and account statements which were regulated, of course, by the SEC and FINRA to set their reasonable expectations that they should have.

As I said earlier, though, instead of SIPC meeting investors' reasonable expectations, now it seems as though they are blaming the victims instead. Instead of customers being able to rely on their account statements to calculate their SIPC protection, they are basically at the mercy of the trustee's formulation of net equity that doesn't take into account for consideration interest earning or the time value of money. Nor does this so-called customer-friendly methodology take into account the receiving of SIPC protection as separate and distinct from the distribution of asset recovers.

One of the results, unfortunately, is a SIPC that has clearly lost the trust of many investors as well as the trust of many Members of Congress as well. So this hearing, Mr. Chairman, is timely. SIPC clearly needs the SIPC Modernization Task Force to assist in its refocusing on its proper role going forward. So I do look forward to the testimony we will hear and the questioning from this panel.

With that, I yield back.

Chairman KANJORSKI. Thank you, Mr. Garrett.

We will now hear from the gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. Thank you very much, Chairman Kanjorski, for calling this very important hearing.

It has been nearly 2 years since Bernard Madoff confessed to masterminding the largest and longest-running Ponzi scheme in history and turned himself in. After that fateful day in December 2008, the Securities Investor Protection Corporation, which is tasked with insuring victims of broker fraud of failure and recovering assets from the fraud of those victims, received over 16,000 insurance claims from Madoff's innocent victims. Of them, to date, SIPC has granted only 2,200.

That means that right now, at this very minute, many, if not most, of the over 13,000 innocent victims of Bernard Madoff who for years reasonably thought that they were entitled to SIPC insurance on the balance of their accounts in the unlikely event that their investments were entangled in a broker-dealer fraud or fail-

ure instead are destitute and out of luck. And those are just the investors who filed actual claims.

What crime did these investors commit? These 13,000 people and their families, like millions and millions of people who invest in our markets, put their trust in our financial system, its regulators, and its safeguards. Two years after Madoff turned himself in, 2 years after these 13,000 people have been turned away time and time again from the protection to which they reasonably believed they were entitled, it has become very clear that Madoff robbed them, our system betrayed them, and our government failed them.

Who is responsible? Who caused this problem? Who do we turn to? Who do the victims turn to?

Now, people have reasonable expectations of government, its agencies, and the organizations that are created by them. Where I come from, if the police don't do their job and stand idly by when terrible things happen, if a doctor just stands around and doesn't do what he is supposed to do, if emergency responders show up in the ambulance and just sit and watch the accident, people wind up suing those agencies and the city and the municipality and the government for negligence. Someone is liable. Whether it is because of incompetence or misfeasance or malfeasance, somebody is responsible for not fulfilling the reasonable expectations that people have and come to rely on.

And here in the Federal Government, if there is not a legal responsibility, there certainly is a moral responsibility for creating the climate that people depended on. That we have failed these investors is heartbreaking enough in terms of human tragedy, but the damage that has been done to investor confidence at this critical time in our economic and financial recovery as a result of our failure to safeguard and protect these innocent Madoff victims and our country's negligence in leading them to believe that they were insured is as frightening as it is self-defeating.

Today's hearing will focus on the Securities Investor Protection Act and the present and future role of SIPC in providing insurance to investors in our markets that they are protected, really protected, not fake protected, against broker-dealer fraud or failure. It is my strong hope that this hearing is a prelude to the subcommittee's consideration of the Ponzi Scheme Investor Protection Act, a bipartisan bill that I have introduced along with numerous members of this subcommittee in the House to provide some relief to many of those innocent victims of Ponzi schemes of all kinds who have been spurned by SIPC and to proactively assure investors in our securities markets that they are protected against fraud, regardless of its scope or longevity.

Mr. Chairman, thank you very much again for scheduling the hearing, and I, too, look forward to hearing from our witnesses. I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Ackerman.

Now, we will hear from the other gentleman from New York for 2 minutes, Mr. King.

Mr. KING. Thank you, Mr. Chairman.

At the outset, let me thank you very much for holding this hearing. I know it is important to get on to the hearing, so I will keep my remarks brief.

I want to fully identify myself with the statement of Mr. Garrett both in precise content and also in spirit. The fact is that the investors of Madoff were let down, were failed by our government, by SEC, by FINRA. Despite numerous reasons why this fraud should have been stopped, it wasn't.

So these investors made the mistake of: number one, relying on Madoff; and number two, and more importantly, relying on our Federal Government. And now that they are victims, they are being treated by the trustee as if they were co-conspirators of Madoff, rather than victims.

I have done some practice of law over the years, and when you listen to the investors and you listen to the tactics and methods being used against them by the trustee, it is similar to people under indictment or under investigation by the grand jury, by the United States Attorney, by the SEC, that years of records are being demanded going back 10, 15, 20 years. Every excuse or every possibility has been looked at by the trustee to try to suck people into this, to bring them in. Not giving them the benefit of the doubt but again treating them as if they were criminal defendants rather than victims.

And to me, as my good friend Mr. Ackerman said, at a time when we are trying to rebuild investor confidence, we are sending the worst possible message to investors to show that not only the government lets them down, but, in effect, the government allows the trustee to go after them when they are victims as if they are guilty themselves. And we are talking about people who have already lost millions of dollars because of this Ponzi scheme of Madoff now having to spend millions and millions of dollars in legal fees to defend themselves. When our government should be working to help them, the government is going out of its way and the trustee is going out of its way to make them victims again.

I find this entire process wrong. I think sometimes we can get caught in our universe when we start debating how many angels can dance on the head of a pin and not realizing that good, good people who have been hurt once are being hurt even worse by the tactics of this trustee. So I think it is important to keep that in mind as we go forward and debate the technicalities and legalities, realize the moral harming that is being done here.

With that, I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. King.

The gentleman from Colorado, Mr. Perlmutter, is recognized for 1 minute.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

I agree with one point raised by Mr. Garrett and Mr. King, and I disagree with another point.

To start where we disagree, in terms of the timing of this, it was under an SEC and under the Administration of George Bush, and there was really not a lot of police on Wall Street even though Mr. Markopolos raised the red flags a dozen times. So you have to take a look at who is in office to decide whether the system is working or not. But it did not work well at that time.

I agree with the gentleman that this is insult added to injury. That really is what we are talking about here, and that seems to be the unfairness of the system, that individuals who, through no

real—they weren't active participants in a fraud. They were innocent victims of a fraud perpetrated by Mr. Madoff. There should be an opportunity for them to recover, either through their taxes, through claims with SIPC, or to not have to face a claw-back if they are not active participants. And the law I think is a real problem in this arena and needs to be changed, and I look forward to working with the gentleman on these very subjects.

Thank you.

Mr. ACKERMAN. [presiding] The Chair will recognize Mr. Childers for 3 minutes.

Mr. CHILDERS. Thank you.

I want to thank the chairman first for holding this important and very timely hearing to address the Securities Investor Protection Act, and I thank our witnesses for being here today.

This subcommittee has looked at a number of issues related to SIPA during this Congress, focusing on the Madoff Ponzi scheme as well as the Stanford Financial Ponzi scheme. I am here today as an advocate of the victims of the Stanford Financial scheme.

While the victims of the Madoff scheme and the Stanford Financial scheme live throughout our country, I realize that, but too many of those Stanford Financial scheme victims live in the district that I serve, the northern portion of Mississippi. They are north Mississippi families who now live an uncertain future. They invested much of their life savings in certificates of deposit with the Stanford Group Company, a SIPC member and registered broker-dealer.

It is estimated that in Mississippi alone, our families lost $68 million. That is no small matter to me and to the State of Mississippi. SIPC has denied coverage to the Stanford victims when the SEC had the jurisdiction to file enforcement action against Stanford in 2009. These investors purchased securities they didn't get. They purchased them from an SIPC member.

SIPC's entire function is to return securities to customers of a broker-dealer when a firm becomes insolvent. There are several legalities to the case for extending SIPC coverage to Stanford victims, and I don't want to get into all of that, but these investors are ordinary Americans, ordinary Mississippians who planned and saved for a retirement that they may never enjoy, and they deserve the protection assured by the SIPC member Stanford Group Company.

As we examine ideas to improve SIPA and work towards a resolution for making these Stanford victims whole, I urge all participants to keep these victims and their hard-working families in mind and the fact that they worked, many times, a lifetime to accumulate this money that they have lost.

I yield back my time. Thank you, Mr. Chairman.

Mr. ACKERMAN. Thank you very much.

We will now hear from our panel of witnesses. Thank you very much for appearing before the subcommittee today, and, without objection, your entire written statements will be made a part of the record. You will each be recognized for 5 minutes to summarize your statement or present it in any way you see fit.

We will get right down to it. First, we have Mr. Joseph Borg, director, Alabama Securities Commission.

Mr. Borg.

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

Mr. BORG. Thank you, Mr. Chairman, Ranking Member Garrett, and members of the subcommittee. I am Joe Borg, director of the Alabama Securities Commission, and I thank you for the invitation to participate today.

Our office has administrative, civil, and criminal authority under the Alabama Securities Act; and we have brought dozens of investigations of Ponzi and pyramid schemes, illegal blind pools, fraudulent private placement offerings, and other scams which have led to numerous enforcement cases and criminal prosecutions.

I have submitted written testimony which has additional details and discussion of the bullet points I will outline here today.

Here are some of my particular areas of concern:

First is the levels of protection. It is my belief that the level of protection with regard to SIPC funds should be increased from $500,000 to $1 million. A large portion of retirement savings consists of securities investments, and most people just do not leave huge amounts of retirement money in banks. It is at the brokerage houses. The $1 million level of protection would also match SIPC's Canadian counterpart, the Canadian Investor Protection Fund (CIPF), which is currently at $1 million Canadian. I also believe that the levels of protection should be indexed to inflation, and indexing would allow some incremental measure of increased protection going forward.

On the issue of fictitious securities, a major issue is the treatment of claims based on a securities position which never actually existed. There are conflicts between decisions from the Second and Sixth Circuit Court of Appeals, and I believe that part of the problem stems from SIPA's distinction between cash and securities.

The disparate protection between claims for cash and securities should be eliminated. For example, if I have $500,000 of securities, I sell $350,000 and the brokerage house is closed before I either cash the check or the money is still in the account, I have just lost $100,000 because of the $250,000 limit.

I would also note that the Canadians eliminated the distinction between claims for cash and claims for securities back in 1998. In a discussion with SIPC staff, a change in favor of eliminating the cash versus securities distinction would not alter the risk models used by SIPC.

The next item is the increase in the line of credit from Treasury. If we expect continued growth in the securities market and a change of coverage to perhaps $1 million cash of securities and you index it to reflect inflation, it may require an increase in the line of credit for Treasury. I know it hasn't been tapped so far in history, but we have asked the SIPC staff 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 from the industry would be an appropriate amount going forward. At the current level of assessments, it will take a number of years to reach the $2.5 billion level—I think the staff has told us about 5 years—but I think if

we target for $10 billion and we start to be—let's be realistic and start planning for them now, that planning should start now.

On assessments, prior to the enactment of Dodd-Frank, SIPC had a floor of $150, ridiculously low. There are now some SIPC members, though, who pay zero assessments because of the change in the law. I think that is just an unintended consequence. It is my belief that there should be a minimum assessment of some amount, perhaps $1,000. I would prefer a range somewhere of $2,000 to $2,500.

Also, I was very surprised to learn that in computing assessments, revenues on mutual funds are not included; and I am of the opinion that since all investors benefit from protection, or should benefit from protection, and broker-dealers benefit from SIPC availability, that revenues on mutual funds should be included for assessment purposes as well.

I would also suggest that anytime a target level is reached, whether it is $1 billion, $2.5 billion, or $5 billion, there should be another determination of whether assessments are adequate based on the current level of investors' assets in the markets.

Let me suggest that the current arrangement with the Treasury for the line of credit that exists, which is now 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.

On investor education, the general public has the misconception that SIPC is some type of insurance, just like FDIC is insurance for banks. If we are going to make a change, it is going to change the entire dynamic. And I am not suggesting we don't change it, but I think that the parameters of what this Task Force is going to look at will change depending on congressional intent. If it was not intended to be insurance for fraud but only for replacing cash and securities, I think this misconception was exacerbated by references to FDIC, tying the amounts of coverage to the same levels as FDIC, and a comparison by the broker-dealer community who tapped specific protection levels.

Suggestion to fix it: TV ads and seminars and publications are great, but that is not how you are going to educate the public. Include in the brokerage statements every quarter or every month that they go out a section on SIPC protection, what it is, but, more importantly, what it is not. I think you are going to need a constant education effort on a regular basis to get over the misconceptions that have occurred.

And I wouldn't do an insert. You know what I do with inserts. You throw them away and you read the statement. It needs to be part of the brokerage statement. I know that SIPC does not have the power to do that. That would have to come from SEC and FINRA.

I know my time is up. I have submitted materials with regard to indirect investing, with regard to retirement plans and hedge funds. I think they ought to be matched up to the way that FDIC and FCUA are looking through those procedures at the present time, utilizing the IRS Code 401(d), 408, and including 457 plans.

And I would lastly say, in conclusion, that under international relations, I have been specifically tasked by the Task Force to look

into matters involving international involvement of SIPC. SIPC just became a member of the International Securities Organization (IOSCO), as an affiliate member. Some of the things we are going to look at I think would be formal rules on cross-border protection, create a dispute resolution mechanism with a team of experts—this is from the Lehman Brothers matter—establish cooperative principles, and develop a platform for exchange of information.

I thank you again for the invitation and the opportunity to be here today, and I will be happy to answer any questions. Thank you.

[The prepared statement of Mr. Borg can be found on page 44 of the appendix.]

Mr. ACKERMAN. Thank you, Mr. Borg.

Next, we have the Honorable Orlan Johnson, the chairman of the board of the Securities Investor Protection Corporation.

STATEMENT OF THE HONORABLE ORLAN M. JOHNSON, CHAIRMAN OF THE BOARD, SECURITIES INVESTOR PROTECTION CORPORATION (SIPC)

Mr. JOHNSON. Thank you, Mr. Chairman.

Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I would like to thank you for the opportunity to appear before you today to discuss the work of SIPC and the possible improvements to the Securities Investor Protection Act.

I am Orlan Johnson, and I am the chairman of SIPC. I also serve as chairman of the SIPC Modernization Task Force, which is conducting a complete and comprehensive review of SIPC's operations as well as the changes to SIPA.

The Task Force was convened on June 17th of this year, and it consists of a very wide range of experts. We are in the midst of a review of all the considerations that are necessary from a statutory standpoint, from a procedural standpoint, and other reforms as it relates to SIPA and SIPC.

At my confirmation hearing before the Senate Banking Committee last December, I made crystal clear that my intent from the beginning was to come in and to have a comprehensive review; and this review is being undertaken. Chairman Kanjorski thereafter contacted us and suggested a number of important topics for the Task Force to consider, and today I will briefly describe SIPC and the work of the Task Force, in addition to providing responses to issues that the subcommittee presented to me in their letter dated September 16th.

The Task Force has drawn its members from all ranks, from all parts of the United States. We have drawn from the ranks of State regulators, attorneys who represent investors, academia, the securities industry, and the trustee of the largest securities brokerage insolvency in history. We have included also the chairman of SIPC's counterpart in China and an observer from the SEC. We anticipate that the diversity of viewpoint results in what I would call a rigorous analysis of the issues that concern investors today.

We have begun our work in earnest, and we are examining the extent of protection and also the problems that have occurred as a result of indirect investors, the use of bankruptcy avoidance pow-

ers, and other fundamental issues of concerns to investors and to Congress.

We anticipate that some of our recommendations are not going to make everyone happy. Nevertheless, it is the role of this Task Force to have everything on the table, all aspects of what we need to be looking at, all aspects of what needs to be reviewed.

We have also created a public input platform on our Web site in which the public is invited to share their comments for all to see.

We have also undertaken a major public outreach to ensure that as many investors as possible will learn about this process and get an opportunity to participate.

In using our Web site portals, we have conducted an open online forum. We did our first one on September 14th. We have another one that is going to be taking place fairly soon. We also are hoping to organize a live event so that we can have members of the public present their views directly to the Task Force.

After discussion of some of the issues, several members of the Task Force have volunteered to help us draft a number of recommendations which we intend to present to the SIPC board, and it is our goal to get a full set of recommendations sometime in the early part of the first quarter of 2011.

My written submission to the committee addresses a number of the specific issues of concern to Congress, and SIPC's work is the focus of attention as it never has been in the last 40 years. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended SIPA and gives SIPC a new and different role in the wind-down of systemically significant financial conglomerates where a SIPC member brokerage firm is involved. I would hope that the Task Force will soon present additional recommendations that will lead to additional legislation and to further enhance and update the SIPC program of investors.

In conclusion, I want to assure the subcommittee that the Task Force is making progress and will continue its work aimed at developing and recommending substantial reform to SIPA and SIPC. I would like to thank you for the time, and I would like to thank you for having members of our Task Force with you. I would be pleased to answer any questions that the members of the subcommittee may have.

Thank you again, Mr. Chairman.

[The prepared statement of Mr. Johnson can be found on page 87 of the appendix.]

Mr. ACKERMAN. Thank you very much, Chairman Johnson.

Next, we have Mr. John Coffee, the Adolf A. Berle Professor of Law at Columbia University. Mr. Coffee.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA LAW SCHOOL

Mr. COFFEE. Chairman Kanjorski, I have only two points to make in my brief remarks: There are things Congress should do to amend, extend, and modernize the Securities Investor Protection Act, but, too, there are things Congress should not do. My hopes for what Congress could do must be balanced against my fears of what Congress might do. The first rule always has to be, do no

harm; and I think there are some harms here in some of the potential reforms. Let me start with my hopes.

I agree very much with Mr. Borg's comments. I think I won't cover the same ground he has covered, so let me start with a different point. Congress should extend the definition of "customer" to reach beneficial and indirect owners in a variety of collective investment vehicles. Americans today invest through collective investment vehicles. The highest priority should be to cover the smaller pension funds and other collective investment vehicles where typically the legal owner has failed or neglected to inform the covered broker of all of the individual accounts that are represented in that collective fund. The presumption, the strong presumption should be in favor of a pass-through approach. That is what both the Federal Deposit Insurance Corporation Act and the Federal Credit Union Act already adopted over a decade ago.

SIPA, the Securities Investor Protection Act, is behind the pack in not having adopted a pass-through approach that reaches the beneficial and indirect owners. Such a pass-through approach is superior to what is being provided and proposed in H.R. 5032, which only amounts to a $100,000 advance to the indirect owner, and it requires the indirect owner to waive their right to sue the feeder funds who put them into the Ponzi scheme. I can see no reason in the world why Congress wants to exempt bodies like Fairfield Greenwich that appear to have behaved very, very recklessly, at the least.

Now I realize that what I am saying, that we should cover beneficial or indirect owners, would be costly for SIPC; and, thus, I think it is necessary to prioritize. I don't think I would initially try to cover the large mutual fund or the very large pension fund because they are, by law, diversified and cannot suffer really significant losses from a Ponzi scheme, but the smaller funds and the smaller pension funds would be my priority to cover first.

And, yes, this may require some increase in the assessment which right now starts at one-half of 1 percent of your gross revenues until the fund reaches a certain size. I think the average small businessman in America spends more than one-half of 1 percent of their gross revenues on covering insurance and similar costs.

My basic point, though, is we now have a system that doesn't cover the smaller person, because they are more likely to be the person who is in the indirect position of being a beneficial owner.

The next point—which Mr. Borg also said and I will say it very briefly—I think we should abolish the distinction between cash and securities. It produces arbitrary distinctions because it is a happenstance what your account consists of on the moment that the broker-dealer fails.

Now, on the other side of the ledger, there are proposed reforms that I would urge Congress not to adopt. Particularly, I would advise you against limiting the powers of the SIPC trustee to sue the net winners in a Ponzi scheme. Because in reality, Ponzi schemes are composed of net winners and net losers. To the extent we protect the net winners, we injure the net losers. When Mr. Pickard, the Madoff trustee, sues the net winners, he is not giving that money to the Federal Government. He is seeking to aid the net los-

ers. Although I can sympathize with the position of some of the net winners, their experience was far less tragic, far less traumatic than that of the net losers; and I don't think Congress should subordinate the net losers to the net winners.

I note that Mr. Pickard has filed as of April some 14 actions seeking $14.8 billion. Those 14 actions are not against poor, unsuspecting people. They are against very large entities. And if 5032 passes in its current form, I think the settlement value would be dramatically reduced.

Thus, I am urging you in my written testimony that if you want to do something for the net winners that you think are unsuspecting, unfortunate victims, it would be better to create either a de minimus exception saying no recovery until the fictitious profits go above a certain level, or use what I will call an imputed interest factor. Say if you put money in 10 years ago, you are entitled to at least a 10 percent return a year, and that would double the recovery. But if you use the current approach, there are going to be people who, according to a published article in the Wall Street Journal, have offered to settle in the neighborhood of $2 billion in just one case who we are going to find that the settlement value of that kind of recovery will be greatly reduced because it is going to be very difficult to prove anybody was complicit in Madoff's fraud or that they are negligent, where they will say they were relying on audited financial information.

Lastly, in just one second, I do think the approach taken in the Financial Services appropriation bill which would compel the SIPC to cover all the losses in the Stanford scandal probably goes beyond what the SIPC can possibly handle. It was established to cover securities that were in the custody of the broker or that were on the broker's books. Asking the SIPC to cover all fraud-related losses could threaten the solvency of the SIPC. That should not be done retroactively.

At this point I will stop, and I am happy to answer further questions.

[The prepared statement of Professor Coffee can be found on page 64 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Coffee.

Next, we have Mr. Ira Hammerman, senior managing director and general counsel of the Securities Industry and Financial Markets Association. Mr. Hammerman.

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

Mr. HAMMERMAN. Thank you, Mr. Chairman, Ranking Member Garrett, and members of the subcommittee. I am pleased to testify on behalf of the Securities Industry and Financial Markets Association on this important subject. My testimony focuses on SIFMA's preliminary recommendations regarding revisions to SIPA in light of issues emerging from recent liquidations and the effect of the Dodd-Frank Act.

SIPA's fundamental purpose is to promote investor confidence in the capital markets by protecting customers against the loss of cash or securities in the failure of the broker holding such property.

It is not intended to protect investors against losses on their investments, only against losses of their investments. When a broker fails, SIPA provides for the distribution of the customer property pro rata to all customers; and to the extent there are shortfalls, $500,000 from SIPC is available to restore to each customer's missing cash or securities. Investors who lose money because of a decline in the value of the securities purchased for their accounts, however, are not protected by SIPA against such losses, whether the decline is due to market forces or even due to fraud.

In this regard, SIFMA opposes the Culberson amendment, as it would extend SIPC's protection to cover fraud by the issue of securities which are neither lost nor stolen but in fact are in the customer's possession.

SIPA's customer protection framework has been challenged like never before by two recent events. The Madoff Ponzi scheme, a massive long-term fraud that inflicted significant harm on many investors, including individuals, families, charitable, and educational institutions highlighted questions about the scope of customer protection under SIPA, especially as it applies to the calculation of a customer's net equity in a Ponzi scheme and the application of SIPC's protection of indirect investors. The insolvency of Lehman Brothers exposed inconsistencies between SIPA and the SEC's customer protection rule.

When a failed broker was operated as a Ponzi scheme, we believe that customer property should be distributed to the victims based on the net amounts entrusted to the failed broker, reduced by any distributions received, without regard to fictitious profits shown on fraudulent account statements. The property held by a Ponzi scheme and available for distribution to the investors is simply the pooled property of all the victims, and distributions based on anything other than their net investment would be fundamentally unfair.

Indirect investors who do not have accounts with the failed broker but invested in another entity like a hedge fund that had an account are not eligible for SIPC's protection. SIPC generally should not provide greater protection to institutions than to individuals.

And, accordingly, SIFMA opposes an increase in the protection provided to customers that are hedge funds, corporations, or partnerships. This principle, however, may not apply to trusts or employee benefit plans, which represent the interests of their beneficiaries in a more straightforward way. Before expanding SIPC protection to these indirect investors, however, Congress should consider the additional cost.

SIPA and the SEC's customer protection rules should work together. This rule requires each broker to maintain possession of its customers' fully paid and excess margin securities and deposit into a reserve account in an amount generally equal to its net monetary obligations to customers. In a SIPA liquidation, the customers' securities are available for distribution to customers. If SIPA and the customer protection rule are harmonized, a failed broker that complied with the rules should have sufficient customer property to satisfy the net equity claims of all customers. Unfortunately, the two are not fully harmonized today.

Additionally, as the SEC begins to develop the requirements applicable to securities-based swap dealers, the divergences between the SEC's customer protection requirements and SIPA will only increase. Dodd-Frank amended the liquidation provisions of the Bankruptcy Code to treat accounts holding securities-based swaps as securities accounts, but no similar amendment was made to SIPA, leaving unclear the treatment in a SIPA liquidation of customer security based swaps and related margin.

Lastly, SIPA provides for the distribution of a single pool of property pro rata among all customers, which may unfairly impose risks of the more complex types of accounts like portfolio margin accounts on the customers who have simpler accounts like cash accounts. To protect customers with the simpler accounts, customers should be divided into separate account classes. The rules tailored to create a separate pool of customer property for each account class and SIPA and the Bankruptcy Code should provide for the distribution of each such separate pool to the customers in their related account class. The best way to harmonize the customer protection rules with the liquidation process and to tailor both to separate account classes is for Congress to authorize the SEC to make appropriate rules under SIPA, the Bankruptcy Code, and the Exchange Act. We also believe that the basis on which members contribute to SIPC's fund may be outdated and should be reviewed in light of the manner in which members currently operate.

In conclusion, SIFMA is strongly committed to working constructively with the SIPC Task Force and this subcommittee to recommend ways to better protect investors and thereby increase investor confidence in the financial markets.

I would be pleased to answer any questions you may have. Thank you.

[The prepared statement of Mr. Hammerman can be found on page 78 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Hammerman.

Finally, we have Mr. Steven Caruso, partner in Maddox, Hargett & Caruso. Mr. Caruso.

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

Mr. CARUSO. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee.

My name is Steven Caruso, and I am an attorney from New York City with the law firm of Maddox, Hargett & Caruso. Our law firm represents investors. That is what we do. I am also now a member of the SIPC Modernization Task Force, and I view my role on that Task Force as looking forward: What can we do to make sure that what we have experienced in the past few years does not happen again?

There is a lot of blame to go around. We can blame the SEC. We can blame FINRA. We heard earlier somebody blaming the prior Administration. That doesn't answer the question.

There are in my mind two questions when we leave here today: One, what do we do to keep anything tragic from happening as we move forward? And, two, what do we do to remedy what has happened to investors in Madoff, in Stanford, and in a host of other

situations where investors have been screwed? Plain and simple. That, in my view, is what this committee needs to consider going forward.

We have heard from other colleagues on this panel about increasing SIPC coverage. That has to be done. We have heard about increasing the target level. That must be done.

Just think over the past few years what we have all seen. Lehman Brothers is gone. Bear Stearns is gone. Who is next? And what happens if somebody needs to step up to cover the exposure associated with those firms?

You need to eliminate the distinction between cash and securities. Every investor for covered securities should get, plain and simple, at least $1 million of coverage. That is the only fair and decent thing to do.

There are other suggestions and other questions that I have put in my materials, but, make no mistake about it, Madoff will happen again. There are people out there who are greedy. Stanford will happen again. Lehman Brothers. It is going to happen again. So what do we do? We build in protections going forward. But it begs the question, what do we do about all these people who have been hurt in the past?

Now, I am not aware of any legislation having been introduced by the Congress that would provide any financial restitution to these people. And it is very convenient to make SIPC the whipping boy for what has happened. But if we want to take care of those people, then I today call on Congress to introduce legislation in addition to the tax relief that would provide a means of restitution away from the SIPC process. That is the most equitable and the fairest thing to do.

I thank you for inviting me today, and I would be pleased to answer any questions.

[The prepared statement of Mr. Caruso can be found on page 59 of the appendix.]

Mr. ACKERMAN. I thank you very much, Mr. Caruso.

I thank the entire panel for your testimony. I think we all have some questions, and I will begin with my own. We will take 5 minutes each, and we will go as many rounds as anybody would like.

I will go backwards and start with the statement that Mr. Caruso just made and that is seeing the mission as looking forward. When I look forward, I see before me some of the wounded warriors of the past, the victims, at least a thousand of whom were traumatized by Bernard Madoff and are now being terrorized by the trustee. That is what I see looking forward for some people. And I believe it was Professor Coffee who said, recalling the Hippocratic Oath of "first do no harm," to look at the situation that we are doing tremendous harm with the issue of the claw-back to many, many people.

I think one of the terrible things that we have done here is, because of the way the zero sum game equation works, we have created classes of victims—I don't understand really, and I know the math—net winners and net losers.

Except for the few who have yet to be identified, should there be those who are complicit with Madoff, everybody else is a victim. People who might have taken more money out of money that they

think is theirs have been victimized. People who put their money in a bank—and I know that is a different system when you are talking about the FDIC and not SIPC—who are using their own money, and suddenly somebody says that wasn't really your money because you weren't entitled to that 7 percent interest or whatever it was, they are victims. If you are telling people their whole lifestyle, not just in the future but in the past, has to be reversed, that they can no longer live in their house or maintain their business or drive in their car or continue to pay for their children or grandchildren's education, they are victims. That is traumatic.

And to create classes of people by saying some are rich, wealthy entities and some are not, a guy dies and the insurance company isn't doing so well so you say to the widow, "I know you have a policy. But you are okay. I will give it to someone else." If you think the money is yours and you paid for the premium—and I don't know what kind of premium, by the way—you think you get $500,000 worth of insurance for $150 a year, and the systems pretends that people have real insurance and the SEC agrees that is real insurance after they are supposed to be supervising the agency. And the U.S. Congress, which is complicit in this thing as well, because we are supposed to be overseeing—and everybody is just pretending. At least in the commercial, the doctor says, "I'm not a real doctor. I'm just playing one on TV." This isn't real insurance. We are just playing make-believe to make you feel better.

My question is about claw-back. If we are going to move forward, how do you move backwards? That is question number one, claw-back. Anybody? Everybody?

Mr. CARUSO. I will offer a suggestion.

I think anytime you get into the issue of claw-backs, you not only implicate SIPC and SIPA but you also do the Bankruptcy Code. Is it fair to go back to somebody who took out money to pay taxes? Is it fair to go after somebody who may have taken money to pay for a grandchild's education? I don't think anybody in this room would say it is necessarily fair. And I think Congress has the power to step up and say that is not fair. That is simply not fair.

Whether you should be able to go back a year or 2 years—clearly, for insiders, it would be different. But for other people to go back 5, 6, 7 years, in my personal opinion, I find that to be stretching the limit. But I don't think SIPC or the Task Force has the power to change that. I think it rests with the Congress. And maybe I am wrong on that, but if—

Mr. ACKERMAN. And what would you suggest should be the policy? Do we have a responsibility to those people?

Mr. CARUSO. I think you clearly have a responsibility to those people. And I heard earlier a suggestion about a distinction about how much of a claw-back would you go after. Would there be a threshold limit? Clearly, if there is somebody like a feeder fund who benefited by millions or billions of dollars, there should be no limitation on the ability to get the money back.

Mr. ACKERMAN. Isn't this a moral question and not a means-tested thing? I am sure, without knowing anything—maybe I shouldn't be so sure. But I would be willing to bet that there are people who took nothing out of their accounts who are much wealthier, much wealthier than some people who took 150 percent out of their ac-

count because they had to live on it. Do we means test this thing, or do we make a policy decision and try to do what is right? This is a real Solomonic question that is before us, and I think we need some policy guidance.

You all are looking at this thing prospectively, how to protect people in the future, but when you come up with a cure for a disease, it is our obligation not only to inoculate people who have not yet gotten the disease but to treat the people who are suffering from it at the same time. How do we deal with these people?

Mr. COFFEE. May I try to address that, Congressman?

Mr. ACKERMAN. Professor Coffee, please, and then I am going to yield to my colleague, Mr. Garrett, because my time is up.

Mr. COFFEE. I would just suggest to you when we look at all of the participants who fall into this heading of net winners, who took more cash out than they put cash in, there is a continuum. There may be people that Congress wants to protect. You could protect them with a de minimus test, saying only that fictitious profits over dollar sign "X" could be recovered. You could protect them with what I will call an imputed interest test. Because if you put this money in 10 years ago, the fact that you made 10 percent a year would entitle you to take out 100 percent or more above the money you put in.

But you do not need to protect the feeder funds and the other people who look like they behaved irresponsibly and probably corruptly. Those names are well known to the financial press. Whether it is Fairfield Greenwich, Mr. Merkin, Stanley Chais, Jeffrey Picker Worth, those people are cheering you on right now. Because if you move the standard up, anytime you make the recovery harder for the trustee, you will reduce the settlement value of the trustee's claims against them, and the trustee can get billions of dollars back from them for the net losers.

I don't think Congress should make it harder to recover by the trustee on behalf of the net losers from the people whom I think were very culpable, and there were a number of those people. Thus, if you would protect the people you want to protect by instead using a de minimus test or an imputed interest test, I think you will achieve most of your objectives without protecting those people who are culpable.

Mr. ACKERMAN. I will respond in a different round or probe that a little bit in a different round.

Mr. Garrett.

Mr. GARRETT. Thanks.

So, going forward, does anyone have a recommendation with regard to the SIPC logo? Some people have suggested that we put a little asterisk by it saying that—warning you that the statements that you are receiving may be interpreted in a different way and you may be subject to claw-backs in the future or other interpretations.

I say that facetiously, but maybe not. Because a couple of your comments—everyone's comments seemed to imply that the investor had a misinterpretation of exactly what they were getting if they understood that SIPC was there and what they were relying on.

But some of you have suggested, Mr. Hammerman, if I was following, I think you said different pools or classifications or what

have you. Mr. Coffee, you are a professor. You were talking about it not in those terms but in a similar approach getting to the end place.

I—as the typical little investor going into my local shop to make my investment and seeing the SIPC logo there probably is not going to know right away, Mr. Hammerman, do I fall in pool number A, B, C, or is there no water in my pool at the end of the day because I miscalculated?

Someone over there, Mr. Coffee or Mr. Johnson, somebody made the comment—no, it was Mr. Borg, about not reading all of the disclaimers and everything you get in the mail, just like none of us read the disclaimers that we get from the credit card companies and all of those things. So how do we address that? Are we going to create a whole bunch of different classifications? I will start with Mr. Hammerman there. And then for me, the little guy who just doesn't follow this to begin with?

Mr. HAMMERMAN. I think the heart of your question is investor education and informing the public to a better extent than we have been doing historically as to what SIPC is all about.

Again, when I talk about SIPC, it is the SIPC of the last 40 years. There is a lot of discussion about where this should go in the future. But certainly, from the industry standpoint, we would be willing to work with all experts—SIPC, NSA, the SEC, FINRA, consumer groups, whomever the right people in the room are—if there is a way to do a better job of investor education so that investors understand. And it is not just a one-time thing, so it is not just a disclosure at the opening of the account. As Mr. Borg said, this needs to be ingrained over time.

Mr. GARRETT. I don't know about you. I get my statements regularly, and I get them all the time. And I look at the number, and, oh, I am doing pretty good. Right now, I am doing pretty poorly. I am not reading through the rest of all the fine print. Maybe I am abnormal in that regard. Maybe other people read through all of that stuff.

So if we do try to reeducate folks and tell them that, in the future—and I think I agree on this—in the future, the American public should not rely upon the Federal Government to be protecting them to the extent that they thought the Federal Government was protecting them in the past, because we have shown that the Federal Government in these areas, the various agencies can't do it. So I think that is one learning lesson that the American people need.

Mr. COFFEE. That is a very good question. I think your question is a profound one. Because when you give an investor an education and you show that there are some arbitrary lines, it really becomes incumbent upon Congress to change those lines and not insist upon arbitrary distinctions.

Mr. Borg, I, and others have told you that the definition of "customer" is too limited. Rather than tell all investors that the definition of customer is limited and arbitrary, it is better to change the definition of customer so it makes a little bit more sense and it includes the smaller person who thought he had coverage but doesn't.

Mr. GARRETT. I appreciate that, and maybe I could do a round—but I want to get to another question for Mr. Johnson.

In your statement, you claim that in the past, the courts and SIPC have rejected using a customer's last statement as a guide for the SIPC coverage in cases where fictitious profits are involved. But in the leading case in the Second Circuit, New Times One, in fact, the customer's final statement was used, I understand, in calculating their SIPC reimbursement.

Comments?

Mr. JOHNSON. We have a number of cases and also the bankruptcy courts have always looked at whether or not there was reason to believe that last statement that you had received actually was the information that was accurate.

One of the things that we have been doing is trying to figure out how do we make sure that we can utilize these statements in a way that we are protecting all the investors. What the primary concern is regarding the final statement is making sure that we don't create an environment where the wrongdoer actually has an opportunity to create the forum for who would be successful and who would not be successful. The reason that is important is because you could have a situation—let's take the Madoff case—where you have someone who tells you something that from the very beginning was not true, but the final statement they tell you is, guess what, you have nothing to worry about, because whatever I got on that final statement is what you are going to be protected from.

That would be the only true statement that would come out of their mouths, and what we would do is be creating an environment where the wrongdoer now gets an opportunity to set the tone for how the government then will be responsible for responding.

So the primary issue we are concerned with is making sure that whatever methods we use are going to ensure that we are not going to allow the wrongdoer to actually set the parameters of how we would go about final decisions and putting Congress in the position where they end up doing something that may be unintended as well.

Mr. GARRETT. You are sort of going down a slightly different road on that, but I understand what you are saying. But there is case law now that says the final statement can be used by you for reimbursement purposes. So going forward on that case law is contrary to the position of SIPC then.

Mr. JOHNSON. There is case law that has said that. There are also bankruptcy rulings that have mentioned the fact that you can look at things from a different standpoint as it relates to not only whether or not you have this fictitious statement but also whether or not you are a net winner or a net loser. And part of that calculation takes into consideration whether or not this fictitious statement or the statement you have is one that is valid.

Now, whether or not it should be taken into consideration, it should be. But at the end of the process, there has to be some analysis to determine whether or not that actual statement is what you should end up using as the basis of how you would go about making a payment on a claim.

Mr. GARRETT. But you are going to continue to reject the use of that as a guide for your coverage in cases?

Mr. JOHNSON. What we will do is we will continue to look at the statements that come in and then we will continue to look at the

global aspect of what happened in a particular set of circumstances. And then, if there is a conflict, we will take it to the court and allow a third party to help us to make a decision whether or not we should move forward.

All we are trying to do is hopefully vigorously pursue the law as we understand it and interpret it. And we understand there can be reasonable minds that may differ on how you may interpret the law, but once we are told from a third party or anyplace else that we should be operating differently, then we intend to vigorously move forward in that vein as well.

Mr. GARRETT. Mr. Caruso, I don't want to throw you on the spot on that one. Any response to that, considering where you come from?

If not, that is fine.

Mr. CARUSO. Clearly, there are going to be different opinions from different circuits from different courts. Part of the confusion that exists is that there is no well-defined standard that is universal throughout the country. And the only way that I know of that finally could be resolved would be through the Congress of the United States. Because you are going to have different court opinions on every issue.

Mr. JOHNSON. I think one other point that is worth mentioning regarding the Second Circuit case is it also points out the fact that where the decision regarding what those amounts are on the statement are arbitrary—and in this case we are looking at a situation where the numbers, for example, in the Madoff statements, were arbitrary—then that would be taken into consideration in terms of coming to a final analysis as well.

Mr. ACKERMAN. Thank you.

Next, my co-collaborator and cosponsor of the Ponzi Scheme Investment Action Act, Mr. King.

Mr. KING. Thank you, Mr. Ackerman.

Listening to this, I don't think we are getting the full import or impact of the reality that, while SIPC was set up to protect investors, in too many cases right now the trustee is acting as a prosecutor of victims. We can try to explain it anyway we want, but the fact is that these people were victims and they are now being subjected to the same type of treatment that defendants are put through in massive criminal conspiracies. Yet there is no evidence that any of these people are co-conspirators. They are victims.

I look at the SIPC Web site and it says, although not every investor is protected by SIPC, no fewer than 99 percent of persons who are eligible get their investments back from SIPC.

So, clearly what is being done in reality is different from what people had every reason to expect. They relied on the statements they received from Madoff. They relied on statements from SIPC that 99 percent of investors would be protected. Yet, in addition to all the money they have lost because of Madoff, they are now running up incredible legal fees, they are being required to produce documents going back 25 and 30 years, and it is being done in I believe a very arbitrary and high-handed way and a very heavy-handed way, which is just perpetuating the terrible injustice that was inflicted upon them in the first place.

Now, as far as going forward with SIPC, if I could just be clear in my mind, how was the trustee, how was Picard appointed?

Mr. JOHNSON. He is really appointed by the bankruptcy court. They have an opportunity to review who the potential trustees may be. There will be recommendations that will be made. They will check to see if there are any conflicts of interest. And then they will go forward and go through that selection process.

Mr. Picard is obviously someone who has been involved in this industry for a long time.

Mr. KING. Let me stop you, because time is running out.

Did SIPC make any recommendation on who the trustee would be?

Mr. JOHNSON. Yes, we do make a recommendation regarding who we think would be a good trustee.

Mr. KING. Who did you recommend?

Mr. JOHNSON. Who did we recommend?

Mr. KING. Yes.

Mr. JOHNSON. I believe we recommended Mr. Picard.

Mr. KING. Mr. Picard. So, in effect, we have the court selecting a trustee that you recommended, and the argument can be made that he is now putting a tremendous effort in to protecting SIPC's funds, that, rather than protecting investors, he is actually working to protect SIPC, and to me there is almost an inherent conflict of interest in that.

I know the court made the final decision, but the recommendation was made by SIPC. And it seems to me if we are going forward with recommendations in the future, maybe trying to correct the injustice of the present, we would find a way to have a much more independent person appointed as trustee in which SIPC would have no input whatsoever.

Mr. JOHNSON. Let me make one thing clear. I don't think that we need a trustee to protect SIPC funds under any circumstances, because these funds, from my standpoint, don't belong to any of us. These are funds that should be utilized in order to protect the customers.

What we are trying to do is make sure that whatever the role of the trustee is going to be utilizing is going to be in compliance with the law. Now, we do have a certain responsibility as we manage this fund, but we are not in the business of trying to figure out how to get as few people helped as possible. But we are in the business of making sure whatever policies and procedures we use can be protected under the law.

Mr. KING. But to me, looking at the record, what the trustee is doing is not trying to protect as many people as possible, but he is using—apart from the fact he has already gotten, I believe, $36 million in fees authorized to himself, I just think—I have seen runaway prosecutors, special prosecutors, and to me what I am seeing in this is a runaway trustee who is putting innocent, wounded people through increased suffering.

I know even as—Professor Coffee made the statement. He said, people we might think are innocent. Don't we have to assume they are innocent? Is there any reason to think that any of the people in this room who lost millions of dollars and are now being put on the rack, is there any reason to assume they are not innocent?

There is almost an inference here that the trustee is being hired because—or has been appointed or his job is to find out those who may have been involved and we think others are involved, when there is no evidence that they were. And to me the presumption should be that these people are innocent, how do we help them, not put them through the incredible ravages and suffering they are going through right now.

There is something wrong about the system. I think somehow we are standing back at 30,000 feet and we are saying, okay, we dropped the bomb and there may be collateral damage, but we are not really—that is what happens in war. The fact is there is a lot of collateral damage right now and it is from people who are already damaged and are now being collaterally damaged again. And I don't know if we are really addressing that, the inequity, the injustice, the horror of that.

Mr. JOHNSON. I think, Congressman King, your point is well taken, and one of the things that I have tried to do as chairman is to make sure that we start out with the proper tone as to how we are going to go forward dealing with any of the individuals who have been victimized.

I think the role of the trustee is one that is difficult and complex in that when you begin to start to go through the process it is unclear who may be complicit, who may have engaged in wrongdoing and who has not. But the one thing we have made clear is that we wanted to make sure that everyone had an opportunity, even if you "received a service of a document," that you had an opportunity to come in and speak with the trustee. Because our goal is to make sure that we are going after the correct individuals.

We are not trying to simply just go after anybody for the sake of going after anybody. We understand that this is a very sensitive issue, and we sympathize with some of the horrors that individuals have gone through. And we want to make sure that at the end of the day, that process is taking place in a way in which we will all be comfortable.

That is basically the commitment that I would like to continue to make here today.

Mr. KING. If Mr. Ackerman will just give me time for one more question, one more statement. If that is the case, then I think someone should tell Mr. Picard. Because I have spoken to many of these people, and they described to me what they are going through. They are not being treated as citizens. They are being treated as defendants. They are being treated as criminals. And there is a high-handed, arrogant attitude by the trustee towards these people.

And I think something has to be done, that the message should come from you or the court or someone, but to tell him to knock it off and treat them like victims, not as criminals.

Mr. JOHNSON. Your point is noted, Congressman King.

Mr. ACKERMAN. And I will also note for the record that there are compassionate conservatives.

Mr. KING. I take exception to that.

Mr. ACKERMAN. You are exceptional.

Several things. These letters that are going out aren't, hey, I am from the government. I am here, and I want to help you. These let-

ters set the tone of a very adversarial relationship, and it is scaring a lot of people. It is now us against you or you against us. And these are people, not if they might have been victimized, they are victims.

What kind of attitude is it, they might have been victimized? Is there any question that they have been victimized? People who have directed their entire lives and the future of their families after working hard over their lives and doing the right things wind up with nothing in an account and being told they are accomplices to spending stolen money? That is pretty adversarial. And you have to give it back, even if you don't have it, and if you have a problem with that, come and talk to me.

I understand your argument, Chairman Johnson, that you don't want to put the crooks in charge of setting the dialogue by having the Ponzi scheme operator send you a statement. But just because the guy lied and put that as the bottom line on the statement, you believed it, and therefore you are guilty of something and therefore the crooks are in charge of the agenda and it is your fault for believing the bottom line—let me tell you something. Your government, my government, our government, the Internal Revenue Service was very pleased, was happy, was delighted to rely on the bottom line in collecting taxes and going after them if people didn't pay based on that bottom line. We empowered that bottom line as being gospel and telling people they had to pay based on that bottom line because that bottom line was the bottom line. And why didn't the government investigate? Why didn't the government do it?

This whole thing is bizarre. It is Kafkaesque.

"First do no harm" should be the rule. It was cited here, and properly so. But instead of the Hippocratic Oath, we are taking the hypocritic oath. We are saying "first do no harm" and then going after these people. The whole notion is weird.

My colleague, Mr. Garrett, talked about the SIPC logo. This is the SIPC logo. People look in shorthand, they look for symbols, they look for things, and this is the way we conduct our lives, fortunately or not. And we all get those little statements from our financial institutions 15 times a week with all that fine print, and it is folded in 16 pieces, and we don't read it, and we throw it out. And sometimes we say, who made these people send this out? And then I scratch my head and say, oh, my God, what have we done?

But we don't read those things. We do the shorthand. People go into the bank. It says, "protected by the FDIC," and people believe they know what that means. It is the government standing behind and they have insurance up to a certain amount, that we just increased in this last Congress, and they know they got insurance and the government is standing behind it.

Then they go to their broker, and they see this, and it looks kind of like the same kind of deal. And you go to your guy to make an investment, and he hands you his business card—and we just pulled two out of the fishbowl that we got. And on it, it says he is a member of the NASD and he is a member of SIPC. Everybody's business card, they are proud, they are a member of SIPC. That is code for "you are protected" and Uncle Sam and the government are standing behind you.

You go into the guy's shop and you go to your broker-dealer and this is on the door. And if you looked them up, like I used to do not too many years ago and those of us who are technologically challenged, and you go to the Yellow Pages and his ad has this in it, his stationary has this on it, his radio ad tells you, his TV ad tells you. You go to the Internet and he is advertising he is a member of SIPC.

And you see what it says right under the logo: Securities Investor—that is me—Protection—that is what I need—Corporation—that is what I have. And instead of a dot on the I, guess what we have? We have the American eagle, just like on my stationary and on the shield of the President of the United States and the Supreme Court.

That is shorthand for "your government is standing behind this." And we have allowed this to happen. It is, "I am not a real doctor, but I am playing one to fool you," and your government is accepting it, and you have insurance for $500,000, except you don't have anything.

We have a moral responsibility to these people, do we not, or am I missing something? Question mark?

Mr. JOHNSON. I think we do have a responsibility to these people, and I think when we look at things, we have a responsibility to every victim who was part of a scheme. And one of the things that we have to figure out is how we balance and whether we do it the right way or do it the wrong way, how do we ensure that we are not simply going to benefit those who by the luck of time got out at the right time, as opposed to those individuals who may not have been as fortunate.

Mr. ACKERMAN. If you got a transfusion first, we should take out the blood to give it to somebody who is a pint short?

Mr. JOHNSON. I wouldn't take out the blood, Congressman, in order to have somebody take their lives away, but we do give blood to others from time to time who are in need. And one of the things that we are simply trying—

Mr. ACKERMAN. Shouldn't that be a collective decision that we do as a society and not have a trustee decide who to go after and take their blood back?

Mr. JOHNSON. I think maybe the role that Congress will end up taking is to help us to get more specific guidelines as to how that needs to take place, and I think we will be more than happy to vigorously follow that rule until whatever way Congress decides to move forward.

Mr. ACKERMAN. Yes, but we are looking to you. This is not King Solomon's court, and none of us pretend to be. And it is an awesome responsibility. And you by virtue of the fact of the role that you have looking forward, which I agree is your role, and sometimes we have to see how to fix the problem looking forward, what we do about the collateral damage, as Pete King said that we have left behind, the carnage here. We shouldn't be trampling on the bodies of those who are injured in order to help those in the future. We have to try to help everybody. And you don't do that by further wounding those people who are suffering.

It is not taking away. We are where we are. It is a static situation right now. Do you go in and further probe the wounds of those

people who may or may not have the wherewithal to do anything to give to people who are "net losers," who may be richer than the net winners? I don't know how you figure this thing out.

We have some legislation on the people who went through broker-dealers and third parties and all that to give them up to $100,000 insurance each. As a society, maybe we who are complicit in it, which is society and us and you and everybody else for letting this happen, to say, okay, this is the help we have to give people. We all bore the responsibility, and we have to pay for it.

It is not just voter education. We all know you can't go over the speed limit, but we still put cops out there. People rely on the cops to enforce the law, and our cops haven't done that. Everybody thought they were doing what they were supposed to be doing and then find out their whole world is topsy-turvy.

My time is up.

Mr. GARRETT. Thank you.

I wasn't sure where you were going with this King Solomon reference, but in the case of King Solomon, of course, we all know the story from the Old Testament. At the end of the day, of course, he didn't slice the baby in half and the baby survived. I thought he was going to go and suggest that in this case we are slicing the baby in half and making that wrong decision, and then the penalty is on both the mother and the dead child.

So just to follow along then also where Peter—the gentleman from New York, excuse me, was saying with regards to the trustee, just two quick questions there.

One question we get oftentimes is, do you know what the trustee has billed SIPC so far and where do those funds come from actually?

Mr. JOHNSON. Yes. I think he has billed the court about $39 million.

Mr. GARRETT. $39 million.

Mr. ACKERMAN. Did he get paid on time?

Mr. GARRETT. The question from almost the peanut gallery, from my colleague here, is does he get paid on time and where do those funds come from?

Mr. JOHNSON. They come from fees that are paid by SIPC members.

Mr. GARRETT. So, in essence, it comes from the same pot of money.

The question was asked by the gentleman from New York with regard to the appointment of the trustee, and I understand your answer. But over time, not just in this case, is it just the norm with regard that SIPC makes a recommendation for a trustee, and is it the norm that the judge would approve that?

Mr. JOHNSON. It is the norm for SIPC to make the recommendation, and it is simply up to the judge. And I can't say that I know of other circumstances where the judge may not have accepted that recommendation, but at the end of the day, it is completely in the judge's discretion.

Mr. GARRETT. Do we know, in other cases, does the investor class or anyone else make recommendations to the court as to who they would—

Mr. JOHNSON. We make the designation basically by statute. So if the statute was different, then it would allow others to be able to make the call. But we are designated by statute to do so, so that is why we really don't have any other third parties that are involved.

Mr. CARUSO. I don't believe investors would have the right to propose their own trustee, at least initially.

Mr. GARRETT. Just a quick question—

Mr. COFFEE. Your statement is correct. It is SIPC who makes the recommendation. The court simply decides if the proposed trustee is qualified. So there is a strong presumption in favor of the SIPC nominee.

Mr. GARRETT. Does anybody here on the panel suggest that is good, bad, or should be changed?

Mr. COFFEE. I think SIPC is very much overseen by the SEC in this regard, and it is the SEC who has asked SIPC to generate a list of potential trustees in advance. So I think this is a combination of the SEC and SIPC that has developed this approach of developing a list of potential trustees in advance.

Mr. GARRETT. Okay. And does anybody suggest that is not the appropriate—some of you said looking forward, so, looking forward, is this something we should be looking at?

Mr. JOHNSON. In terms of that whole process, that is on the table in terms of what we are looking at during the Task Force. The way we are looking at the Task Force is we want to take a look at everything that we are doing from top to bottom. We just went and had a complete full view of the operations of the staff, which was something that I wanted to have an opportunity to take a look at. So we have everything on the table in terms of how we think we can best protect investors and customers when this is all said and done.

Mr. GARRETT. Okay, would one of those other things—and anyone can answer this question, and this was in my opening statement—was the question regarding how net equity should be calculated and the question as far as access to the records to the investor class in order to help make those determinations. I understand that—obviously, it will be critically important for the investor class to be able to have those information as well as SIPC to have them. But, right now, I guess they are not done.

I understand the SIPC trustees—SIPC's formulation could be called into question if you were to have access to those records and to look at those records and to say in those examples that some of you are raising that, yes, some of these transactions over the last—how many years—couple of decades were actually legitimate transactions, right? And so when I got my statement I put in a half million on and it said $3 million, maybe $750,000 of them were actually legitimate transactions, right?

So when you all figure out the net valuation on that, you want to know that, right? But if the investor folks don't have access to the information, they are not in a position to argue that. So what are we doing with those records?

Mr. JOHNSON. That point is well noted, and I think from my standpoint I don't really see a reason why they shouldn't have access to that documentation, and that is one of the issues we will

look at and make the recommendation potentially with the Task Force.

Mr. GARRETT. But where are we right now on that?

Mr. JOHNSON. I am sorry?

Mr. GARRETT. It is in the court right now. Is this something that can be changed with regard to what is going on right now?

I am not talking about Mr. Caruso's fine comment saying what do we do in the future on the next Madoff? We are talking about the situation right now I guess for some of the folks behind you. Can we say that tomorrow this information is available, or where are we?

Mr. JOHNSON. In terms of where we are right now, I am not sure if we have the authorization to make that available. But that is something that we can take a look at, and if we have the authorization to do so, we will.

Mr. GARRETT. So there is a question of whether SIPA itself may need to be amended in order for that to occur?

Mr. JOHNSON. That is clearly the case.

I make it very clear that is a statute that really hasn't been reviewed for about 40 years in a serious way, and that is part of the reason we are trying to figure out how to get this statute to be more flexible to be able to deal with the issues that we are currently dealing with in this type of market, in this type of investment climate, and understanding the type of investors we are dealing with right now.

Mr. GARRETT. Just so I am clear, that needs to be done, and you don't have the flexibility under the current language?

Mr. JOHNSON. We are reviewing it, and we will determine whether or not we have the flexibility under the current language. So, in the event that we do not, that may be a recommendation that we may move forward with.

Mr. GARRETT. All right, then you just opened up the next question then when you said you are trying to determine this: How long does that take in order to determine it? Because I think that is the information I would want yesterday.

Mr. JOHNSON. That is information that we can find out very quickly; and as soon as I have that response I can get it back to you, Congressman. But I can't imagine it would take us a long time to make that determination.

Mr. GARRETT. Thanks.

The gentleman next to you?

Mr. BORG. I was going to make an analogy to some of the cases that are non-SIPC. Most of the cases I prosecute, my office prosecutes, are Ponzi schemes with fictitious securities and whatnot, but there is no SIPC coverage or there hasn't been in the past. I would like to see nothing better than everybody get all their money back, but I am not so sure how you can do that.

Mr. GARRETT. Hold that thought. Can you explain how it comes about that they are not going through SIPC?

Mr. BORG. Historically, because the securities are not either held by a broker-dealer. For example, private placements is a big area for us, the Reg Ds. We have complained about this many, many times.

The sales have that occur through a broker-dealer, it might be a private placement where they get an LLC partnership, a limited partnership type certificate or something. The certificate is not held at the broker-dealer. It is not in inventory.

They do get account statements, because there is a report, and they will actually get, say, that according to your oil and gas well or whatever it may have been, you have "XX" dollars. Historically, that has not gone through SIPC, and I guess I have had this discussion with SIPC since the mid-1990's on that, but there was no interest from any government body at the time to take that on up. This goes back to the microcap area that I testified to in the Senate back in 1996.

As a practical matter, though, the Ponzi schemes that we oversee end up having a very limited pool of funds. Although we very rarely see the claw-back issue come up, because, quite honestly, these Ponzi schemes usually don't last 20 years. The ones we see on a local level are a lot shorter in duration, and therefore, the time value of money is not really that significant. And let's face it, most of these folks don't want the cheese, they just want out of the trap and to get their money back, if they can. Most of the time it is pennies on the dollar.

I am going to suggest, though, if we are looking at things like covering the Stanford matter, I have five cases right now in the last year. That is another $7 billion that need to be added to that.

What is not reported is that Stanford and Madoff, just because of sheer size, are not unusual cases. They are unusual because of the size. I have one case that had 18,000 victims in it, but the dollar numbers were small because we caught it early. But, that being said, there was no coverage there.

I think that as much as I would like to get everybody coverage, if you are going to cover the fictitious securities outside of the broker-dealer custody area, you are probably going to look at a several hundred billion dollar fund that needs to be funded, and that is going to take time, depending on what you do with the assessment.

I would love that to happen. I don't think it is practical, at least under the current standards. But I do think—let's not forget, I think, that there are other frauds out there that, if we are going to expand coverage, we need to do it for all Americans and all frauds, not just a Stanford fraud or a Madoff fraud. I can give you a list of 20 that we have prosecuted in the last 12 months that range from anywhere from half a million dollars to a couple hundred million dollars. The effect of losing your retirement funds to Madoff—

Mr. ACKERMAN. I think all of the legislation that we have cited here that we have proposed is not Madoff-specific, but they apply to all Ponzi schemes, some of them within a timeframe.

Mr. BORG. I think that is something that really does need to be looked at, and I compliment you for that.

Mr. ACKERMAN. Mr. King.

Mr. KING. Thank you, Mr. Ackerman.

Mr. Johnson, what rate, if any, does SIPC give to the final statement?

Mr. JOHNSON. I am sorry?

Mr. KING. I said, what rate, if any, does SIPC give to the final statement in Madoff?

Mr. JOHNSON. The final statement has to be part of the analysis, because that is where we begin to determine exactly how we got to this point and then we start to look back from there. So in terms of the final statement, we have to begin with something, and then once we start to go through the analysis regarding how did we get to that point, that is when we have to determine whether or not it is fictitious. And the bankruptcy courts and SIPC and the trustees have reviewed this issue for a number of years and we have found that in instances where it is fictitious, the courts will come in and make a decision that is something we have to look through and go to find out what the real loss is going to be.

So we do have to begin with that and then hopefully try to draw some type of analogy as to where we are supposed to end up.

Mr. KING. Does it weigh at all in determining the reasonable expectation of the investor or what the reasonable belief of the investor was?

Mr. JOHNSON. Oh, sure. No one is saying that we have a situation where you get this statement that someone is complicit and therefore should not have had some type of reasonable belief.

What we are trying to do is to make sure that, even when we go through that analysis, we have a bigger picture to understand, that although you may have believed this was the case, and in most Ponzi schemes you have a lot of individuals who believe that something actually belonged to them and the responsibility of the third party is to come in and make clear what really belonged to somebody else and try to figure out how you balance that equation so more people are going to be benefited when it is all said and done. That is the same practice that we go through.

Mr. KING. Moving on, I guess my concern—first, I thank all of you for your testimony. Obviously, this is a very complex situation.

But I am just wondering after all of this, if another Madoff scheme occurs 10 years from now, is there any reason to believe that investors would receive any more equity than they are right now? With all of the recommendations that are coming out here, unless we set up a fund of several hundred billion dollars, it would appear we could be back in the same place 10 years from now where you have innocent people who took the money out, relying on a statement which they thought was guaranteed by the government, and they then get clawed back; and then others who left their money in, also, they are in a terrible situation, too.

Is there anything that is coming out of this hearing or any of the review that would make the situation any better 10 years from now for innocent people in a Madoff-like scheme?

Mr. JOHNSON. That would be the hope. The idea is when you look back to when the first Ponzi scheme came into play, we would have hoped we would have never had to see that happen again; and our primary goal is hopefully trying to put in place some modernization that will make our statute flexible enough to be able to deal with those things that we can't imagine.

The biggest issue that we have is that the 1970, the current statute we had, could not have anticipated this, and we are hoping we are going to put something in place that would deal with this.

Mr. KING. I guess what I am saying, besides hope, is there any reasonable expectation for the hope we would be able to protect a person who took his money out, say systematically relying on the statements, took the money out over the years and now is suddenly confronted with a massive claw-back which is going to destroy that person, destroy that family, destroy their business, and also destroy any hope of financial security for their children and grandchildren?

Do you see anything coming out of the discussion so far that would protect those people in the future, in a large-scale scheme such as this?

Mr. BORG. I have listened to Professor Coffee's idea. I don't think that under the current system, if another Madoff happened in 10 years, you would be any different. I think where you would be different is if you do set the limitations on the claw-back that Professor Coffee has suggested.

Because, from my point of view, there is also a limited pool of money; and, historically, in the cases that we have—again, the non-SIPC, because that is where most of our experience is—we always have, for example, $10 million. That is all I have. That is every asset. We have taken the houses and the lands and whatnot, and I have $100 million worth of claims.

The only fair way I have been able to do it, without having any SIPC coverage, is to say if you put in $100,000 and you took $50,000 out, yes, I know that you were expecting that was interest. But I have somebody here who put $100,000 in and never took anything out. Therefore, your loss has to be $50,000 and their loss is $100,000. And then when I do the mathematics pro rata, you are all going to get the same sort of share of the loss, as opposed to trying to make you whole.

If you have an unlimited fund or a fund of $500 billion or something like that, then, of course, you can do different, if you have that expectation and you can cover anybody's expectation. I don't think it is practical to cover everybody's expectation for the full amount without some limitations, 10 years, 5 percent, 10 percent, whatever it is, though I do think 10 percent is high in the current economy. I would love to get 10 percent on a CD at a bank, if I could.

But whatever the number is, I think the important thing is that we have a finite number to start with, and that is a finite number that has to be divided. If I have five people in my family and there is a lemon pie, I can cut it into five pieces. But if somebody already has a piece, I am not sure they are entitled to a full piece the next time around.

Mr. KING. Let me start with Professor Coffee on that. Have you done any of the math if that reasonable expectation was built in over the years, how that—

Mr. COFFEE. Let me take Mr. Borg's example, and take it one step further. If you put in $1 million and you take out $50 million—and there are those cases in Madoff—I do not want to totally disarm the trustee. Trustees in bankruptcy for the last 500 years have had the power to attack fraudulent conveyances. I think we would be sweeping too broadly if we totally disarmed the trustee.

I understand your concerns. I think the better way to deal with the people you are most sympathetic to is to create either a de minimus test, saying if it is only $500,000, $700,000, some number like that, that you took out, that is immune. Or your personal assets, your home is immune. Or we could say we are going to give you a minimum return of 10 percent a year because you have been invested in here for 10 years. All of those techniques would reach most of the people you are talking about.

But if we were to disarm the trustee entirely, the next case may come along and you are going to be having a congressional hearing as to why this trustee couldn't do anything when there was real fraud going on here. So I am saying be careful about how broadly you disarm the trustee.

Mr. KING. I realize that dilemma is there. I am just wondering, has anyone done any research on what the impact would be if it was 8 percent or 9 percent or 10 percent had been built in as the reasonable rate of return over the years, how that would affect Madoff investors?

Mr. COFFEE. Madoff went on for over 20 years, maybe 25 years or more. If you used compounded interest, you would be able to get up to 3 or 4 times what you invested and be exempt from any kind of claw-back.

Mr. KING. Thank you very much.

Mr. ACKERMAN. Can I come back to the pie? What if you discovered suddenly that you had more pie than you thought?

Mr. BORG. I can tell you from my personal experience on the occasion where we do have more pie than we thought we make the pro rata distributions go up. It is almost like all the victims would get—you get a dollar, a dollar, you raise it all up.

Mr. ACKERMAN. Would you continue to try to stomach pump the guy who ate the first piece of pie?

Mr. BORG. If I had enough to go around? I personally wouldn't. I do not like claw-backs. I have very, very rarely ever done a claw-back.

But, again, most of my Ponzi schemes are not 20-year-long Ponzi schemes, so the claw-backs haven't been significant enough to even make that determination. But if you have more assets and you can cover all folks, then why do the claw-back?

Mr. ACKERMAN. If you somehow discover that you have more pie, I am sure it is not going to be enough to cover everybody's total expectations, and probably not even if you do the imputed interest that my colleague, Mr. King, was inquiring about. But would you discontinue doing harm to those people who already ate the pie? They could have eaten that pie 3 years ago.

Mr. BORG. That is true. But there are some folks who tried to save that pie and put it over in the fridge and didn't eat it, and now they don't have it at all, so they never got the benefit of the first piece of pie in the first place.

Mr. ACKERMAN. Yes, but those people may have six other pies.

Mr. BORG. Yes, but the problem with that is we don't get into—at least I haven't, and I am not talking about the Madoff situation because I am not involved in the Madoff trustee case. That is why I don't know the details. But in the cases we have where we have seen that someone else has a lot of assets, the point is they are still

entitled to protection under my statute and they are entitled to cover that.

Mr. ACKERMAN. Exactly.

Mr. BORG. If I have excess property, I probably don't have much of a case to worry about, because I have enough money to go around.

Mr. ACKERMAN. Not excess, but more than you thought you had. Nobody is going to get excess, because there wasn't enough money generated.

Mr. COFFEE. We do have a $50 billion loss here, and even if there is more pie here, it is going to add just a few more pennies, a few more dollars to the recovery of the entire class of victims.

Mr. ACKERMAN. One of the things that I think we would like to look to you towards, you are tasked with the responsibility of what we do in the future to make this situation better for future investors, and you guys are looking at this in a lot more depth than the total Congress or even this committee. We have lots of other legislation and stuff that we do, despite the fact that the victims would like to think we are doing this and this exclusively full time. Everybody knows we have a lot of other balls that we are trying to keep in the air. So, you guys, this is your job as well. We are not begging off at all.

But it would be useful for us to hear your suggestions for the future to treat people fairly and equitably and justly. Why wouldn't those recommendations that hopefully you will make sooner than later be applicable to the people who were already victimized as far as how we approach this? If this is the way we should have done it because we are going to do this in the future, why can't we backfill and see if we could be helpful to these people that way?

Mr. JOHNSON. Really what that boils down to, it would be a legal question. If it turns out that, pursuant to the law, that we can look back, then that is something we can take into consideration. But if the law, for example, sets certain specific guidelines, like, for example, we have been talking about how far back the trustee can go, the law actually has a limit as to how far back the trustee can go, and that is 6 years. You can't get beyond that timeframe in terms of doing an analysis.

So what we would be looking to do is really to be in compliance with the law. If it turns out that the law allows us to be able to look back in some way, then that will have to be taken into consideration as we go forward in making recommendations. But that basically would be what we would use as, hopefully, the parameter as to how we would make the decision of what we would do retroactively.

Mr. ACKERMAN. If you are tasked with the responsibility of looking forward, it doesn't mean that you can't look over your shoulder.

Mr. JOHNSON. I don't think we can really adequately know what to do for it unless we have looked back over our shoulder to do a real analysis as to where we came from.

Mr. ACKERMAN. My question is, if you are making judgments based on what you believe is just—I am asking a theoretical question—why should that not be applicable? Why should we not use that as a standard?

Mr. COFFEE. We sympathize. I am not saying we can't. But this is a private insurance system, and if you suddenly decide you want to cover losses that the insurance system never reserved for, you are going to sink the insurance system. That is the problem of Alan Stanford. If you ask broker-dealers to cover fraud-related damages, that is the kind of liability that dwarfs what is in the fund.

Mr. ACKERMAN. I don't want to go back and beat a dead horse, but I know that we all know that this private insurance system was inadequately funded. Now, whose fault that is, is a matter of speculation on people's part, and I think there is a big shared responsibility here.

I would say it is not the fault of the guy who walked into a broker's office and saw this. It is not his fault or her fault. We have allowed that to perpetuate in a myth that these people were adequately protected.

The hospital hires a guy who is not a real doctor and he operates on your kid, God forbid. There is a liability here. This guy who hung up this certificate to operate on your finances wasn't protected with the insurance that you thought he had, and your goal is to try to fix that in the future. But the way that you fix it in the future I would think would set a moral tone to the responsibility that we have to look at as far as how do we help the people who already took a hit, and not only that they already took a hit but, with the claw-back thing, are going to continue to be traumatized.

Before I move on to my colleague, I just want to—and this is not your responsibility either, but the government should not be the ultimate beneficiary of the ill-gotten gains of Bernard Madoff. And that is our job, to try to figure out how to fix that. Some of us have some legislation that is moving forward in the Congress.

Mr. Garrett?

Mr. GARRETT. Thanks.

So, just to wrap up, so the gentleman from New York often holds that logo up and the issue of what the expectation was. As I sit here listening to that and sit here also thinking about what we have done in Congress over the last year-and-a-half and what the Fed has done, I think we are probably in even a more difficult position than ever before as far as lowering the level of expectations, regardless of what SIPC did or didn't do in this situation.

I can make the suggestion, oh, what we really should do is just send out a blanket notice to everyone who comes in the dealer's office and say you are not protected for X, Y, and Z in big bold letters or something like that so everyone would know, and you all say education or what-have-you.

We already had a law to that effect on something that I use, and that is the money market fund. Every time I call up my money market fund, I get an automatic recording at the beginning or the end of the phone call that says these are not FDIC-insured so there is no protection by the Federal Government. I knew that going in, that there was absolutely no guarantee.

But guess what? At the end of the day, when the Reserve Fund had a problem and there was a problem on Wall Street, all of a sudden they basically were guaranteed, and they didn't want all the funds to break the dollar at that point.

We just created something, and I guess the appointment was made this past week, of a new CFPA, Consumer Financial Protection Agency. So now the American public really doesn't have to worry about anything, if you listened to the testimony over the last several months, because we have an agency out there that will protect us from ourselves, and any investment or any—not securities per se under the CFPA, but any financial product that is out there, because the CFPA is going to be watching out for us.

So regardless I guess of what SIPC does in this regard, we know that the good faith and credit of the United States Federal Government will be behind any future financial activity that I engage in and I should be able to look to the Federal Government.

I think that is a problem that you will have going forward to be able to actually, whatever your recommendations are, to delineate exactly what your responsibilities are, whether it is $500,000 or $1 million, as some people say, or something else. The folks at home are going to think, no, it is not. The Fed is going to step in, Congress is going to step in, just like they did in these other situations, and it is irrelevant.

So you have a difficult job ahead of you to try to reeducate and convince the public that there are limitations to this.

One question on that, though—and I know you weren't around back then—but back in 2003—you were around someplace in 2003, but you weren't here—the GAO and Members of Congress warned that the size of the fund wasn't the right size, I guess, and should be increased. I guess that was done.

So if you want to comment on your understanding of what may have occurred back then to your best analysis, your best opinion on that. But more to the point where you right now, now you have at $2.5 billion. Is there statistics or an actuarial analysis to say that is the right size? Because I think some other folks here were suggesting that should be a much higher figure.

Mr. JOHNSON. That is actually, I would say, one of the real conversation points that we have as it relates to the Task Force, how do we right-size that number? And a lot of it really boils down to what would be the ultimate responsibilities that we would be taking on at SIPC.

If, for example, Congress were to decide that SIPC should be in the business of protecting against fraud, then that number would have to be a completely different analysis that we would have to go through. It could be a situation why you take the number up to $10 billion maybe that we are raising from fees and therefore you never tap the Treasury line. That would be an analysis of how we could figure out what number we need to be at.

But part of what we are going through with the Task Force is really going through an analysis and hiring those to be part of the process to help us figure out how do we right-size what that number is. And what it really boils down to is what are the responsibilities that the Congress wants us to take moving forwards, and that would help us be able to get to that point.

Mr. GARRETT. Of course, the issue of fraud, most people coming into the broker don't differentiate what they are being protected for right now. It is just like I don't differentiate under the FDIC what I am being protected for. I am just protected to the limits.

Which goes to a question, Mr. Borg was saying that you dealt with cases outside of SIPC, right? So it seems to me we are talking about maybe two different things here when you are talking about claw-backs and what have you. In your non-SIPC case, then you are just dealing with—what—an estate, right? And you are taking this little estate or big estate and saying, how am I going to divvy it up and maybe use some of it? If it was long term, present value of money, you might have done that. If it is short term, you are not going to do that, right?

Mr. BORG. That is correct, on a cash-in, cash-out basis, plus whatever you took out.

Mr. GARRETT. Exactly. But here we are dealing with that, and so you have to make those decisions, and I understand that, and with regards to the issue about the statements and everything, and you understand that.

But here you are talking about something else with SIPC, right? Because you are dealing with—what—sort of my way of thinking, an insurance policy but a separate pot of funds that you have collected over the years from the dealers.

There that is different in my estimation with regard to how that should be treated. Because that is really where the expectation—when I come in, I see that thing. I think, if I am smart enough—I'll bet you most people don't even ask how much I am covered for, but if is up to $500,000, then it goes to Mr. Coffee's comment. If I invested $500,000 20 years ago and now it is $50 billion and I took out $50 billion, I still have an expectation, just like I have—I am sorry I used the word—an insurance policy for $500,000 worth of coverage, regardless of whether I took it out or not. That is different in my estimation of what you are doing or you are also doing with the estate residual. Is that correct?

Mr. BORG. Yes, sir, that is absolutely correct. That is why I was trying to distinguish the SIPC coverage from the non-SIPC coverage, only from the point of view of anything over that amount we still have to do some sort of proration. My point was really that the coverage is going to depend on how big a pot you have to deal with.

Mr. GARRETT. But only for the residual, not for the $500,000.

Mr. BORG. Exactly. I think we are saying the same thing, but I was using that as an example to show what else is out there on the net equity type calculations.

Mr. GARRETT. Right. So when you give the example you did before, if somebody invested a million bucks, so he thinks he has $500,000, right, and he took out—what did you say—$50 million over the last years, but the statement comes out and still says I have $1 million on my statement today, right, that person should still have the correct interpretation that he has a half a million dollars worth of coverage or protection and there should be absolutely no claw-back for that $500,000, correct?

Mr. COFFEE. There is never a claw-back for the SPIC funds. The claw-back is for the amounts that were earlier distributed that were fraudulent conveyances, arguably.

Mr. GARRETT. Right. That is why I wanted a clarification on Mr. Borg's comment.

Thank you, and I thank the panel, too.

Mr. ACKERMAN. I have one question, and then we have Mr. Klein.

Has any thought been given to, as you point out, the private sector? Because this is private-sector insurance, the private sector that made so much money over the years on people's investments, huge profits, underpaying insurance to give people—that in effect gave people a false sense of confidence, that they stepping up to the plate and increasing the size of the pie by putting in whatever by whatever formulaic circumstance additional amounts, perhaps based on a recalculation of what a reasonable premium should have been, because they indeed stand to profit—made a profit and stand to profit additionally by restoring investor confidence in the market.

Mr. JOHNSON. I think the role of—

Mr. ACKERMAN. Or is that too sensitive of an issue for you guys to go to?

Mr. JOHNSON. I think the role—I guess what I was kind of trying to mull through in my mind is the role of private insurance. It sounds like what we are talking about is to actually act as an additional backstop. Is that where we are going with that, Congressman?

Mr. ACKERMAN. No. I am saying, hey, boys, let's chip in and make this thing good.

Mr. JOHNSON. I see what you are saying. What we wind up doing really is increasing the assessments. Because increasing the assessments at some point is the only way that we will actually end up getting the funding.

Mr. ACKERMAN. I know. But we have made a decision that the assessments should have been a heck of a lot larger to begin with. We are going to fix that in the future.

But has anybody given any thought to saying the guys who are going to profit by keeping investors as investors, making good to restore confidence and paying what they should have paid in the first place into the fund?

Mr. JOHNSON. That is an area that we can take under consideration.

In terms of how that role would be going forward, I am unclear on how it would play out, but that is something that we could take a look at.

Mr. ACKERMAN. I think that might be a good thing.

Mr. Klein from Florida.

Mr. KLEIN. Thank you very much, Mr. Chairman; and I thank the panel and the people here today in support of a full understanding of what can be done to fix this.

Obviously, there is the going-forward assessment of what can we do to avoid something in the future, but I think we have all heard from in our communities the people who have suffered and have lost these resources and had certain expectations based on the SIPC sign on the door and the rest of these things.

So first, I want to associate myself with Mr. Ackerman's and Mr. King's comments. I think they were strong, and I agree, and they don't have to be repeated.

Certainly representing South Florida, where I am from, we have had a whole lot of people who are very, very concerned about the

whole claw-back issue, again, based on expectations, based on the fact that they paid taxes on monies they received, and there doesn't seem to be any relief from that whole story. This is a serious problem.

And the fact that there is a limited amount of pooled resources available is making it even more complicated, particularly based on Mr. Ackerman's last comment that there was an underassessment in the first place. And I would agree with that. I think there was a ridiculously under-assessed issue. So I guess I want to stress the point about addressing the claw-backs and even if we have to change the definition of net equity to get to the right place here.

I think, again, the people who have come to me and talked about this—and they have been on both sides of the equation here. But, again, just in what is fair in terms of trying to make it whole and make sure the SIPC lives up to its obligations, maybe Mr. Ackerman's comments are the way to get there, but I certainly want to encourage as quickly as possible—this has taken a long, long time to get through all these things. People have been suffering through having lost these resources. Some had to make pretty dramatic changes in their lives.

I also want to mention the Stanford issue, also, because although it is complicated, again, it seems to me that these victims also should be compensated under the SIPC as well.

So, again, I think the questions have been asked, and I just want to be here to support very strongly, as quickly as possible. A lot of frustration has gone on through this whole thing.

And, again, I look at the victims, and that is one level. But I also look at the investor public that really depends, and our country's economy depends, on confidence in investing. And if we don't have that kind of confidence, it creates a whole lot of other problems.

And we are not looking to go back to the point in time where people are putting money in their mattress. We want people to feel when they invest and they are getting a statement and they are dealing with people that, in the absence of fraud, that they know where this money is and how they can recompense themselves. And we have to have a structure going forward that is set up in a way to make sure that the resources—and the people who are benefiting from it, these companies, have to stand up for it. And I think that is just part of the deal.

So, Mr. Chairman, I won't take up any more time. But I want to reflect on that issue in as strong as possible statement to get the SIPC right on this and to get our folks who have been impacted made whole.

Mr. ACKERMAN. Thank you, Mr. Klein.

The committee would just like one clarification of something I think Chairman Johnson might have said on the issue of claw-back. Did you say that the trustee was looking on going back limited to only 6 years on the claw-back?

Mr. JOHNSON. We have a statute of limitation, I believe, as to how far back we can go.

Mr. COFFEE. Six years is the New York rules. And the statute lets you use either the Federal rule or the State rules. So 6 years is New York's.

Mr. ACKERMAN. So we are under New York law on this?

Mr. COFFEE. The statute lets you use the Federal rule, which I believe is 2 years, or the State rule, which is, in New York's case, is 6 years.

Mr. ACKERMAN. So you have chosen the New York statute?

Mr. COFFEE. I have chosen nothing. I am just a humble academic.

Mr. ACKERMAN. Mr. Johnson?

Mr. JOHNSON. That is what the trustee has chosen. Yes.

Mr. ACKERMAN. So the claw-back can go back 6 years and no further?

Mr. JOHNSON. That is correct.

Mr. ACKERMAN. Let me thank the panel. You have been very, very helpful. This is a very complicated and emotionally charged issue. We appreciate all the thought and the work that you have put into it, and we know that everybody is going to not be completely satisfied. Some people will be emotionally as well as financially scarred forever, and we know you are doing the best that you can. We have to do some work as well. But you have been very helpful to us in our deliberations. I thank the members of the committee as well.

The Chair would also note that some members may have additional questions for the panel which they wish to submit in writing. If you would answer them in writing to us, we would be appreciative, and that would be made part of the official record. Without objection, the hearing record therefore will remain open for 30 days for members to submit questions in writing and for the responses to be placed in the record. Without objection, that is so ordered.

There being no further business before the committee, the panel is dismissed with our thanks.

I have a script. Before we adjourn, the following written statements will be made part of the record of this hearing: the statement of Mr. Ron Stein, president, Network for Investor Action and Protection; the statement of Ms. Ronnie Sue Ambrosino, coordinator, Madoff Victims Coordination; a letter dated February 22, 2010, from Mr. Stephen Harbeck, president of the Securities Investor Protection Corporation (SIPC), in response to Members' questions during the December 9, 2009, hearing entitled, "Additional Reforms of the Securities Investors Protection Act"; a letter dated March 4, 2010, from Chairman Kanjorski to Mr. Stephen Harbeck, president of SIPC, encouraging the broad representation of the newly-created task force to consider SIPA reforms; a letter dated August 20, 2010, from Chairman Kanjorski and Ranking Member Scott Garrett to Mr. Stephen Harbeck, president of SIPC, requesting claims data; and, finally, a letter dated September 7, 2010, from Mr. Harbeck, president, SIPC, in response to a request from Chairman Kanjorski and Ranking Member Garrett requesting claims data.

Without objection, it is so ordered.

The panel is dismissed with the thanks of the committee and the Congress, and the hearing is adjourned.

[Whereupon, at 12:09 p.m., the hearing was adjourned.]

A P P E N D I X

September 23, 2010

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON ASSESSING THE LIMITATIONS OF THE SECURITIES INVESTOR PROTECTION ACT

SEPTEMBER 23, 2010

Nearly two years have passed since the massive $65 billion Madoff Ponzi scheme came to light. Since then, we have enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among many other things, this law amended the Securities Investor Protection Act, the statute that works to return money and securities to customers of failed brokerages.

To better protect the customers of failed brokerages going forward, the Dodd-Frank Act increases cash protection limits and bolsters the resources of the reserve fund used to replace customers' missing cash and securities. This new law also quintuples penalties for misrepresentations of membership in or protections offered by the Securities Investor Protection Corporation. Moreover, the statute makes important changes to prevent, rather than simply replace, the loss of customer property, including new custody safeguards for customer assets held by certain financial professionals.

The Dodd-Frank Act additionally requires the auditors of broker-dealers to register with the Public Company Accounting Oversight Board, and this regulatory body has the authority to regulate these market gatekeepers. This change ought to put incompetent and unscrupulous one-man auditor shops like the one which blessed the books of the Madoff brokerage out of business before investors get harmed.

Much more, however, remains to be done to protect investors. The victims of the Madoff Ponzi scheme and the Stanford Financial fraud include many hardworking families and frugal retirees who invested their hard earned money with now imprisoned or indicted con artists. Numerous press stories have relayed accounts about how these victims who sought to play by the rules have now had to greatly modify the ways that they live. The victims of these frauds believe that SIPC has fallen short in meeting its responsibilities, and they want more change. I do, too.

We have many questions to explore today. For example, although SIPA's protections do not currently extend to the customers of investment advisers, we must explore the issue of expanding SIPA's coverage as investment advisers may also commit fraud.

In any serious efforts to reform SIPA, we must also consider what responsibility SIPC has to honor the broker statements that customers receive. SIPC has denied the claims of customers based on the seemingly legitimate paperwork provided to them by their brokers, yet SIPC expects customers to use those very same statements to report unauthorized trading in their accounts. This inconsistency is unacceptable, and we must work to resolve it.

Investor trust, for which SIPA was designed to preserve, has been seriously eroded by SIPC's narrow interpretations of its statutory mandate. While SIPC's actions may follow the letter of the law, many would argue that SIPC has ignored the spirit of the law. We therefore must consider the best way to change the tone at SIPC and refocus this body on maintaining

confidence in the financial system and promoting investor protection. To the extent possible, we ought to also explore how SIPC could learn from the success of the Federal Deposit Insurance Corporation in maintaining the public's trust.

To address these questions and many others, SIPC has formed a modernization task force, and several members of this panel will appear before us today in their personal capacities. I, for one, expect this task force to complete its work with great transparency, considerable outreach, and much speed. Moreover, this task force must view its mission as broadly as possible and work to provide Congress with a comprehensive plan for reforming SIPA.

In closing, we can further improve SIPA by building on the reforms of the Dodd-Frank Act. The witnesses before us today are recognized securities experts. Their recommendations—along with those offered by the Madoff victims at our hearing last December—will undoubtedly help us in our work to update SIPA and better protect investors.

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. UULevels 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

[1] *In Re: New Times Securities Services, Inc.*, 371 F.3rd 68 (2nd Cir. 2004)

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 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.

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[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.

[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.

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 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

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[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.

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

_____. 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

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

[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)].

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 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 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

[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

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 time that the fraud was ongoing. I would respectfully suggest, based on our 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.

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compensation plans) and certain non-profits.

[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.

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. 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

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

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:

1. "Does SIPA adequately protect customers in the event of the insolvency of a member which is a multi-national corporation?"

[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.

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.

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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

"Assessing the Limitations of the Securities Investor Protection Act"

Thursday, September 23, 2010

By

Steven B. Caruso

Maddox Hargett & Caruso, P.C.

Chairman Kanjorski, Ranking Member Garrett 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 current 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 a current public member 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

I am honored to be able to have the opportunity to share with you my thoughts and perspectives on the Securities Investor Protection Act ("SIPA") and the Securities Investors Protection Corporation ("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 Modernization Task Force ("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, 2009, it is reported that there were 4,956 members of SIPC.

Since the inception of SIPC in 1970 through the end of 2009, 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 has distributed cash and securities to an estimated 625,100 customers of those failed brokerage firms in the approximate aggregate amount of $108.5 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.

Creation of the SIPC Modernization Task Force

In view of recent events that have publicized SIPC and its role in the protection of investors, as well as the fact that the last significant amendments to SIPA had been effectuated in 1978, based on discussions that I understand had been originally

held before this Subcommittee last year, SIPC announced on June 17, 2010, that it had created the SIPC Modernization Task Force ("SIPC Task Force").

The stated mission statement of the SIPC Task Force is to undertake a comprehensive review of both SIPA and SIPC's 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.

The twelve (12) members of the SIPC Task Force include representatives of the securities industry, investor advocates, government regulators and academia, from across the nation, as well as one international member.

I believe that the objective of the SIPC Task Force is 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.

Among the topics being considered for review by the SIPC Task Force are 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 are being undertaken by the SIPC Task Force, an interactive website has been established (www.SIPCModernization.org) through which the general public is being given the opportunity to provide comments and recommendations to SIPC and each of the members of the SIPC Task Force. It is also anticipated that, in the course of the review that is being undertaken by the SIPC Task Force, several public forums will be held through which investors and other interested parties will have the opportunity to provide comments, thoughts and suggestions on the process that is being undertaken. In fact, on September 14, 2010, the first national public forum was held and the members of the SIPC Task Force will be reviewing the comments and suggestions that were received as we continue to move through the process.

It is anticipated that the SIPC Task Force will present its findings, conclusions and proposals for reform in a written report, or possibly a series of written reports, that will be submitted to the SIPC Board of Directors later this year which will then review those

findings, conclusions and proposals with a view towards legislative changes and other potential operational improvements. Of equal importance, it is anticipated that the reports of the SIPC Task Force, and all related documentation, will be made publicly available.

Focus on Specific 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 topics that are and should remain the subject of specific focus by both the SIPC Task Force and the members of this Subcommittee.

These topics include, but are not necessarily limited to, the following:

1. Whether the distinction in SIPA, between a customer claim for cash and a customer claim for securities, remains a viable distinction not only in the context of the securities industry today, but of equal if not greater importance, in the context of ensuring that customers understand the nature of the protections that are provided by SIPC when their broker-dealer firms encounter financial difficulties and/or fail;

2. Whether 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 a level that more adequately reflects the economic realities of the securities industry today and the amount of investable assets that investors entrust to their financial advisors;

3. Whether the protection that is provided by SIPC in a SIPA proceeding should be extended to additional classes of investors who, based on SIPA and numerous judicial interpretations of both the SIPA statute and SIPC Rules, may not currently receive any SIPC protection because the investors do not have a "direct" customer relationship with the failed brokerage entity – these additional classes of investors would include, for example, investors in hedge funds and other similar types of indirect alternative investments, investors who entrust their assets to investment advisors, individual beneficiaries of defined benefit pension plans and individual beneficiaries of defined contribution plans;

4. Whether the educational materials and related information that are available to investors in connection with the protection that is provided by SIPC and, of equal if not greater importance, the protection that is not provided by SIPC, should be enhanced so as

to minimize any misimpressions and/or misunderstandings that may exist in the investment community;

5. Whether the legislation that has been proposed and is currently pending before Congress, which was intended to address some of the more egregious victimizations of investors in the Bernie Madoff and Allen Stanford Ponzi scheme debacles, represents an economically viable, equitable and efficient solution for investors;

6. Whether customers of a failed broker-dealer should have a potential means of recovery for unpaid arbitration awards, whether through the protection that is provided by SIPC, a SIPA proceeding or otherwise, that are procured through an arbitration proceeding against a failed broker-dealer and/or its former agents; and

7. Whether the minimum balance of the SIPC Fund, which was recently increased to a target of $2.5 billion, with a corresponding recommendation to similarly increase the U.S. Treasury credit line to an additional $2.5 billion, will be adequate to address both SIPC's statutory responsibilities and the promotion of investor confidence in our nation's securities markets in the coming years.

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 Professor John C. Coffee, Jr.

Adolf A. Berle Professor of Law
Columbia University Law School

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

"Assessing the Limitations of the Securities Investor Protection Act"

Chairman Kanjorski, Ranking Member Garrett, and Fellow Congressmen:

I am pleased and honored to be back before your committee again. At the outset, however, I must stress that, although I am serving on the "SIPC Modernization Task Force," I am not in any way a representative of, or spokesperson for, that Task Force or for the Securities Investor Protection Corporation ("SIPC"). I speak only for myself.

My comments will begin with and largely focus on H.R. 5032 (the "Ponzi Scheme Investors Protection Act of 2010"). As you will see, I strongly believe that if any changes are to be made in current law, they should be much more limited than it proposes:

1. Avoidance Actions and Fraudulent Conveyances. The victims of Ponzi schemes fall into two categories: "Net Winners" and "Net Losers." Net Winners are persons who manage to withdraw amounts from the Ponzi scheme greater than they originally invested; Net Losers are the vast majority whose withdrawals are less than their original investment. To illustrate, let us take two investors who both invested $1 million of their own funds in a Ponzi scheme. Investor A (the Net Winner) invested early and saw his investment purportedly rise to $10 million, at which point he withdrew $5 million. Although he lost the balance when the Ponzi scheme was discovered, this investor is a Net Winner of $4 million (because he invested $1 million and withdrew $5 million). Investor B (the Net Loser) also invested $1 million, and his account also rose to $10 million, but he never made any withdrawals; thus, he lost a "paper" profit of $10 million but a Net Equity loss of $1 million (again on a "cash in" minus "cash out" calculation).

Although both Net Winners and Net Losers deserve our sympathy, the latter lost much more and were brought much closer to economic desolation. Thus, it is extraordinary in my judgment that H.R. 5032 subordinates the interests of Net Losers to those of Net Winners. It does so in Section 8A(f), which restricts the ability of the SIPC trustee to recover the fictitious profits of the Net Winners. Under existing law (and this is the generally prevailing law of the Bankruptcy Code, not a special provision of the Securities Investor Protection Act), the trustee can recover these "fictitious" profits and place them in a fund where they will benefit all victims ratably. In some cases, such recoveries by the trustee may exceed any payments from SIPC.

Thus, the interests of Net Winners and Net Losers are necessarily in conflict, and "reforms" that benefit the Net Winners injure the Net Losers. It is thus particularly surprising that Congress should wish to apply its proposed rule retroactively (see Section 8A(h) of H.R. 5032) in order to benefit the Net Winners in the Madoff Ponzi scheme. The practical result is that a principal source of recovery to which the Net Losers in the Madoff Ponzi scheme can look will be denied them (or will be significantly reduced).

The Madoff trustee (Mr. Irving Picard) has indicated that he may sue some 1,000 investors who were Net Winners in the Madoff scheme.[1] Already some fourteen avoidance actions have been filed as of April, 2010, and just these fourteen actions seek to recover $14.8 billion.[2] Although the $14.8 billion sought in these actions will likely not be fully recovered (and may yield substantially smaller settlements), this number

[1] See Jerry Kronenberg, "Net Winners Face Suit; Lawyer Targets Madoff Victims' Profits," The Boston Herald, July 27, 2010 at p. 24.
[2] See "Picard: $1.5 B recovered to benefit Madoff victims," Infovest 21 News, April 12, 2010.

dwarfs the $1.5 billion that the SIPC trustee has actually recovered from other sources.[3] Moreover, The Wall Street Journal has reported that one such action (against the estate of Jeffrey Picower) has reached a tentative settlement in the neighborhood of $2 billion.[4] Already, a subsidiary of Banco Santander has agreed to settle for $235 million, and another settlement for $220 million has been reached.[5] All these funds will go to the Net Losers in the Madoff scheme – unless Congress intervenes and changes the legal rules to the detriment of the Net Losers.

Of course, I recognize that Section 8A(f) does not give complete immunity to the Net Winners. Under its terms, they can still be sued by the SIPC trustee if "such investor was either complicit or negligent in their participation in the Ponzi scheme." But in reality whenever one raises the legal standard for recovery, one reduces the likely recovery. Particularly in this context, cases tend to be settled, not litigated, and the proposed revised legal standard in Section 8A(f) will reduce the settlement value of avoidance actions against the Net Winners. This is so because the SIPC trustee cannot afford to try every case or conduct complete discovery against every Net Winner. Under existing law, if the trustee can show the Net Winners received fictitious profits, it can reclaim those profits for the injured victims as a whole. Proving negligence will be difficult because most Net Winners can argue that they relied on audited financial statements and had no obligation to inquire further.

The inevitable result is to protect the Net Winners in the Madoff scheme, but to injure the Net Losers. Although there may be many persons within the Net Winners with

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[3] Id.

[4] See Michael Rothfield, "Fight for Funds Delays Settlement for Madoff Victims," Wall Street Journal, August 4, 2010, at C-3.

[5] See supra note 2.

whom we can sympathize, they are certainly no more deserving of protection than the Net Losers. Moreover, some of the "feeder funds" that are being sued are far from sympathetic, and they will benefit from this proposed change, at least marginally.

The goal of the Bankruptcy Code is not to punish the Net Winners, but to share the losses equitably. Thus, it permits the trustee to recover "fictitious profits" in order to share these profits ratably among all the victims. If Congress thinks this is a bad policy, it should directly amend the Bankruptcy Code. But this proposed legislation does not do that; instead, it only amends the Securities Investor Protection Act ("SIPA") to limit the powers of a SIPC trustee. SIPA is inapplicable to the vast majority of Ponzi schemes, which are typically carried out by persons other than brokers and dealers, because SIPA only applies to the insolvency of a brokerage firm. To illustrate, if a traditional con man takes money from investors, telling them that he is investing in real estate, diamonds, currency transactions or whatever, the trustee in this proceeding will be able to bring avoidance actions against the Net Winners on behalf of the Net Losers, because this trustee is not governed by SIPA.

This point may seem formalistic, but it is revealing. It shows that Section 8A(f) does not address the general policy of fraudulent conveyance law (which legal doctrine is centuries old), but only seeks to provide protection for a limited (but well organized) group of investors who managed to make net profits in the Madoff scandal. If the general policy is ill-advised in providing that fraudulent conveyances of fictitious profits can be recovered by a trustee, then Congress should amend the Bankruptcy Code. But if that policy makes sense, Congress should not change it on a piecemeal basis just to protect the Net Winners in the Madoff scandal.

Is any "reform" justified with respect to avoidance actions in SIPA reorganizations? 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 (including the "feeder" funds).

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) could instead 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.[6] This distinction rests on a real economic difference between these two investors.

2. Beneficial or Indirect Investors. Section 8A(d) of H.R. 5032 makes an elaborate attempt to provide "Payments to Indirect Ponzi Scheme Investors." Although I am sympathetic to its goal, I see problems in the way it is done.

To illustrate both how this Section would work and what the problems are, let us assume a hypothetical case in which a small hedge fund (with some fifty investors) made a $50 million investment in a Madoff-like Ponzi scheme. Assume each investor made a $3 million investment in the hedge fund and one third of that amount was invested in the Madoff-like Ponzi scheme. If we assume that the Madoff-like scheme fails entirely and has no assets, each investor in the hedge fund can receive a maximum of $100,000 from the SIPC trustee under proposed Section 8A(d)(2). Thus, the trustee will pay out $100,000 times the fifty investors or $5 million. This is certainly more than the $500,000 claim that the hedge fund, itself, today has against SIPC.

But will the investors in the hedge fund actually apply for such a payment? They may not because, under Section 8A(d)(4), by applying for such a payment, they waive their right to sue their hedge fund with respect to their losses. On the above assumed facts, they have each incurred a $1 million loss and may not want to waive their right to sue the "feeder" fund that placed them in the Ponzi scheme simply to recovery $100,000. Frankly, I see no reason to require this waiver. Section 8A(g) also makes clear that the

[6] For the sake of simplicity, I am not considering the compounding of interest in this hypothetical.

indirect investor is faced with a harsh choice: take the SIPC advance or sue the fund that placed you into the Ponzi scheme. The rationale for requiring this election escapes me, because Congress has no conceivable reason to protect the "feeder funds" in the Madoff scandal.

In the actual Madoff case, some feeder funds appear to have behaved recklessly and ignored obvious red flags in continuing to invest with Madoff (and some may even have been complicit – hard as that is to prove). Although the indirect investor should not receive a double recovery, he should not be required to sacrifice his claims against his feeder fund, which owed him a fiduciary duty to exercise at least reasonable care. Also, SIPC could take his claim against his feeder fund by subrogation to the extent of the advance.

Another problem with Section 8A's attempt to benefit the indirect investor lies in its ambiguous definition of "Indirect Ponzi Scheme Investor" in Section 4. This definition (which will become Section 16(15)(C) of SIPA) includes "any person . . . who is an investor in a Ponzi scheme investor. . . ." This may work adequately when we are dealing with mutual funds or hedge funds, but it is unclear whether a pensioner under a pension fund is covered. Typically, a pensioner is not considered an "investor" in the pension fund, and it would be desirable to include the pensioner in at least a defined contribution plan more explicitly.

In any event, a superior alternative to Section 8A should be considered: the definition of "customer" for purposes of SIPA could be expanded to cover a variety of beneficial or indirect holders on a "pass through" basis. This is already the prevailing pattern under both the Federal Deposit Insurance Act ("FDIA") and the Federal Credit

Union Act ("FCUA"). Both these statutes allow for each beneficiary of a pension, profit-sharing plan, or individual retirement account to receive up to $100,000 of insurance coverage.[7]

Legislation that adopted this "pass through" approach should also transcend the special problem of Ponzi schemes. A brokerage firm could fail for entirely different reasons (including a market crash, fraud by employees against the brokerage firm, etc.), and indirect beneficial interests should be protected in all these cases.

At the same time, it must be recognized that any expansion in coverage may necessitate a larger fund. For this reason, I believe it is premature to address the question of the adequacy of the size of the SIPC fund.

3. The Differential Between Coverage of Securities and Cash. Although Section 929H of the Dodd-Frank Act has effectively increased the coverage of cash in a brokerage account to $250,000, there is still a substantial difference between the ceiling on securities losses ($500,000 subject to an inflation adjustment) and this ceiling on cash losses. I believe that this is an outmoded distinction that should be eliminated because it produces unjustifiable disparities in treatment. Worse, it could give rise to perverse incentives. For example, if an investor was concerned about the solvency of his or her brokerage firm, the investor might become reluctant to sell even risky securities and thereby increase his cash balance at the brokerage firm to a level above the current

[7] See 12 U.S.C. §1821(a); 12 U.S.C. §1787(k). One decision should be noted. In Waukesha State Bank v. National Credit Union Admin. Bd., 968 F.2d 71 (D.C. Cir. 1992), the D.C. Circuit declined to find that multiple accounts should be covered where a bank failed to disclose to a credit union that its account with the credit union was in fact three accounts for different customers. Thus, indirect customers remain exposed to the risk of non-coverage where their representative fails to disclose their separate identities. Such a rule causes the indirect investor to suffer because of his or her representative's mistake and is not necessary to protect SIPC's solvency.

ceiling. This would be an unfortunate incentive to create because SIPA does not insure against market declines in securities, and any incentive not to sell securities because of insurance coverage concerns would be unfortunate.

4. New Responsibilities. A draft amendment to the Financial Services Appropriations Bill offered by Representative John Culberson of Texas would extend the definition of "customer" to cover "any person who suffered a loss due to a Ponzi scheme fraud involving a member of the Securities Investor Protection Corporation that was placed in receivership after January 1, 2009 and before March 1, 2009." Effectively, this would require SIPC to cover the losses suffered on certificates of deposit issued by the Stanford International Bank, Ltd., which sold them to investors though the services of the Stanford Group Company, a member of the SIPC. Because CDs are neither cash nor securities, the SIPC takes the position that it cannot insure these losses. It argues that the SIPC was not designed to, nor is capable of, covering the losses experienced by purchasers of a foreign bank's CDs. Frankly, I do not believe that it is realistic or efficient to impose such an obligation on the SIPC, even where the broker-dealer may have been complicit in the fraud, because the broker did not hold the financial instruments in its custody for its customers. SIPA never intended to make the SIPC the guarantor of all losses caused by a broker's fraud; to do so could overwhelm the SIPC. Again, this example shows the danger of rushed, special interest legislation.

5. Specific Questions from the Committee.

a. Should the SEC be given a seat on the SIPC board? I do not think that this is an important reform because the SEC already has a statutory veto under SIPA over any

change in SIPC's bylaws or rules and thus has sufficient leverage. Still, the downside is also modest.

b. Should SIPC trustee be subject to Bankruptcy Court approval? Have SIPC trustees been efficient and effective? Actually, the Bankruptcy Court does approve the qualifications of the SIPC trustee. Still, the Court's real control and leverage over the trustee is through its power to approve the fees of the SIPC trustee. This assures that the SIPC trustee will be responsive to the Bankruptcy Court and sensitive to its wishes. Although I am not in a position to evaluate the relative performance of SIPC versus non-SIPC trustees, I have no reason to believe SIPC trustees have been less effective.

c. Is the standard for filing a SIPC claim too low? I am not aware of any flood of frivolous claims in SIPC reorganizations, and also think ordinary investors should be encouraged, not discouraged, to file claims.

d. Are SIPC's direct payment procedures effective and efficient? I believe proposals may be forthcoming in this regard from the Task Force, but it is premature to comment at this stage.

e. Does the statutory definition of "customer" eligible for SIPC coverage remains adequate? As discussed above, I believe that SIPA should be revised so that it shifts in the direction of greater "pass through" coverage. Thus, the current definition in Section 78lll needs to be expanded to cover many forms of beneficial ownership. Admittedly, this would be extremely costly to SIPC in the case of mutual funds and pension funds, and thus some compromise is needed. Because most mutual funds are diversified, I see less need to cover their shareholders, but smaller retirement and pension funds were victims in the Madoff scandal.

f. Definition of "customer property". This also needs revision (as broker/customer relationships are more complex). However, the need for this revision would be somewhat reduced if the separate ceilings on cash and securities were eliminated.

g. SIPA's definition of "net equity". I believe the "cash in, cash out" approach used by SIPC is preferable, because it does not allow the fraudster to favor some victims over others. The "last account statement" approach gives too much discretion to the architect of the Ponzi scheme to direct a greater recovery to those he prefers. I would also point out that definition of "net equity" is now before the courts in both the Madoff and Bayou Fund cases, and it would be advisable to obtain the judiciary's considered views in these cases before Congress acts.

Outside of the Madoff or Ponzi scheme context, I am advised that SIPC often does consider other evidence when customer's statements and the broker-dealer's records are in conflict. Hence, I think it is only the Madoff context where greater clarity is needed.

h. Interest on customer-named securities and customer-named property not distributed within 60 days. I have no basis for an informed view on the need for such a provision or its likely impact. I doubt, however, that this should be a Congressional priority.

i. Should the avoidance powers granted to a SIPA trustee differ from those under the Bankruptcy Code? As discussed above, I do not want to disarm the SIPC trustee. In true Ponzi schemes, there is an inevitable conflict between the Net Winners and the Net Losers, and reducing the SIPC trustee's powers injures the latter. As discussed above, I

believe that an imputed interest concept could be used to soften the amount that the Net Winners could be required to return to the bankrupt estate.

j. New methods for informing investors. This is fundamentally a problem in investor education, and SIPC needs to enter into working partnerships with the other principal bodies (FINRA, NASAA, and industry groups).

k. Whether the private sector could or should provide primary coverage? Although the concept seems attractive at first glance, I suspect that some smaller broker-dealers would be uninsurable and that insurance would often be cancelled as a brokerage firm approached insolvency. Today, the private insurance market often uses broad and ambiguous exclusions (in areas like D&O coverage) that are the subject of constant litigation and arbitration proceedings. Small claimants would find it difficult to protect themselves if a private insurer disclaimed coverage because of an ambiguous exclusion. In short, private insurance may be a partial substitute, but it would require constant monitoring by some agency. In contrast, SIPC is consumer friendly.

l. Whether the capital adequacy rules for broker-dealers were sufficient to prevent significant customer losses? This is, of course, the SEC's responsibility, not SIPC's. The SEC has now abandoned its Consolidated Supervised Entity program, which, introduced in 2004, deregulated capital adequacy and produced a significant increase in leverage at each of the five largest brokerage firms that were in that program. Today, the largest broker-dealer firms are members of a bank holding company and are supervised by the Federal Reserve Board. My personal view is that financial institutions will continue to evade capital adequacy rules (even after Basel III) by finding ways to exploit off-balance

sheet financing (just as they used SIVs and liquidity puts prior to the 2008 crisis). But all this is beyond SIPC's jurisdiction.

m. Whether investment advisers should be included under SIPC and subjected to assessments or included a similar protection regime? As I have previously testified before this and other Committees, the clearest lesson from the Madoff scandal is one that the SEC will simply not listen to because it is inconvenient. All investment advisers are required by law to use custodians in order that they cannot misappropriate their clients' funds. But once Madoff became a registered investment adviser, he continued to use his own brokerage firm as his custodian (a "self-custodian," in the vernacular). But no one can be his own watchdog, and the continued toleration of self-custodians by the SEC invites future scandals. Rather than worry about assessing investment advisers a SIPC fee, the much more needed reform is to require them to use an independent broker-dealer or bank as the custodian for their clients' funds. To the extent that broker dealers remain "self custodians" for their investment advisory affiliates, they are riskier and should pay higher assessments to SIPC.

n. What other legislative changes could be made to clarify SIPA's provisions? As discussed above, a revision of the definition of "customer" so as to include indirect, beneficial holders is greatly needed (although it may need to exclude mutual fund shareholders from such a "pass through" provision). Also, the separate and lower ceiling on cash should be dropped. Finally, depending on the outcome of pending cases, the definition of "net equity" may need to be revised.

TESTIMONY OF IRA HAMMERMAN,
SENIOR MANAGING DIRECTOR AND GENERAL COUNSEL,
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON:
ASSESSING THE LIMITATIONS OF
THE SECURITES INVESTOR PROTECTION ACT

SEPTEMBER 23, 2010

I. Introduction

Chairman Kanjorski, Ranking Member Garrett, members of the Subcommittee:

My name is Ira Hammerman, and I am a 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 a representative of SIFMA and not of SIPC. Thank you for allowing me to submit my full statement for the record.

The work of the Task Force to undertake a comprehensive review of the Securities Investor Protection Act ("SIPA") and SIPC's operations and policies and to propose reforms to modernize SIPA and SIPC has only recently begun. Therefore, my testimony will focus on SIFMA's preliminary recommendations regarding appropriate revisions to SIPA in light of issues emerging from recent SIPA liquidation proceedings and the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

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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.)

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 resulting from the failure of the broker-dealer holding such property. 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." 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 — *i.e.*, to the extent some customer funds or securities are missing — up to $500,000 of SIPC's funds are advanced for each customer in order to replace the missing securities and funds (up to a maximum of $250,000 for missing cash). SIPC's funds as intended by Congress, however, are available only to replace missing customer property; they are not used to protect investors against any other risks.

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) were not protected by SIPA against the possibility that those certificates of deposit were worthless. As such, SIFMA strongly opposes the SIPA amendment proposed by Representative John Culberson (R-TX) in the fiscal year 2011 Financial Services and General Government Appropriations Act as it would extend SIPC's protection to cover, for the first time, fraud by the issuer of certain securities (or in this case, certificates of deposit) purchased by the customer which are neither lost nor stolen but in fact in the holders' possession. The amendment would significantly expand SIPC coverage, for benefit of one narrow class of investors, and therefore, would undermine the efforts of the Task Force and this Subcommittee's consideration of appropriate SIPA modernization. Further, such action 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.

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, are 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 broker-dealer 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 in a failure of the broker-dealer. SIPC's $500,000 advances are therefore only available to customers who do not receive their cash and securities investments in the distribution of customer property, not to customers whose investments go sour or turn out to be fraudulent.

SIPA's customer protection framework has been challenged like never before by two recent events: the massive Ponzi scheme perpetrated through Bernard L. Madoff Investment Securities LLC ("Madoff") and the insolvency of one of the country's largest broker-dealers, Lehman Brothers Inc. ("Lehman"). The Madoff Ponzi scheme was a massive, long-term fraud that inflicted significant harm on many investors, including individuals, families, and charitable and educational institutions. This fraudulent scheme highlighted questions about the scope and extent of customer protection under SIPA, especially as it applies to (i) the calculation of a customer's "net equity" in a Ponzi scheme and (ii) the application of SIPC's $500,000 protection to "indirect investors" who did not have accounts directly with a broker-dealer but invested in another entity (like a hedge fund or retirement plan) that had an account with the broker-dealer. The Lehman insolvency raised a large number of issues, including concerns about inconsistencies between the scope of customer protection under SIPA and the SEC's Customer Protection Rule. The modernization of SIPC should address both the scope and extent of SIPA's customer protection framework in the context of a Ponzi scheme and the inconsistencies between SIPA and the SEC's Customer Protection Rule.

II. "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 protection (only $250,000 of which can relate to a claim for cash). 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 Madoff's customers, 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.

When a failed broker-dealer was operated as a Ponzi scheme, SIFMA believes that, as a matter of fundamental fairness, the 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.

Consider a simple example (summarized in the illustration below), where a Ponzi scheme has two investors. Each investor "invested" $2 million in the scheme. The first investor ("Investor A") opened his account early in the scheme, was credited $2 million of profits, and withdrew $1 million from his account around the same time the second investor ("Investor B") opened his account. Soon thereafter, the broker-dealer fails and is liquidated. Suppose also that the liquidation trustee is only able to collect $2 million in customer property (the remaining $1 million received from the two investors having been siphoned off and spent by the Ponzi scheme operator).

If the liquidation trustee distributed the $2 million recovered from the Ponzi scheme based on statement balances:

- Investor A will receive 60% of the $2 million, or $1.2 million, since Investor A's statement balance of $3 million is 60% of the $5 million total statement balances; and

- Investor B will receive 40% of the $2 million, or $800,000, since Investor B's statement balance of $2 million is 40% of the $5 million total statement balances.

If distributions are made in this manner, Investor A will actually make a profit of $200,000 on his investment in the Ponzi scheme (equal to the excess of the $2.2 million in distributions over his $2 million investment). Investor B, on the other hand, will suffer a loss of $1.2 million, which is the entire $1 million stolen by the Ponzi scheme operator and the extra $200,000 of profits paid to Investor A. This method results in the trustee perpetuating the Ponzi scheme by taking money invested by Investor B and paying it to Investor A.

In contrast, the net investment method will not result in the perpetuation of the Ponzi scheme:

- Investor A will receive one third of the $2 million, or $666,666, since Investor A's net investment of $1 million is 1/3 of the $3 million total net investment; and

- Investor B will receive two thirds of the $2 million, or $1,333,333, since Investor B's net investment of $2 million is 2/3 of the $3 million total net investment.

If distributions are made in this manner, Investor A will lose $333,333, or one third of his net investment, and Investor B will lose $666,666, which is also one third of his net investment. Because losses are shared *pro rata* among the victims, this method is consistent with SIPA's

basic principle of *pro rata* distribution. And, since each victim would lose the same portion of his net investment, this method would not result in the perpetuation of the Ponzi scheme by the liquidation trustee.

Illustration: Simple Ponzi Scheme

	Ponzi scheme / broker-dealer	Investor A	Investor B
Jan. 2008	Receives $2M	Invests $2 million	
Jan. 2008 to Jan. 2009	Siphons off and spends $1M	Credited $2 million of profits	
Jan. 2009	Receives $2M and distributes $1M	Withdraws $1 million	Invests $2 million
Feb. 2009	Fails and enters liquidation.		
	Has $2M of customer funds ($2M - $1M + $2M - $1M).	Statement balance: $3M	Statement Balance: $2M
		Net investment: $1M	Net Investment: $2M
Distributions *pro rata* on statement balance:		Receives $1.2M ($2M * $3M / ($3M + $2M))	Receives $800,000 ($2M * $2M / ($3M + $2M))
		Net profit of $200,000 ($1M + $1.2M - $2M)	Net loss of $1.2M ($800,000 - $2M)
Distributions *pro rata* on net investment:		Receives $666,666 ($2M * $1M / ($1M + $2M))	Receives $1,333,333 ($2M * $2M / ($1M + $2M)
		Net loss of $333,333 ($1M + $666,666 - $2M)	Net loss of $666,666 ($1,333,333 - $2M)

Whether SIPC's funds should be used to protect the fictitious profits shown in fraudulent statements produced by the perpetrators of Ponzi schemes does not involve the same issue of fundamental fairness, since providing SIPC's $500,000 of protection for fictitious profits would not perpetuate the Ponzi scheme. However, SIFMA notes that expanding SIPC coverage to protect these fictitious profits would have financial costs, in some cases, possibly in amounts exceeding SIPC funds. Ultimately, therefore, application of SIPC funds in such cases is a question of allocation of such costs among the victims of the Ponzi scheme and the other participants in the securities industry. Consideration should also be given to whether it is fair to protect the outsized fictitious profits credited to investors in Ponzi schemes when other investors in the securities markets receive smaller returns and take genuine risks of loss on their investments.

III. Indirect Investors

As mentioned above, each customer of a failed broker-dealer in a SIPA liquidation is eligible to have up to $500,000 of SIPC's funds used to replace their missing assets (but no more

than $250,000 for missing cash). This protection is extended only to investors that are customers of the failed broker-dealer. "Indirect investors," who did not have accounts directly with a broker-dealer but invested in another entity (like a hedge fund or retirement plan) that had an account with the broker-dealer, are not eligible for the $500,000 SIPC protection.

In this respect, SIPC's $500,000 protection for broker-dealer customers is generally similar to the FDIC insurance for bank depositors. The FDIC also generally insures only depositors; for instance, when a corporation, partnership or unincorporated association has a deposit account at a bank, the account is insured for $250,000, regardless of how many investors the corporation, partnership or unincorporated association might have. Unlike SIPC, however, the FDIC applies different rules to employee benefit plan accounts and irrevocable trust accounts. Employee benefit plan accounts receive pass-through coverage, where the interest of each plan participant is insured to up to $250,000. Subject to certain conditions, the FDIC gives similar treatment to the interests of beneficiaries in irrevocable trusts.

SIFMA believes that SIPC generally should not provide greater protection to institutional customers than to individual customers, and accordingly opposes any effort to increase the protection provided to customers that are hedge funds, corporations, partnerships or unincorporated associations by extending SIPC's $500,000 protection to their investors. This principle may not apply in the same way to trusts or employee benefit plans, which represent the interests of their beneficiaries or participants in a more straightforward way. However, amending SIPA to provide SIPC protection to beneficiaries of irrevocable trusts and participants in employee benefit plans would not be without cost to SIPC.

Before expanding SIPC protection on a pass-through basis to beneficiaries of irrevocable trusts and participants in employee benefit plans in a manner similar to the pass-through deposit insurance provided by the FDIC, Congress should consider whether such costs would be justified by increased investor confidence.

IV. Consistency between SIPA and the SEC's Customer Protection Rule

SIPA and the Securities and Exchange Commission's ("SEC") Customer Protection Rule should 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 will have sufficient customer property to fully satisfy the net equity claims of all of the 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 eligible to share in the *pro rata* distribution of customer property under SIPA (although not eligible for SIPC's $500,000 protection), 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 Lehman liquidation, for instance, Lehman Brothers International (Europe) ("LBIE"), an English broker-dealer affiliate of Lehman, has filed customer claims for approximately $10 billion based on its proprietary positions but the Customer Protection Rule did not require Lehman to maintain possession or control of LBIE's securities or make deposits into its reserve account in respect of obligations to LBIE. Even though the entire $10 billion claim is not expected to be allowed as a customer claim, this gap between SIPA and the Customer Protection Rule may cause a sizeable shortfall in the customer property available for distribution to Lehman'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. 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 eligible for customer status under SIPA.

V. Clarity and Consistency in the Treatment of Securities-Based Swaps

SIFMA is also concerned that, as the SEC begins to develop 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" 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). SIFMA believes that customers who have securities-based swaps in an account at a broker-dealer 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.

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 broker-dealer customers be divided up into separate account classes, that the customer protection rules be tailored to each specific account class and activity and provide for a separate pool of customer property for each separate account class, and that, in a liquidation under SIPA or the Bankruptcy Code, the customer property for each account class be distributed 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. These customers hold only fully-paid long securities positions and cash credit balances. The SEC 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. These more sophisticated 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 (but allowing other 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 would also be subject to customer protection requirements relating to possession or control of customer securities and to the funding of a reserve account, but these 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.

VI. Rule-Making Power

SIFMA believes that 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 of the Commodity Futures Trading Commission (the "CFTC") under Section 20 of the Commodity Exchange Act (the "CEA") 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.)

VII. SIPC Assessments

The basis on which SIPC members are assessed contributions to SIPC has not been updated in a number of years (other than the Dodd-Frank Act change in the minimum assessment amount). Some elements of the calculation may not make sense when applied to the business of SIPC members as they operate today. As a result, a determination of "SIPC net operating revenues," the basis for each member's assessment, often does not accurately reflect actual revenues of such member. SIFMA recommends that the determination of the assessment base be reviewed in light of the manner in which members currently operate, including consideration of the following questions:

- How should the assessment apply to members that engage in transactions that involve taking positions in securities and offsetting positions in hedging products (*e.g.*, related futures contracts)? Is it appropriate to base the assessment on revenues that may in whole or in part be offset by losses that are not currently calculated as part of the assessment?

- How should accounting interpretations (*e.g.*, FAS 167), which may increase a firm's revenues and expenses by similar amounts, affect the assessment?

- Should the assessment base take into account the effects of interest expense, dividends on short positions and related revenue impacts?

VIII. Conclusion

In conclusion, SIFMA strongly supports the work of the Task Force and is committed to working constructively with the Task Force to review SIPA and recommend ways to modernize SIPA to better protect investors and thereby increase investor confidence in the financial markets. We appreciate the opportunity to testify and look forward to continuing to work with the Subcommittee on these important investor protection issues.

Statement
of
Orlan M. Johnson
Chairman
Securities Investor Protection Corporation
Before the
United States House of Representatives
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
Committee on Financial Services

September 23, 2010

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the work of the Securities Investor Protection Corporation or "SIPC" and possible improvements to the Securities Investor Protection Act or "SIPA."[1] My name is Orlan M. Johnson and I am the Chairman of SIPC. I also serve as Chairman of the SIPC Modernization Task Force ("Task Force") which is conducting a complete review of SIPC's operations, as well as considering changes to SIPA.

Convened on June 17, 2010, the Task Force consists of a wide range of experts and is in the midst of its review and consideration of possible statutory, procedural and other reforms to SIPA and SIPC. At my confirmation hearing before the Senate Banking Committee last December, I made clear my intent to have this review undertaken. Chairman Kanjorski

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[1] 15 U.S.C. §78aaa et seq.

thereafter suggested a number of important topics for the Task Force to consider. Today I will briefly describe SIPC and the work of the Task Force, in addition to providing responses to the issues covered in the Subcommittee's letter of September 16 inviting me to appear at this hearing.

SIPC

SIPC is a non-profit membership corporation that was created under SIPA in 1970. With some narrow exceptions, every registered securities 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 of the United States 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. 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. Upon appropriate notification, SIPC may seek to have a firm placed in liquidation.

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. That credit line was increased from $1 billion to the current limit as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In its nearly 40-year history, SIPC has never drawn upon the credit line.

With some narrow exceptions, 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 322 customer protection proceedings which have involved the distribution, through 2009, of roughly $108.5 billion of assets for customers. Of the $108.5 billion, approximately $107.6 billion has come from debtors' estates and $866.9 million from the SIPC Fund.[2]

The Task Force

The Task Force draws its members from the ranks of state regulators, attorneys who represent investors, academia, the securities industry, a trustee in the largest insolvency in history, the Chairman of SIPC's Chinese counterpart, and an observer from the SEC. This diversity of viewpoints results in a rigorous analysis of the issues that concern investors in today's world. We have begun our work in earnest. We are examining the extent of SIPA protection, the problem of "indirect" investors, the use of bankruptcy avoidance powers, and other fundamental issues of concern to investors and Congress.

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[2]The figures are from SIPC's 2009 annual Report, and include $667,000,000 to customers in the Madoff case. SIPC continues to advance funds in that case. SIPC has now committed a total of $722,000,000 to customers in the Madoff liquidation.

We also have created a public input platform on the Web at www.SIPCModernization.org in which the public is invited to share its thoughts for all to see. SIPC is undertaking a major public outreach effort to ensure that as many investors as possible learn about the process and get a chance to participate in it.

Using that website, we conducted an open online forum on September 14th where members of the public submitted comments and questions. I responded to those comments and questions, as did another member of today's panel, Mr. Borg. We are organizing a second such forum, with other Task Force members in the near future.

I also hope to organize a live event so that members of the public can present their views directly to the Task Force.

After discussion of some of the issues, several members of the Task Force have volunteered to draft a number of Recommendations which will be presented to the SIPC Board. It is our goal to make a full set of Recommendations in the first quarter of 2011.

Issues of Concern

The remainder of this statement contains my responses to the questions included in the Subcommittee's letter of September 16 inviting me to testify.

Whether the SIPC Board should include a representative of the Securities and Exchange Commission and what, if any, other modifications to the governance structure may be appropriate.

SIPA already provides for substantial oversight of, and participation by the SEC with respect to, SIPC matters. An SEC staff representative is always invited to SIPC's Board Meetings and actively participates. In addition, the SEC may inspect SIPC and require reports or

records from it as it deems appropriate or necessary. 15 U.S.C. §78ggg(c)(1). SIPC also must file an audited annual report with the SEC and obtain SEC approval of any proposed SIPC rule or bylaw or change to its rules or bylaws. 15 U.S.C. §§78ggg(c)(2) and 78ccc(e). In light of the fact that the SEC is the only entity that can compel SIPC to take certain actions, it would be improper to have an SEC Commissioner or other representative on the SIPC Board. In SIPC v. Barbour, 421 U.S. 412 (1975), the Supreme Court held that only the SEC has the right to sue SIPC to require SIPC to begin a customer protection proceeding. See 15 U.S.C. §78ggg(b). Thus, having an SEC representative on the SIPC Board who would have decision making as well as oversight authority would present questions of conflict of interest and attorney client privilege. In addition, the SEC has never exercised its power to sue SIPC, which indicates that, in all disputed situations, there has been a satisfactory resolution.

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.

The Task Force has discussed the "How much is enough?" issue in a number of contexts. SIPC's current "target" of $2.5 billion is set by bylaw. In light of the SEC's ability to compel a SIPC bylaw change, the current mechanism seems adequate. This is true in view of the fact that the former $1 billion target has proved adequate to meet the requirements of all SIPA cases to date. The SIPC Board consistently reviews the adequacy of the SIPC Fund, as I am sure it will do when SIPC reaches the $2.5 billion target.

Whether any trustee appointed by SIPC should also be subject to Bankruptcy Court approval and whether trustees appointed in SIPA liquidations have been as efficient and effective as those appointed under similarly sized non-SIPA liquidations.

The Bankruptcy Court currently appoints trustees. The Court holds a hearing to determine if the persons designated by SIPC are disinterested. Pursuant to a suggestion from the SEC, SIPC maintains a geographically based file of possible trustees who are screened for the ability and expertise required to conduct a liquidation proceeding. SIPC typically receives less than two days' notice between the initial SEC notice that the firm is in distress and the filing by SIPC of court papers in the appropriate United States District Court. SIPC must also review potentially disqualifying conflicts of interest. Further, in light of the successful record of SIPC trustees and their counsel with respect to having interpretations of SIPA upheld by the courts, there is little doubt with respect to competence and compliance with the mandates of the statute. Since SIPC handles smaller cases using streamlined procedures, there is also little doubt that the small case process is efficient and economical as well.

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 customer that their claim is *bona fide*.

There is no indication that there have been a great number of frivolous claims in SIPA proceedings. In the best interest of investors, SIPC would prefer that any colorable claim be filed, since failure to file a timely claim is an absolute bar to recovery in such instances. In the Madoff case, many people who are not eligible for protection have filed claims, but SIPC and the trustee encouraged anyone with a colorable claim to file.

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.

The direct payment procedure is efficient and effective. SIPC had previously proposed legislation that would expand the Corporation's ability to use this tool. I believe SIPC will once again proffer an amendment to SIPA to expand the ability to use the direct payment procedure.

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 is examining the possible modification of the "customer" definition for some, but not all, so called "indirect" investors. I am confident that the resulting determination will expand protection in this area on a prospective basis.

Whether and how SIPA's definition of customer property should be amended in light of the changing nature of customer arrangements 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.

The customer property definition is adequate for most individual investors. However, more sophisticated investors, particularly large institutional investors, have more complex relationships with brokerage firms, and resolution of these evolving, interconnected relationships was clearly not contemplated in the original drafting of SIPA. The Task Force is studying this issue in detail, and may conclude that such mega-investors should be subject to a separate regime.

Whether and how SIPA's definition of net equity should be revised to address situations whereby a customer's 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 the statements they have received.

In the vast majority of cases this is not an issue. Thus, in the Lehman Brothers case, the MJK Clearing case, and most of SIPC's other major cases, the books accurately reflected what the customer is owed. It is, of course, an issue in the Madoff case. What all parties seek is a true and accurate picture of what the customer is owed. The current burden of proof allows a customer to provide other documentation to contradict the debtor's books. Thus, timely correspondence from a customer objecting to a transaction is frequently used to demonstrate that the books of a debtor are wrong.

SIPC, trustees and courts have consistently followed the principle that last statements reflecting fictitious profits should not be used to calculate a customer's claim. Rather, customer claims are calculated on the basis of the net equity in the customer's account as of the closing of the broker-dealer or, in other words, the amount of the funds that a customer invests through the broker-dealer minus any funds received from the broker-dealer. This method ensures that a criminal operating a fraudulent scheme of fictitious trades and profits does not determine the amount of money owed to customers after the collapse of the scheme.

Whether a 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 promptly satisfied.

Again, usually this is not an issue, particularly where there is an account transfer to a solvent brokerage. I have one thought about claims for securities which are not delivered within a six-month period. (This rarely happens, but it keeps a claimant at market risk without the

ability to take market action.) Perhaps the burden of the loss could shift at the six-month break, and the claimant could have the option of receiving either the filing date value of the portfolio or the securities themselves. As to cash, the general rule in bankruptcy is that cash claims, whether disputed or not, do not accrue interest. Given that, SIPA cases should be no different. It also must be noted that the reason for any delay in satisfying claims usually is not because a trustee and his staff are not zealous, but because the trustee lacks the books and records to compare claims against, the books and records are otherwise unreliable, or books and records cannot be easily accessed because they are in the custody of law enforcement authorities. In these circumstances, claims review necessarily is a time-consuming process and assessing interest could encourage incomplete or inaccurate claims review in the interest of speed.

Whether the avoidance powers granted to a trustee in a SIPA liquidation should differ from the U.S. Bankruptcy Code.

I believe that Congress gave these powers to a bankruptcy trustee for good and valid reasons. SIPA cases are no different. History has consistently shown that the avoiding powers accomplish equitable results.

Again, however, these powers are rarely used in SIPA cases. This is because a combination of customer property and SIPC advances usually means that it is very unusual that someone who withdrew assets during the avoidance periods would not have received exactly the same distribution had the withdrawal not been made; hence the avoiding powers do not pertain. The Madoff case is an obvious exception, but the Task Force has discussed this in great detail and will issue a recommendation on the subject.

Whether the mechanics for informing investors about the existence of and protections afforded by SIPC should be altered.

Investor education is a critical part of investor protection, and SIPC continues to focus on the development and implementation of new methods of educating investors about SIPC coverage. SIPC welcomes suggestions and assistance as to how to convey the complexities of a complicated statute in a sound bite or a video clip. The fact remains that this is very difficult. The Task Force is also reviewing this issue and I expect its work will result in recommendations.

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.

I doubt that the private sector could replace SIPA protection and maintain investor confidence. Despite the views of some of our critics, I genuinely believe that SIPC provides prompt and full protection to investors consistent with the law. I do believe there is a role for the private sector insurance industry with respect to things that SIPC does not, and in my opinion should not, cover. Thus, I am an advocate for a more strenuous broker blanket bond requirement with respect to fraud claims, particularly by introducing brokers which possess minimal capital. However, the reality is that even if the private sector were to provide primary protection, an entity to administer that process would still be needed. The existing entity, in the form of SIPC, as a governmentally established entity, takes into account and reflects the views not only of the private sector, but of the public sector as well. Thus, the Treasury, the Fed, and the SEC have an important say in the formulation of SIPC policy. Because of the potential implications of the failure of a brokerage on investor confidence and the economy as a whole, it is important that the

entity consider not only private, but public, interests. Moreover, private insurers that have provided so-called excess SIPC protection have not been beneficial to investors to date.

Whether the capital adequacy rules for broker-dealers are sufficient to prevent significant customer losses.

I believe the capital rules are generally sufficient to cover losses with respect to "custody" of customer securities. However, the capital requirements are not sufficient to cover possible other obligations an introducing firm may have.

Whether investment advisers should be scoped into and subject to assessments under SIPA or a similar protection regime.

By law, investment advisors may not hold customer assets at any time. I do not know the extent of investor losses with respect to the conversion of investor assets by investment advisors. If this is a serious problem, then SIPC protection could be considered. If it is not a serious problem, then perhaps an "Investment Advisors Blanket Bond" might be a solution.

Whether other legislative changes could be made to clarify SIPA's provisions and reduce the number of corresponding lawsuits brought about by ambiguities in SIPC coverage.

I am confident that the Task Force will reach a consensus on a number of legislative changes. I would note, however, that whenever a particular creditor's "status" in a bankruptcy is changed and affects the difference between being made whole, and receiving nothing, litigation may be inevitable. "Customer" status fits that model.

* * *

In conclusion, I want to assure the Subcommittee that the Task Force is making progress and will continue its work aimed at developing and recommending reforms to SIPA and SIPC.

Thank you, and I would be pleased to answer any questions Members of the Subcommittee may have.

Submitted Statement of

Ronnie Sue Ambrosino
Coordinator,
Madoff Victims Coalition

Before the

House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

For Hearing on

Assessing the Limitations of the Securities Investor Protection Act
Thursday, September 23, 2010
2128 Rayburn House Office Building

Honorable Paul Kanjorski
Chairman
House Financial Services Subcommittee
on Capital Markets, Insurance, and Government
Sponsored Enterprises

Honorable Scott Garrett
Ranking Minority Member
House Financial Services Subcommittee
on Capital Markets, Insurance, and Government
Sponsored Enterprises

Dear Chairman Kanjorski and Ranking Member Garrett:

Thank you for the opportunity to be heard. Prior to December 11, 2008 I lived a quiet, serene life. Now, I am the Coordinator for the Madoff Victims Coalition, a group of investors who had their savings stolen by Bernard Madoff. The testimony I am submitting will focus on a small subset of the many issues facing all Madoff victims. I speak for the victims who are concerned about the inconsistent actions we are seeing by the Securities Investor Protection Corporation and the Trustee assigned to the Madoff case, Irving Picard.

DOES THE FAULT LIE WITH THE SIPA OR WITH ITS IMPLEMENTATION BY SIPC?
While I admire the intent of the Subcommittee to hold today's hearing to address the limitations of the SIPA, no effort to propose reforms would be complete without first reviewing its current effects on investors. The need for today's investigation has arisen from SIPC's past failures to adequately protect the investors.

However, we must question whether this is the shortcoming of the SIPA, or the fact that SIPC is not acting in accordance with the intent of the SIPA, that being to keep investors confident and secure in their investments. And, it wouldn't be complete without the input from the victims themselves who have firsthand knowledge of how best to reform SIPC.

The GAO and Congress have admonished SIPC on multiple occasions for not having adequate funds on hand should there be a 'large' broker failure. In a 1992 Report to Congressional Requestors, the GAO reported "The $1 billion fund may not be sufficient to finance worst case situations such as a massive fraud at a major firm." SIPC refused to comply, continued to charge its member brokers $150 per annum and as a result, Mary Schapiro acknowledged after the Madoff fraud was exposed

that SIPC had insufficient funds to pay the Madoff victims. I ask that the funding amount be clearly defined and that it be mandatory. The value should be reassessed at least bi-annually.

If the funding on hand should ever be inadequate at the time of a broker failure, I am asking that SIPC be required to assess its members immediately in order to abide by its mandatory requirement to "pay promptly".

SIPC ACKNOWLEDGED ITS SHORTCOMING
Four months after Madoff confessed, SIPC increased its member fees from $150/annum to .25% of net operating income. The $150 fee had been in effect for the ten years prior to the Madoff fraud.

WHAT IS THE TRUE PROTECTION SIPC OFFERS?
SIPC insurance – and, yes it was marketed as insurance by brokerage companies worldwide as well as by Senator Muskie and President Nixon as early as 1970– was created to give investors assurance in exchange for taking physical delivery of securities. The brokers benefited with less paperwork and faster transaction time while the investors were led to believe that their securities, although in street name, were protected from fraud. President Nixon's intent to protect investors is evident when he signed SIPA into law on December 30, 1970 and said, "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."

In that same year, the SEC, in its annual report, described SIPA's purpose as to "provide insurance for customer account." (sec.gov). Stephen Harbeck, President and CEO of SIPC agrees with that intent: "When SIPC was founded in 1970, Congress stated that one of the primary purposes of the legislation was to restore confidence in the market." (sipc.org/media/release01dec03.cfm)

As recent as their 2010 brochure, FINRA described SIPC as " a non-profit organization created in 1970 under the Securities Investor Protection Act (SIPA) that provides limited insurance to investors on their brokerage accounts if their brokerage firm becomes insolvent."

I am asking for a more definitive and consistent definition of "protection" so that investors may decide for themselves whether to keep their savings in 'street name' or even to invest with a broker at all.

HOW DOES SIPC DETERMINE PAYMENT FOR INVESTORS?
"For purposes of distributing securities to customers, all securities shall be valued as of the close of business on the filing date." 78fff-2(c)(1). In the Madoff case, the Trustee has redefined how securities are valued. Although this hearing is forward looking to address the limitations of the SIPA, I ask that you also acknowledge that the limitations are actually in the **implementation** of SIPA. SIPA has clearly defined the manner of valuing claims , and SIPC has chosen (in the Madoff case) to redefine SIPA's intent. However, in previous SIPC cases the above statutory definition was actually used.

In a December 2009 hearing, Congressman Ackerman questioned SIPC President Stephen Harbeck and stated, ""And as a matter of fact it was-- it was you, and -- and your agency that -- that testified -- and your testimony in the New Times case, where you say were a claimant or -- this is a -- this is a quote, "Reasonable and legitimate claimant's expectations on the filing date are controlling even when inconsistent with transaction reality" -- I'm quoting you. "

Trustee Irving Picard made the following questionable statement in the July/August 2010 issue of Fraud Magazine, "The money in/money out methodology is the approach that has generally been used in resolving claims in Ponzi scheme cases, going back to the fraud perpetrated by Charles Ponzi."

SIPC's own words regarding a SIPA liquidation: "In SIPA liquidation proceeding, customers of a failed broker-dealer may submit claims for "net equity," defined as:
The dollar amount of the account or accounts of a customer, to be determined by
(A) Calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase **on the filing date**, all securities positions of such customer...; minus (B) Any indebtedness of such customer to the debtor **on the filing date**..."(sipc.org)

Stephen Harbeck is denying any right to reimburse victims on the pretext that the money was never actually traded. This contradicts his previous position on the same issue as stated below:

MR. HARBECK: Even if they're not there.
THE COURT: Even if they're not there.
MR. HARBECK: Correct.
THE COURT: In other words, if the money was diverted, converted
MR. HARBECK: And the securities were never purchased.
THE COURT: Okay.
MR. HARBECK: And, if those positions triple, we will gladly give the people their securities positions. Source: Hearing Transcript at 37-38, In re New Times Sec. Servs.Inc., 371 F.3d 68 (B. E.D.N.Y. 2000)

Josephine Wang, SIPC General Counsel in conversations with Street Insider eight days after Madoff was arrested stated , "If clients were presented statements and had reason to believe that the securities were in fact owned, the SIPC will be required to buy these securities in the open market to make the customer whole up to $500K each."

In a 12/27/05 legal brief before the 2nd Circuit court of appeals, SIPC legal counsel stated: "In a reasonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transaction reality. Thus, for example, where a claimant orders a securities purchase and receives a written confirmation statement reflecting that purchase, the claimant generally has a reasonable expectation that he or she holds the securities identified in the confirmation and therefore generally is entitled to recover those securities (within the limits imposed by SIPA), even where the purchase never actually occurred and the debtor instead converted the cash deposited by the claimant to fund that purchase." Source: [Br. of Appellant SIPC at 23-24 (citing In re New Times Sec.Servs. Inc., 371 F.3d 68, 72 n.2 (2d Cir. 2004).].

The Bankruptcy Court's conclusion is unsupported. In *New Times I* this Court held that there is a critical difference between "non-existent *transaction*" and "non-existent *securities*." The "net equity" definition can readily be applied to securities positions on customer statements whether or not any *transactions* occurred; it is only where the *securities* themselves do not exist that the statute provides no valuation criteria. As the securities on the BLMIS statements have ascertainable market values, *New TIMES I* - and SIPA itself - require the statutory definition of "net equity" be employed to determine customer claims.

Davis Polk & Wardwell Brief/US Court of Appeals/8/9/10

I would like to ask the Subcommittee to review previous SIPC fraud cases and acknowledge that the statutory definition was used to pay investors whose statements showed ownership of actual securities. Any inconsistent implementation of investor payment would weaken the original intent of SIPA. I speak of this in an effort to exemplify the failure of the trustee (or SIPC) to follow the SIPA, and thus ask that the effort of the subcommittee not be limited only to a review of the SIPA. I ask that SIPC's execution and implementation of the SIPA also be reviewed.

INCONSISTENCIES
SIPC Chairman Orlan Johnson (when defending the newly-defined-by-SIPC manner of paying victims based on money in/money out method) stated that, "This method ensures that a criminal operating a fraudulent scheme of fictitious trades and profits does not determine the amount of money owed to customers after the collapse of the scheme".

In fact, SIPC states in its publication "Understanding your Brokerage Account Statement" that "the best way to track your brokerage account activity and performance is to carefully review your monthly statements."

I am asking that you ensure the confidence for all investors that their account statements are a true representation of the value of their securities by directing SIPC (through the SEC) to strictly follow the statute that governs them.

THE IRS AND CAPITAL GAINS TAXES PAID BY MADOFF INVESTORS
While it is not the primary purpose of this Subcommittee to address issues relating to the IRS, it cannot ignore the clear and inherent contradiction of the fact that this fraudulent scheme has also enriched the United States Treasury. If the trades and profits reflected on the statements are insufficient for SIPC to rely on, then the taxes dutifully paid by Madoff victims on the profits based on their "fraudulent" statements to the IRS/US Treasury, were not, in fact, due and must be returned in full. Second only to the fees SIPC has paid the Trustee's law firm, the IRS has been the biggest beneficiary of the Madoff fraud.

The IRS has allowed Ponzi victims to reclaim 5 years of taxes, thus acknowledging the ill gotten gains. Why stop at 5 years when many victims paid taxes for 20, 30 and 40 years? I ask that the Subcommittee act in conjunction with the appropriate subcommittee(s) in order that there be a consistent statement valuation and taxation procedure.

THE FUNCTION OF THE TRUSTEE NEEDS TO BE REASSESSED AND ACCOUNTABLE.
There is a possible conflict of interest when a SIPC appointed trustee also acts in the bankruptcy proceedings. I am asking for a provision for the separation of powers for the trustee.

In addition, the SIPC appointed trustee is given "carte blanche" in determining claims given the statutory phrase, "to the satisfaction of the trustee". This makes each SIPC case an opportunity for subjective interpretation of the intent of SIPA.

In effect, a trustee's interpretation of the statute can overrule the actual SIPA. This gives investors no true basis to assess the risk they may have when investing with a broker, thus defeating the purpose of SIPC; which is to instill confidence. I ask that the Trustee's role be specifically defined and his/her actions in defining and implementing claims be held accountable to an oversight board.

We are seeing unprecedented billing from the Trustee in the Madoff case ($2M/week) while only 2219 (out of 13379) victims have received any compensation from SIPC. Hourly billing may have the effect of removing any incentive to act expeditiously to pay investor claims.

I am asking for an independent review board of the billing (requiring detailed invoices), and hiring practices of the Trustee.

IN CONCLUSION

The current market is far different than it was in 1970 when SIPC was created. However, the basic premise has not changed. The SIPA came about as a result of a lack of investor confidence after illegal and fraudulent practices of the 1960's. That same environment is here once again and without proper implementation of the act that alleges to protect investors, we will find our financial markets failing. It is for that reason that I implore the Subcommittee to take the ideas presented into consideration and insure that consumer confidence is assured and investors are protected, as promised by Congress through SIPA in 1970.

I thank you for the opportunity to be heard and hope that you will consider the reality of the situation as it applies to each individual victim. Staffers in each of your offices have previously received an email presentation from the Madoff Victims Coalition reflecting the thoughts of more than 70 Madoff victims in their own words. I hope you review that presentation and realize that these citizens did not take the promise of SIPA lightly when they invested their lifesavings with a broker who was legitimized by the SEC.

As a Senator in 2006, Barack Obama said *"If the people cannot trust their government to do the job for which it exists - to protect them and to promote their common welfare - all else is lost."*
I ask you to ensure that your constituents and ALL Americans will know that all is <u>not</u> lost.

Respectfully,

Ronnie Sue Ambrosino
Coordinator
Madoff Victims Coalition
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February 22, 2010

The Honorable Paul E. Kanjorski, Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
United States House of Representatives
2188 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Kanjorski:

Introduction

At the December 9, 2009 hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, the members of the Subcommittee, including yourself, requested information and possible legislative proposals on a number of issues. SIPC's legislative counsel has also been in touch with the Subcommittee staff to refine and round out those information requests. This letter will begin SIPC's response to the Subcommittee.

I should note that SIPC has already proposed a number of substantive amendments for the Subcommittee's consideration, several of which were included in H.R. 4173. In addition, subsequent to the December 9 Hearing, I discussed with President Obama's nominees for Chairman and Vice-Chair of SIPC an action plan for the first full fledged review of the Securities Investor Protection Act ("SIPA") since the mid-1970s. Those nominees, Orlan Johnson and Sharon Bowen, were confirmed by the Senate on February 11. SIPC is forming a Task Force to take a comprehensive review of the entire SIPA statute, and to propose any relevant amendments, beyond those SIPC has presently proffered. I anticipate that the Task Force will go beyond the items raised by the Subcommittee on December 9.

Issues Raised By The Subcommittee

1. Retroactive Assessments

You raised the issue of retroactive assessments. As you explained, this would give members of SIPC an incentive to report to regulators any irregularity which might give rise to a brokerage firm failure. As explained below, we believe this is already the case.

First, if there were a regime that implemented retroactive assessments, it would be impossible to assess SIPC members that have left the industry, and collect additional assessments. Typically, those entities have gone out of business.

Second, SIPC members that were in existence at the time of a "Madoff-like" situation, and which remain SIPC members after such an event, are precisely the SIPC members that are assessed to pay for such a failure, by means of increased assessments to reconstitute the depleted SIPC Fund. And while it would be possible to assess those members based upon the respective net operating revenues previously earned by those members during the time of an ongoing "Madoff-like" situation, a backward-looking assessment rate does not take into account the effect of such assessments on the current financial condition of any particular member. In contrast, a change in the assessment, applied prospectively, allows the member to budget accordingly. The current assessment, initiated as a result of SIPC's expenditures in the Madoff proceeding, has clearly made SIPC members aware of the fact that they...and no one else... will pay for Madoff's fraud, and the failure to detect it. Even were it necessary for SIPC to borrow against its line of credit with the United States Treasury, SIPC members, and no one else, will repay those borrowings. The incentive for a SIPC member firm to report illegal or suspicious conduct is identical in both cases. Legislation providing a "safe harbor" for such reports, that is, protection against lawsuits arising from such reports to a regulatory authority, may be advisable.

2. International Coordination and Arbitration

You have requested comment and possible legislative proposals to speed the process of international dispute resolution in the context of a multinational brokerage insolvency.

The difficulty with a legislative solution is this: Even if Congress were to enact a mandatory arbitral forum for such dispute resolution, there would be no way

to compel a foreign counterparty to comply. Similar, if not identical legislation, would be required in every jurisdiction relevant to any particular dispute.[1] In a significant international dispute, any number of jurisdictions could be involved. Passage of a law by Congress could not force a recalcitrant foreign counterparty to agree to be bound by it, especially if the law of that counterparty's jurisdiction offers that party a different legal outcome.

SIPC proffers two alternative solutions, both of which are relatively recent developments and are being implemented now. Further, a relatively recent chapter of the Bankruptcy Code warrants possible amendment to include reference to brokerage firm failures.

A.
Bilateral Memoranda of Understanding Between SIPC and SIPC's International Counterparts

SIPC has in fact anticipated the need for an international vehicle to solve the problems you have identified. Currently, SIPC has executed a Memorandum of Understanding with each of the following entities:

- The Financial Compensation Scheme in the United Kingdom
- The Canadian Investor Protection Fund
- The China Securities Investor Protection Fund Corporation
- The Securities and Futures Investor Protection Fund in Taiwan
- The Korea Deposit Insurance Corporation
- The Egyptian Investor Protection Fund.

SIPC shares information with each of these entities, attends international forums to understand the nature and limits of the operation of those counterparts, and

[1] I met with Gaytri Kachroo, an attorney in Boston, and a major advocate for such an arbitral forum, to discuss this issue at some length. Also present was my Canadian counterpart, Rozanne Reszel, the President of the Canadian Investor Protection Fund, and SIPC's General Counsel, Josephine Wang.

cooperates where possible with those entities.[2] SIPC affirmatively intends to seek out additional opportunities for similar bilateral agreements.

Where possible, the typical MoU agreement contains a provision whereby the parties specifically agree to cooperate in the event of a cross border brokerage firm failure that has consequences in both jurisdictions, particularly with respect to claims. (See, for example, the MoU between SIPC and the Canadian Investor Protection Fund, attached as Exhibit 1.)

In addition to the Bilateral MoUs, SIPC became an auxiliary member of the International Organization of Securities Commissions in 2009. This will further facilitate international cooperation, and I hope, international dispute resolution.

B.
Cross-Border Insolvency Protocols

Specific situations require specific solutions. The insolvency of Lehman Brothers Holdings, Inc., its subsidiary Lehman Brothers Inc., which was a SIPC member, and other related corporate affiliates, is the largest bankruptcy proceeding in history. The Lehman corporate empire spanned the globe. In order to deal with insolvency proceedings in multiple jurisdictions in an efficient and economical way, the parties developed a "Cross-Border Insolvency Protocol For The Lehman Brothers Group Of Companies." This document is attached as Exhibit 2. I have also attached as Exhibit 3 a Report of the Official Representatives and Other Participating Affiliates Pursuant To The Cross-Border Insolvency Protocol which demonstrates the enormity of the undertaking. I believe that the Cross-Border Insolvency Protocol may serve as a model for dealing with international cooperation and dispute resolution.

---

[2] As a part of this program of international cooperation and coordination, I addressed an international forum in Beijing on the problems encountered as a result of the failures of Bear Stearns, Lehman Brothers, and Bernard L. Madoff LLC in November 2009.

C.
Chapter 15 of The Bankruptcy Code:
Ancillary and Other Cross-Border Cases

Enacted in 2005, Chapter 15 of The Bankruptcy Code is an adaptation of the Model Law on Cross-Border Insolvency promulgated by The United Nations Commission on International Trade Law ("UNCITRAL"). I would note that Chapter 15 is specifically not applicable in a proceeding under the Securities Investor Protection Act ("SIPA"). See 15 U.S.C. section 1501(c)(3). There is no legislative history which explains this exclusion. I intend to discuss with counsel for Lehman Brothers Holdings, Inc., and the Trustee for Lehman Brothers Inc., the issue of whether the continued exclusion of SIPA liquidations from the provisions of Chapter 15 makes sense in light of the Lehman experience. SIPC is open to the prospect of changing that provision of the Bankruptcy Code if it will expedite dispute resolution. I will report to the Subcommittee their conclusions.

3. Representative Speier's Request For Proposed Legislation For Updated Protection That Reflects Contemporary Investment Practices

In the Madoff case, a number of defined benefit pension plans were decimated by Mr. Madoff's depredations. As I stated in my testimony on December 9, SIPC will examine whether a change in the SIPA statute, to protect individual pensioners, is feasible. Currently, only the pension plan which has an account at the brokerage, and not individual participants in the plan, is protected by SIPC. While the FDIC has such protections, doing so with respect to a pension plan's securities holdings at a SIPC member firm presents far greater logistical problems. It is also necessary to study this issue from a risk management perspective. I am confident the Task Force, mentioned above, will address this issue. I will report to the Subcommittee on the results of those studies.

4. Representative Speier's Request for Information on SIPC Assessments

From SIPC member 2009 assessments, SIPC anticipates receiving approximately $360 million. SIPC currently anticipates receiving $480 million for 2010 assessments. SIPC will continue the current level of assessments until the SIPC Fund reaches $2.5 billion. Based upon projected expenditures, particularly in the Madoff liquidation proceeding, and projected assessment revenue in the future, SIPC should reach the new Fund target by 2015.

Congresswoman Speier also asked for an estimate of the current SIPC Fund balance if SIPC had not reduced assessments to a flat fee from 1990 to 2008. The following calculations are based on data provided by the SEC and employ the definitions for 'net operating revenue' derived from SIPC and FINRA. Data for 2009 is not yet available.

There are some data limitations which provide a possible upward bias to the results. Definitional changes in brokerage firm financial reporting line items over the years may have biased the data, but probably not to a significant degree. Consequently, total revenues and net operating revenues are likely overstated somewhat, though the degree of overstatement is unknown. The numbers are thus most likely an upper bound on the theoretical SIPC Fund balance if member assessments had been at ¼ of 1% of total revenue and net operating revenue, respectively, during the period.

The calculations show that, at a ¼ of 1% assessment rate based on total revenue, the SIPC Fund might have grown to $11.3 billion by the end of 2008, an increase of $9.6 billion over the funds actual balance at that date of $1.7 billion. If based on net operating revenue, the fund might have reached $8.5 billion, an increase of $6.8 billion.

Representative Speier has asked how SIPC determined to use .25% of SIPC member net operating revenues as the basis for assessments. A history of SIPC's assessments provides context for the answer. SIPC has continuously worked to assure that the SIPC Fund is adequate to protect the investing public.

A.
Statutory Assessment Requirements

When the SIPA statute was enacted in 1970, Congress set a minimum target for the SIPC Fund at $150 million. See 15 U.S.C. section 78ddd(d). That subsection requires assessments of ½ of 1 percent of gross revenues until the Fund first reached $150 million and at any time the Fund balance is below $100 million. At any time the Fund is below $150 million, the statute requires an assessment of 1/4 of 1 percent of gross revenues. Thus, the statute gives SIPC some guidance as to the appropriate levels of assessments.

B.
SIPC's Continuous Review of Capital Adequacy

Given the passage of time, SIPC did not rely on the targets set as a minimum in 1970. Historically, SIPC's Board periodically reviewed the capital adequacy of SIPC on a continuous basis. A summary of the more important milestones in that continuous review follows.

i. Special Study of the SIPC Fund and Funding Requirements, October 8, 1990, Deloitte & Touche

This study concluded:

> [T]he SIPC Fund and funding structure is adequate to fund maximum projected losses and intermediate cash flows. In closing, however, we note that the cash requirements to fund the liquidation of a very major firm could temporarily deplete the SIPC Fund almost entirely. Thus, while the current SIPC Fund and funding would appear to be adequate to manage a major failure or failures, we believe that our projections establish a framework for the Securities Investor Protection Corporation Board to utilize in evaluating whether, as a policy matter, such depletion could be allowed.

At year end, 1990, the SIPC Fund balance was $581,716,987.

ii. Report and Recommendation of the SIPC Task Force on Assessments, 1991

The Board established this Task Force and instructed the group that the Board wished to increase the SIPC Fund to $1,000,000,000. In arriving at that amount, an increase of more than 40% of the Fund balance, the Board simply felt that the statutory targets were too low, given inflation and other market factors, and that a $1,000,000,000 Fund would promote investor confidence. The purpose of the Task Force was to determine how best to reach that goal. The Task Force addressed the fact that the SIPC Fund is "currently in a very strong position."[3] Report, page 2.

After determining that fact, the Task Force recommended that the Board institute a growth goal of 8% per year until the SIPC Fund reached $1,000,000,000.

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[3] At year end 1991, the SIPC Fund stood at $652,623,120.

While the Board accepted the principles of the Task Force Report, the Board determined to increase the SIPC Fund at the more aggressive rate of 10% per year.

iii. GAO Report: Securities Investor Protection - "The Regulatory Framework Has Minimized SIPC's Losses", 1992

Congressmen Donald W. Reigle, Jr., and John Dingell requested that the General Accounting Office review "the operations and solvency" of SIPC. The gist of the Report, at page 5:

> SIPC Has Addressed Its Funding Needs
> There is no scientific basis for determining what SIPC's level of funding should be because the greatest risk the fund faces – a breakdown of the effectiveness of the net capital and customer protection rules – cannot be foreseen. However, given the growing complexity and riskiness of securities markets, GAO believes that SIPC officials have acted responsibly in adopting a financial plan that would increase fund reserves to $1 billion by 1997. While GAO cannot conclude that this level of funding will be adequate, $1 billion should be more than sufficient to deal with cases of fraud at smaller firms, and it probably can finance the liquidation of one of the largest securities firms. The $1 billion fund may not, however, be sufficient to finance worst-case situations such as massive fraud at a major firm or the unlikely simultaneous failures of several of the largest broker-dealers. Periodic SIPC and SEC assessments must account for factors such as the size of the largest broker-dealer and any signs that regulatory enforcement of the net capital or customer protection rules has deteriorated. (See pp. 40-46; emphasis supplied.)

The SIPC Fund reached the $1,000,000,000 mark by 1996, ahead of the Board's schedule.

iv. William M. Mercer/Peat Marwick: Report On The Adequacy Of The SIPC Fund, 1998

Using "Ruin Theory," this Report states, at page 1-2:

> We find that the probability of a large demand on the SIPC Fund appears smaller today than in the past. For a liquidation proceeding

> to cause a substantial demand on the Fund, one of the largest firms in the brokerage industry must fail and a significant amount of customer assets must be missing. Liquidation proceedings of relatively large brokerage firms have historically required SIPC's assistance for only a small percentage of distributions to customers and administrative costs. The largest brokerage firms' bond ratings continue to be high in quality, indicating that it is unlikely that a large firm will become insolvent in the near future. Our application of Ruin Theory shows that, based on historical proceedings data, the probability of exhausting the Fund in the future is extremely remote. Sensitivity testing of scenarios suggests that the state-of-the-world where a reasonably possible demand on the SIPC Fund could deplete the Fund in a few years would have to be dramatically different from what we observe today.
>
> Therefore, we find the current level of the Fund, as adjusted for its expected inflow from proceedings and operating expenses, to be sufficient for the foreseeable future. However, if for any reason the soundness of securities markets were to deteriorate significantly, our predictions regarding the safety of the SIPC Fund would cease to apply.

Other aspects of the report of interest include the Extrapolation of Historical SIPC Experience to Large Firms, which includes a Scatter Plot and Regression Analysis (Report, p. 51-56), and a discussion of Alternatives to Increasing the Size of the SIPC Fund (Report, p. 72). The Report specifically notes (p. 54) that there is "one in 250 chances that the failure of a firm with $1 trillion in customer assets would create a positive claim on the SIPC Fund." (Emphasis supplied.)

The Mercer/Peat Marwick Report also states (p. 67) that "one time out of 40,000, the current level of the fund plus expected earnings (at 5.5% per annum) would not be sufficient to meet all claims in the next 5 years. For a 25 year period, the current Fund size and expected earnings should not be sufficient one time out of 1,650." (Emphasis supplied.)

v. SIPC Internal Analysis, 1998

Subsequent to the Mercer/Peat Marwick Report, Joseph F. Marino, then SIPC's Vice President-Finance and Operations, assembled a variety of prior memoranda on the subject of liquidity needs at the outset of a large liquidation. Mr.

Marino concluded that SIPC funds could be advanced to a trustee to free securities subject to margin loans from the Debtor's margin lender, so as to be able to transfer the securities positions to an acquiring broker. The acquiring firm would then use the securities as collateral with its margin lender, and reestablish both the long securities position and the margin debt in each customer's account. The acquiring firm would then repay the trustee – who could then repeat the process, and use the same funds once again.

Using this "recycling" method would alleviate the short term liquidity needs at the start of a proceeding without the necessity of a larger SIPC Fund.

vi. Fitch Risk Management Study, 2003

After the collapse of MJK Clearing, Inc. in Minneapolis in September 2001, SIPC chartered a study of that case and an analysis of the losses incurred. On January 31, 2003, Fitch Risk Management issued its Review of SIPC Risk Profile and Practices: the MJK Clearing Event, the Securities Lending Exposure, Risk Management Practices and Capital Requirements. That Review used a Risk Qualification Methodology to find that the SIPC Fund "is sufficient at a 99% confidence interval . . . we believe that the total claims paying abilities are adequate to withstand an extremely severe stress case." The review concluded that "the adequacy of the SIPC fund remains sufficient," and "that a loss in excess of $500 million is expected . . . once in 100 years." (Review, p. 51).

vii. Other Developments

SIPC added a Risk Manager to its staff in August 2003. The Risk Manager's role is to provide SIPC's Board and senior management with a continuing analysis of risk factors and exposures to the SIPC Fund. In addition, the SEC approved an amendment to SIPC's Assessment Bylaw. The 2003 amendment to the Bylaws allowed SIPC to initiate immediately a change in the assessment rate, once the Board of Directors determines a change is appropriate, rather than wait until November of that year.

The wisdom of enacting the 2003 Bylaw amendment was demonstrated when the Madoff fraud was uncovered. SIPC immediately reinstituted revenue based assessments.

Finally, as a direct result of the Lehman Brothers and Madoff liquidations, SIPC submitted a proposed Bylaw change to the SEC in September, 2009, to raise

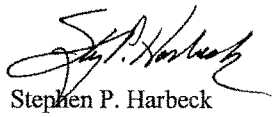
the target amount of the SIPC Fund to $2.5 billion. That Bylaw is now in effect. SIPC will now continue to collect assessments based upon 1/4 of one percent of net operating revenues of SIPC members, at least until the new target is reached. The determination as to what rate to use for assessments was made after extensive analysis by SIPC's Risk Manager, who presented alternative projections to the Board prior to the adoption of the present rate in the Bylaws.

In an extreme emergency, where the SIPC Fund was depleted to $100 million, the SIPA statutory rates of "not less than ½ of 1 percentum of gross revenues" would control. The absolute maximum assessment is set forth in 15 U.S.C. section 78ddd(c)(3)(B) and is one percent of a member's gross revenues.

Conclusion

I look forward to working with you and the Subcommittee to make SIPA a stronger vehicle for investor protection. Please let me know if you have any comments or questions.

Very truly yours,



Stephen P. Harbeck
President

SPH:ved

Enclosures

PAUL E. KANJORSKI
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Mr. Stephen P. Harbeck
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Dear Mr. Harbeck:

Thank you for your letter of February 22, 2010 which responds to questions raised by Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Entities during a hearing on December 9, 2009. Those proceedings focused on the need for additional reforms to the Securities Investor Protection Act (SIPA). As you know, I recently introduced a number of investor protection legislative proposals, including reforms to SIPA, that have now passed the House as part of H.R. 4173, the Wall Street Reform and Consumer Protection Act. As I said at the hearing, these House-passed proposals are the first of many reforms that I believe are needed to modernize SIPA and modify how the Securities Investor Protection Corporation (SIPC) operates.

In your correspondence, I was pleased to learn that SIPC is forming a task force to undertake a comprehensive review of the entire SIPA statute. The task force's focus, however, ought to be much broader. I believe that the task force should also explore how SIPC operates, including how SIPC appoints trustees, establishes target fund levels, determines the scope of securities covered, and completes cross-border settlements. I therefore request that the task force consider what internal reforms are necessary for SIPC to put in place to better protect investors, including modifications to SIPC's bylaws, corporate governance standards, organizational structure, policies, and procedures, among other things.

As you know, the Government Accountability Office (GAO) has previously reviewed SIPC's performance. GAO issued a report on May 2001, which it reviewed in July 2003 and further updated via a letter to me on July 9, 2004. The U.S. Securities and Exchange Commission (SEC) has additionally examined SIPC's operations in recent years. Specifically, the SEC issued an exam report in January 2003. I expect that the SIPC task force will consider whether changes implemented in response to the GAO and SEC reports continue to be effective. In particular, the task force should consider whether SIPC has fully responded to prior

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recommendations that SIPC take additional steps to improve investor education. The results of the Madoff Ponzi scheme suggest otherwise.

Moreover, I believe that the task force should explore a number of related policy issues, including the advisability of continuing to allow excess SIPC insurance, the availability of excess SIPC insurance to all market participants, and the regulation of this financial product. The task force also needs to consider what reforms will ensure that SIPC will never again risk tapping the line of credit it can secure via the SEC. The task force must further explore whether or not SIPC coverage should be expanded to include the customers of investment advisers, investors in hedge funds and funds-of-funds, and participants in pension plans.

Even more, the liquidation of the Madoff estate has raised concerns by some about the fairness of how SIPC distributes the assets of failed broker-dealers and who beyond the failed broker-dealer SIPC seeks to obtain assets to compensate investors. So that Congress can make informed decisions about legislative proposals to revise SIPA which have already started to circulate, the task force therefore should examine the pros and cons of altering existing distribution regimes.

With respect to the participants of the SIPC task force, I firmly believe that in addition to the Chair and Vice Chair of SIPC the panel should include equal representation from industry and investors. This composition will ensure that stakeholders with a broad range of views are represented and provide greater confidence in any recommendations that the task force ultimately makes. During its investigations, the task force should also consult with both the GAO and the SEC given their expertise on these issues.

Finally, I urge the SIPC task force to begin its work without any further delay. To restore investor confidence, we need to put in place legislative, regulatory, and organizational reforms as quickly as possible. I therefore request that the task force send me a final report that addresses the complete scope of the task force's work, findings, recommendations and an aggressive timeline for implementing recommendations that do not require legislative action on or before August 31, 2010. The unfortunate crisis in our securities markets demands a robust and speedy response from policymakers, and a serious, substantive, and comprehensive report from the task force has the potential to lead to important reforms that better protect investors in the future.

Sincerely,

Paul E. Kanjorski
Member of Congress

cc: The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street NE, Room 10700
Washington, DC 20549

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

COMMITTEE ON
FINANCIAL SERVICES

CHAIRMAN:
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON OVERSIGHT AND
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August 20, 2010

Mr. Stephen P. Harbeck
President
Securities Investor Protection Corporation
805 Fifteenth Street, NW, Suite 800
Washington, DC 20005-2215

Dear Mr. Harbeck:

The Capital Markets Subcommittee will soon convene a hearing to assess the limitations of the Securities Investor Protection Act (SIPA). As you know, the liquidation of the Madoff estate has raised concerns by some about the fairness of how the Securities Investor Protection Corporation (SIPC) distributes the assets of failed broker-dealers and who, beyond the failed broker-dealer, SIPC seeks to obtain assets from in order to compensate investors and minimize outlays of SIPC's reserves. In addition, court documents and news reports have, at times, presented data that varies greatly by source regarding the scope of the Madoff Ponzi scheme, the pool of potential claimants, and SIPC's actions related to compensating Mr. Madoff's victims.

In order to prepare for this hearing and to generate a better public understanding of the actual experience and data related to resolving the Madoff fraud -- and so that Members of Congress can adequately respond to ongoing constituent questions about the liquidation of and claims processed on behalf of the victims of the Madoff Ponzi scheme -- please provide us with the following information as of August 1, 2010:

1. A schedule that details the total balance of the SIPC Fund as defined by SIPA. Of this balance, please identify how much is unallocated, reserved for the Madoff proceeding, and reserved for all other proceedings.

2. An explanation of how SIPC Members are presently assessed annually and an estimate of the aggregate assessment that will be added to the SIPC Fund during the remainder of 2010 and in 2011.

3. A schedule that details all lines of credit available to SIPC, outstanding borrowings, and remaining credit available. Also, please disclose whether any lines of credit have been closed during 2009 and 2010 and explain why.

4. For claims related to the Madoff Ponzi scheme, please provide a schedule that details the number and aggregate value of allowed claims and the number and aggregate value of allowed claims at or below the statutory limits of SIPC protection. Also, include the average disbursement per claim.

5. Please estimate how many Madoff Ponzi scheme claimants would be eligible for advances of up to $500,000 under the final statement method of calculating "net equity" as that term was defined in the

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case considered by the U.S. Bankruptcy Court for the Southern District of New York (Case No. 08-01789-brl). Also, please estimate the aggregate value of advances that would have been made under this method.

6. Please estimate the total number and value of distributions made to Madoff investors in excess of their investments. Of these distributions, please estimate how many avoidance actions that the trustee has brought or expects to bring and the amount the trustee has recovered and expects to recover in the future. Further, please break out the number of and expected recoveries from avoidance actions between investors who may have known about or participated in the Ponzi scheme and those who were likely to be unaware of the Ponzi scheme.

7. For all Madoff-related SIPC claims, please provide a schedule stratified by claims of less than a million dollars, between one and three million dollars, between three and five million dollars, between five and ten million dollars and in excess of ten million dollars that details how many claims would be eligible under both the final statement method and the cash-in/cash-out method of calculating net equity. Further, please provide the aggregate amount that could be clawed backed from claimants under each method.

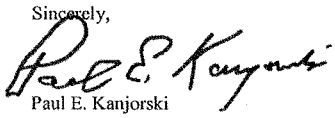
8. Please estimate the number of Madoff-related claims not yet determined and estimate the timeframe for when those claims will likely be determined. Also, for all claims filed since the liquidation proceedings started, please calculate the average time period expressed in months between the filing of the claim and the trustee's determination of the claim.

9. For all Madoff-related claims, please detail how many claims have been disallowed because the investors were not directly invested with Mr. Madoff's firm.

10. For each year, from 1992 until the liquidation of Bernard L. Madoff Investment Securities, please detail the aggregate funds that flowed into the firm and out to investors.

It is important for the Congress to receive this information in order to maintain transparency into the SIPC liquidation and claims process related to the Madoff matter. This information may also assist Congress as it considers options for modifying and updating SIPA. Consistent with all applicable laws and regulations, we look forward to receiving this information from you on or before September 8, 2010.

Sincerely,



Paul E. Kanjorski
Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Scott Garrett
Ranking Member, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

cc: The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street NE, Room 10700
Washington, DC 20549

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September 7, 2010

BY MESSENGER

Honorable Paul E. Kanjorski
Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
2188 Rayburn House Office Building
Washington, DC 20515-3811

Honorable Scott Garrett
Ranking Member, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
2188 Rayburn House Office Building
Washington, DC 20515-3811

Dear Chairman Kanjorski and Ranking Member Garrett:

Below is the information that you requested in your letter dated August 20, 2010. The information follows each request and, as per your request, is as of August 1, 2010.

1. A schedule that details the total balance of the SIPC Fund as defined by the Securities Investor Protection Act ("SIPA"). Of this balance, please identify how much is unallocated, reserved for the Madoff proceeding, and reserved for all other proceedings.

Response:

The SIPC Fund, as defined by SIPA, consists of cash on hand or on deposit and amounts invested in United States Government or agency securities.

As of August 1, 2010, rounded to the nearest $100,000, the SIPC Fund consisted of:

US Government Securities maturing within 10 years at fair value (including accrued interest receivable)	$1,204,600,000
Cash on hand or on deposit	$23,600,000
Total	$1,228,200,000

The SIPC Fund does not have "reserves" established against it. All expenditures by SIPC are made out of the Fund as provided under SIPA. It is used to meet all SIPC obligations under SIPA as they occur.

2. An explanation of how SIPC Members are presently assessed annually and an estimate of the aggregate assessment that will be added to the SIPC Fund during the remainder of 2010 and in 2011.

Response:

Since April 1, 2009, the SIPC member assessment has been based on 0.25% of each member's net operating revenues as reflected on the members' financial reports filed with the Securities and Exchange Commission ("SEC" or "Commission") and the Financial Industry Regulatory Authority.

Members must complete a General Assessment Payment Form at their mid-year and a General Assessment Reconciliation Form at their year end. These filings and any assessment payments are due 45 and 75 days after the end of the period, respectively.

It is currently estimated that collection of member assessments will add an aggregate of approximately $500,000,000 to the SIPC Fund during the remainder of 2010 and in 2011.

3. A schedule that details all lines of credit available to SIPC, outstanding borrowings, and remaining credit available. Also, please disclose whether any lines of credit have been closed during 2009 and 2010 and explain why.

Response:

In the event the SIPC Fund is or may reasonably appear to be insufficient for the purposes of SIPA, the SEC is authorized to make loans to SIPC and, in that connection, the Commission is authorized to issue notes or other obligations to the Secretary of the Treasury in an aggregate amount not to exceed $2.5 billion. Currently SIPC has no other lines of credit available. There is currently no outstanding borrowing and to date there has not been. SIPC had a $500 million revolving line of credit with an international consortium of banks which expired effective March 1, 2009, and an additional $500 million revolving line of credit with that consortium of banks that expired effective March 1, 2010. Given the developing financial crisis, the consortium of lenders on SIPC's commercial credit lines was unwilling to renew the credit lines.

SIPC, by bylaw, increased the "target" for the SIPC Fund to $2.5 billion. Assessments based upon a percentage of net operating revenue will remain in place until that higher target is reached. Once the target is reached, together with the Government line of credit, SIPC will have access to $5 billion of funds.

I would note that SIPC, under current law, has demonstrated that it has sufficient resources for its statutory mission.

4. For claims related to the Madoff Ponzi scheme, please provide a schedule that details the number and aggregate value of allowed claims and the number and aggregate value of allowed claims at or below the statutory limits of SIPC protection, Also, include the average disbursement per claim.

Response:

This question and those that follow use the term "claims" with respect to the information being sought. However, SIPA provides protection per "customer," as defined in SIPA, and not per claim. Two claims submitted by the same customer could be aggregated for purposes of SIPA protection if that customer held more than one account in the same capacity at the brokerage. For example, if John Jones had two accounts at a brokerage, both of which were in his name and held by him in the same capacity, the accounts would be combined for purposes of the SIPC advance.

The answers that follow are predicated upon an analysis of the customer accounts that have been determined, or remain to be determined, by the Trustee and the relationship of those customer accounts to the claims that have been filed. Wherever possible, the Madoff Trustee and SIPC encouraged claimants to file claims to preserve any rights the claimants might have. Consequently, there are many more claims than there are customer accounts. It also should be noted that much of the information relating to claims analyzed under a last fictitious statement approach are rough approximations at best. The claims have not been reviewed or analyzed on that basis and some adjustments to the information could become necessary upon actual review. With this background in mind, the answer to question 4 is as follows:

The Trustee has allowed 2,175 claims related to 1,893 accounts, with a total allowed claims value of $5,556,299,243.18. The 2,175 allowed claims include 282 amended and/or duplicate claims. With respect to these allowed claims, SIPC has committed $713,037,947.41 in SIPC advances to these claimants. Of these allowed claims, 1,330 claims representing 1,149 accounts were allowed for more than $500,000.00. 845 claims representing 744 accounts were allowed for $500,000.00 or less. The average SIPC protection committed per account with an allowed claim is $376,671. The claims review and determination process continues.

5. Please estimate how many Madoff Ponzi scheme claimants would be eligible for advances of up to $500,000 under the final statement method of calculating "net equity" as that

term was defined in the case considered by the U.S. Bankruptcy Court for the Southern District of New York (Case No. 08- 01789-brI). Also, please estimate the aggregate value of advances that would have been made under this method.

Response:

The last fictitious statement approach assumes that claimants should be paid based on the last fictitious account statement issued to them by Bernard L. Madoff Investment Securities LLC ("BLMIS"). These statements reflect phony backdated securities positions chosen by Bernard Madoff to yield fake profits pre-determined by him. Under an approach that honors the final fictitious statement, there could be 4,459 accounts eligible to share in customer property and to the extent not fully satisfied, eligible for a SIPC advance. The holders of these 4,459 accounts could be entitled to a total of $2,010,467,854.23 in SIPC protection. The $2,010,467,854.23 includes the $713,037,947.41 which SIPC already has committed in customer advances and an estimated additional amount of approximately $175,000,000.00 that the Trustee expects to ask SIPC to advance, after August 1, 2010, for the satisfaction of customers under the Trustee's cash-in/cash-out methodology. Thus, if the Trustee were to use the final fictitious statement method of calculating "net equity," an additional $1,122,429,906.82 in SIPC advances could be made.

It should be noted that allowance of claims on this basis necessarily would reduce the amount of customer property available to satisfy those claimants who have yet to recover their principal. The SIPC advance supplements the distribution of customer property that the Trustee collects for the benefit of customers. Such property is shared pro rata by customers. Distribution to claimants based on a last fictitious statement approach means that customer property and a SIPC advance will be used to pay not only customers who have yet to recover the amount deposited with BLMIS, but those customers who, while the firm was in business, took out more than they put in. Enlarging the pool of claimants sharing in customer property necessarily means less property for those who have yet to recover their principal and more property for those who, while the firm was in business, withdrew their principal and received other investors' money in the form of fake profits. In other words, the fake profits of the investors who already recovered their principal continue to grow when the firm is in liquidation to the continued detriment of those investors still owed their principal.

6. Please estimate the total number and value of distributions made to Madoff investors in excess of their investments. Of these distributions, please estimate how many avoidance actions that the trustee has brought or expects to bring and the amount the trustee has recovered and expects to recover in the future. Further, please break out the number of and expected recoveries from avoidance actions between investors who may have known about or participated in the Ponzi scheme and those who were likely to be unaware of the Ponzi scheme.

Response:

There were approximately 90,000 disbursements totaling $18.5 billion made to Madoff investors in excess of their investments.

The Trustee has brought 19 avoidance actions under the Bankruptcy Code seeking to recover approximately $15,000,000,000.00.

The Trustee advises that he anticipates bringing avoidance actions in two categories. One category would involve customers who received other customers' money, withdrew more than they deposited with Madoff, and as to whom knowledge is not a factor. At this time, the Trustee is reviewing the facts of approximately 1,000 possible avoidance actions that could result in the recovery of approximately $4,800,000,000.00 for the benefit of customers who have yet to be repaid their principal.

The other category consists of avoidance actions in which the Trustee alleges that the customer had enough information to be on inquiry notice of the fraud. At this time, the Trustee is considering the commencement of about 100 avoidance actions seeking the recovery of at least $2,000,000,000.00 for the benefit of customers who have yet to recover their principal.

7. For all Madoff-related SIPC claims, please provide a schedule stratified by claims of less than a million dollars, between one and three million dollars, between three and five million dollars, between five and ten million dollars and in excess of ten million dollars that details how many claims would be eligible under both the final statement method and the cash-in/cash-out method of calculating not equity. Further, please provide the aggregate amount that could be clawed backed from claimants under each method.

Response:

Under the Cash In/Cash Out Methodology, below is a stratified schedule of accounts potentially eligible for SIPC protection:

Category	Accounts	Total Combined Amount
Less Than $1,000,000	1,204	$381,921,324.59
$1,000,000 to $2,999,999	626	$1,096,526,388.57
$3,000,000 to $5,000,000	198	$754,646,856.41
$5,000,000 to $9,999,999	153	$1,027,403,169.73
Greater Than $10,000,000	138	$14,026,555,101.15
	2,319	**$17,287,052,840.45**

The following is a stratified schedule of accounts that potentially would be allowed under a last fictitious statement approach:[1]

Category	Accounts	Total Combined Amount
Less Than $1,000,000	1,485	$670,889,986.09
$1,000,000 to $2,999,999	1,372	$2,522,097,200.08
$3,000,000 to $5,000,000	569	$2,172,486,413.62
$5,000,000 to $9,999,999	529	$3,690,585,075.03
Greater Than $10,000,000	499	$48,055,627,602.00
Dec 2008 Accts[2]	5	$76,905,772.00
	4,459	**$57,188,592,048.82**

For the answer to the final part of question 7 as to the transfers that the Trustee might seek to avoid under the Bankruptcy Code, please see the answer to question 6 above.

8. Please estimate the number of Madoff- related claims not yet determined and estimate the timeframe for when those claims will likely be determined. Also for all claims filed since the liquidation proceedings started, please calculate the average time period expressed in months between the filing of the claim and the trustee's determination of the claim.

Response:

Of the 16,374 filed claims, 13,189 have been determined and 3,185 claims remain to be determined. The Trustee has advised that he expects to have all claims determined before the end of this year. For the 13,189 determined claims, the average time period between the filing of the claim and determination is 7.55 months.

In analyzing the foregoing information, there are certain facts that are very important for a complete understanding of these statistics. First, this is not a typical SIPC proceeding in which securities or cash were on hand at the time of the failure of the brokerage house. As is well known, this was a Ponzi scheme in which the only assets were other people's money or assets derived from such funds.

Furthermore, this was a Ponzi scheme of long standing, going back over at least 30 years. Since the traditional approach in all Ponzi scheme matters and the one consistent with SIPA is to return to the investor what the investor put into the scheme, the Trustee was

[1] This analysis excludes the potential results of settlements negotiated by the Trustee.

[2] This category relates to accounts that were opened after November 30, 2008. These accounts did not receive a November 30, 2008 Customer Statement.

required to do a full forensic analysis of all the books and records of the debtor, going back to at least the early 1980s in order to fully determine the amount of money which might be due to each customer based upon the customer's investment.

This forensic analysis included not only a complete review of the books and records of the failed brokerage house, but also documents received from third parties, such as banking institutions, clearing houses and other brokerage houses, as well as documents received from the customers themselves. There are literally millions of documents that have been reviewed by the Trustee and his staff in connection with the evaluation of each of the customer claims filed. Furthermore, access to books and records required coordination and sharing with law enforcement authorities which complicated and, in some instances, necessarily delayed the review.

Moreover, in order to reach out to customers who might be in financial distress, the Trustee instituted a Hardship Program early in the case which gave every customer the opportunity to advise the Trustee of his or her financial circumstances so that the claim could be processed as quickly as possible. Hundreds of customers filed hardship applications, and as a result of the Trustee's actions, many of these hardship applications were granted and the Trustee determined those claims as promptly as possible.

In addition, it should also be noted that due to the long term nature of this Ponzi scheme, many of the customer accounts presented multiple generational investments by customers with Mr. Madoff. Thus, it was not simply a matter of examining a single account for a short period of time, but in many instances, it required an analysis of multiple accounts going back several decades in order to fully determine the amount of money invested by the customer and whether the customer had invested more money than he or she had received from Mr. Madoff.

Notwithstanding these extreme difficulties, the Trustee has determined over 80% of the customer claims filed. The review and determination of customer claims is an ongoing process. The remaining claims include the most difficult ones, such as those of members of the Madoff family and extended family, insiders (former employees), feeder funds and others.

9. For all Madoff- related claims, please detail how many claims have been disallowed because the investors were not directly invested with Mr. Madoff's firm.

Response:

There are 8,489 determined claims submitted by claimants who had no account at Madoff that were disallowed. There are an additional 2,094 undetermined claims that tentatively are in this category but may be re-categorized upon further review.

10. For each year, from 1992 until the liquidation of Bernard L. Madoff Investment Securities, please detail the aggregate funds that flowed into the firm and out to investors.

Response:

For each year from 1992 through 2008, the following represents the aggregate funds that flowed into and out of BLMIS:

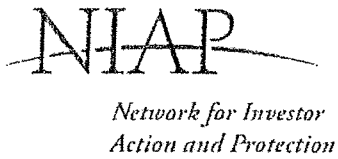
Year	Cash In	Cash Out
1992	($2,097,318,423.98)	$2,077,513,621.46
1993	($2,018,244,086.41)	$2,127,095,135.34
1994	($2,784,953,707.68)	$2,784,003,353.00
1995	($4,346,500,359.97)	$4,407,047,285.35
1996	($6,669,384,242.44)	$6,549,481,308.31
1997	($9,046,919,591.00)	$8,636,920,182.65
1998	($12,826,039,594.36)	$11,697,071,675.76
1999	($17,917,907,439.09)	$17,094,507,049.12
2000	($25,629,825,795.12)	$25,702,346,740.45
2001	($37,404,909,113.36)	$37,580,315,488.37
2002	($3,315,517,149.06)	$3,564,299,618.83
2003	($3,162,410,682.31)	$3,667,760,430.70
2004	($4,045,509,142.92)	$3,528,053,488.39
2005	($3,616,828,561.93)	$4,803,025,580.01
2006	($5,951,217,967.82)	$4,403,608,692.87
2007	($7,284,216,531.24)	$4,488,987,554.54
2008	($6,308,482,583.89)	$10,556,145,532.54

Respectfully submitted,

Stephen P. Harbeck
President

SPH:ved

cc: Hon. Barney Frank
Hon. Spencer Bachus



PREPARED STATEMENT OF:

RON STEIN, PRESIDENT

NETWORK FOR INVESTOR ACTION AND PROTECTION

SEPTEMBER 23, 2010

HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

www.investoraction.org
P.O Box 2159 Halesite NY 11743 Phone (800) 323-9250 Fax (631) 421-5701

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

The Network for Investor Action and Protection ("NIAP") thanks you for this opportunity to present its views.

NIAP was formed approximately one year ago to educate the public about, and to seek protection against, fraud and misconduct in the securities industry. It already has nearly 1,000 associate members. One of the subjects it has looked into at some length is the origin and initial passage of the Securities Investor Protection Act (SIPA) of 1970, the amendments to the Act in 1978, and the performance of the Securities Investor Protection Corporation (SIPC) under the Act.

> *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.*
> *– President Richard M. Nixon, 12/30/1970*

THE CREATION OF SIPA and SIPC

The Congresses which enacted SIPA in 1970 and amended it in 1978 had very specific goals in mind. Spurred by securities firms' disastrous back office problems of the 1960s -- problems which threatened the viability of our markets and the threatened insolvency of nearly half the brokerage firms on Wall Street -- Congress desired to protect investors (especially small ones). Congress desired, through protection of investors, to build confidence in markets and to enable investors to realize their reasonable expectations; it specifically said that investors' reasonable expectations generally are the amounts shown in the statements and confirmations they receive from their brokers; it intended SIPA, modeled on the FDIC, to provide insurance for investors if their brokerage houses went bankrupt; it wanted investors to be paid *promptly* by SIPC, not after a lapse of years; and it wanted investors to be given, whenever possible, the securities they lost rather than cash.

Congress also wanted SIPA to facilitate a change in our securities system to eliminate a problem that had brought Wall Street to its knees because of back office problems, and that had thereby threatened our markets and our economy. The change was that, instead of obtaining physical delivery of their securities, the investors would leave them in street name at their brokerages (which could use them in various ways to make money). The investors would then rely on statements and confirmations received from brokers to evidence the investors' holdings (see attached Appendix, page 8). The investors would look to SIPC for securities or advances if the brokerage house went bankrupt and would rely on SIPA insurance instead of personal physical possession of the securities if the brokerage went down.

The persons who *repeatedly* spoke to those goals of the legislation included many of the most famous Executive and Congressional figures of the day. They included President Nixon and

Secretary of the Treasury David Kennedy. They included a Senator and a Congressman who each ran for President, Senator Muskie and Congressman John Anderson. They included well known, highly placed Senators such as Harrison Williams of New Jersey, Alan Cranston of California, William Proxmire of Wisconsin and Vance Hartke of Indiana. They included leading members of the House of Representatives such as Congressmen Rostenkowski, Staggers, Moss, Eckhardt and others. (The comments made in Congress by these legislators and others are collected in an appendix to this testimony.)

With SIPA, therefore, the US government and the securities industry made a promise to the American people: in return for the acceptance of paper account statements in lieu of the investor's possession of physical securities as evidence of ownership, the government and industry (the SEC and NASD) would provide risk management and oversight to protect investors from broker failure, further backed up by a safety net (SIPC) should those layers fail. It was the responsibility of the investor to choose their investments wisely, to select brokerage firms that were regulated and overseen by NASD (now FINRA) and registered with the SEC, and to realize that they were still subject to normal market risks and risks above the protected amounts.

It was the responsibility of the SEC and NASD to perform their underwriting and oversight responsibilities competently. It was the duty of SIPC to protect investors should the NASD and SEC fail. The investors would look to SIPC for securities or advances if the brokerage house went bankrupt and would rely on SIPC's insurance instead of personal physical possession of the securities if the brokerage went down. SIPC was charged with the responsibility to establish a fund and charge its members fees to cover those risks and pay claims to cover the failures of its members.

Congress and the securities' industry were fully aware of the attendant risks when they pressed for the "street name", account-statement-based system in 1970. Aside from the fact that the paper-based book entry system had been operating on a small scale for some time, the added risks of theft, incorrect or fictitious purchases, investments never made, fabrication and others would have been and certainly were obvious concerns at that time particularly from the industry perspective.

Furthermore, in addition to the brokerage theft and other fraud issues that had been taking place using physical securities, Ponzi and pyramid schemes were well known to Congress and the financial world, with three well-publicized major Ponzi schemes taking place within that time period. The legislative history indicates the concern by the industry that the public might not even trust such a system. The simple truth is that the SEC and the investment industry entered the world of street name, book-entry, and account statements with eyes wide open. Those were the agreed-upon ground rules.

<u>It is, therefore, important to note that nowhere in SIPA law are any of the perils of theft, non-investment, Ponzi-fraud exempted from SIPC protection or that certain groups of investors might get preferential treatment in either protection or recovery of the assets of an insolvent broker.</u>

SIPC OPERATION AT ODDS WITH CONGRESSIONAL INTENT

To carry out the goals that were repeatedly emphasized as the intent of SIPA and to stabilize the financial markets, leading figures and their Congressional colleagues created SIPC. But, sadly, SIPC emphatically has *not* carried out Congress' intent. How does it do this? Instead of viewing its responsibility and directive of helping to protect the small investor, it has repeatedly taken an extremely narrow view of what falls under the umbrella of protection, creating legal distinctions without differences, asserting unreasonable responsibilities on investor victims, often forcing claimants into years-long costly legal battles, and behaving like a rogue insurance company.

Instead, almost from the very beginning, rather than carrying out Congress' intent that it *protect* investors, SIPC took actions which frustrated that intent. It can all be summed up in a single idea: SIPC has for decades made every effort, and put forth every conceivable argument, to *avoid* paying investors who have lost money because their brokers went bankrupt. In fact, up until at least the year 2000, SIPC had paid 37 percent more money to lawyers and trustees to *fight* the claims of investors than it had paid *to* the investors. We believe this type of imbalance remained true until the Madoff case, where the magnitude of the losses dwarfed even what SIPC could pay to fight claims -- although SIPC *has* been paying over one million plus dollars per month to lawyers and their assistants in the Madoff matter.

SIPC and the Trustee have misapplied bankruptcy law to further the assault on victims. Bankruptcy of a small business outside of the SIPC/investor protection regime should not be confused with or likened to that of a regulated broker dealer. The regulated broker dealer industry, like the regulated banking industry is central to the efficient operation of the nation's financial markets. Special regulations are imposed, therefore, to more clearly limit the operational risks that could otherwise wreak havoc to the system. The rules of SIPA were expressly intended by Congress to be different than, and take precedence over, bankruptcy laws when dealing with the insolvency of a broker dealer. Yet SIPC and the Trustee have gone to great lengths to impose inappropriate bankruptcy statutes that have no place in the regulated "investor protection" universe.

Because SIPC has so aggressively resisted the payment of investors' claims, it has, as said, vitiated Congress' intent to protect investors. It has vitiated investors' reasonable expectations, damaged confidence in markets, refused to provide the insurance desired by Congress, failed to give investors securities rather than cash, and has taken years to give investors whatever it ultimately does give them -- if anything -- after forcing them to wage years-long, costly battles. *And* because (i) SIPC tells the district courts who should be the SIPC Trustee in each case, and (ii) being a SIPC trustee is so lucrative, SIPC has built up a corps of trustees who do its bidding and whom it therefore regularly calls upon. They are its "go-to guys," so to speak. This has even been the subject of public comment.

Until the recent calamitous failures of Madoff and Stanford, SIPC's thwarting of the goals of Congress has mainly taken place under the radar -- which was perhaps the only way SIPC behavior could have gone unnoticed for so long. Yet, while *largely* unnoticed, SIPC's actions have not passed *entirely* unnoticed. Here and there the actions were commented on over the decades.

Back as far as 1984, a court in Florida devoted much of its opinion to warning that investors should not be fooled into thinking that SIPC trustees were independent assessors of the situation. They are, rather, a dependency of SIPC, and investors, the court said, should not be fooled into thinking they are in the hands of an objective, independent decision maker. In 1991, when rejecting, one after another, a host of meritless SIPC arguments made by SIPC Trustee Irving Picard, a federal bankruptcy court judge said of a SIPC argument that "Except that the Trustee appears to urge this most seriously, the Court would deem the contention too frivolous even to consider."

In a lengthy article published in the *New York Times* in 2000, financial writer Gretchen Morgenson extensively detailed SIPC's actions and strategies to avoid paying investors in case after case, so that as few as one percent of investors were sometimes paid in a given case. Morgenson presented information derived from lawyers, state securities commissioners, victims, and other knowledgeable people. A copy of her article is appended to my testimony.

SIPC, THE TRUSTEE and THE MADOFF LIQUIDATION

The Madoff case and SIPC's behavior regarding the case are essential to informing Congress and the Committee about what actions need to be taken to protect both existing victims and prevent future ones. Now, because of that case, it has become widespread knowledge that SIPC has frustrated the intent of Congress that investors be protected by what the Senators and Representatives considered insurance, and it has become apparent that SIPC has invented some new ways, never or almost never used before, to avoid paying investors. In specific, in the Madoff matter SIPC is using several techniques to avoid paying investors or to obtain money from them:

1. It is defining net equity by the cash-in/cash-out method instead of by the final statement method that has been used in nearly every other SIPC proceeding -- proceedings which are subject to some importantly different rules than a proceeding governed only by bankruptcy rules. By using cash-in/cash-out, SIPC is denying payments to literally thousands of devastated investors -- including small, middle class investors who were the main focus of SIPA, who relied on SIPC insurance, and who are now reduced to penury in their 60s, 70s and 80s.

2. Unlike any prior SIPC proceeding that we know of, the Trustee and SIPC are threatening to claw back from investors amounts of money they took out that exceeded amounts they put in. This has struck enormous fear into the hearts of hundreds or thousands of middle class and lower middle class persons who had to take out money to live and pay taxes, who are now reduced to poverty, who might have to sell their homes to raise money to give to the Trustee, who might have to give him whatever tax refunds they obtain, and who never had the slightest hint anything might be the least bit wrong with Madoff. The Trustee occasionally claims he will not seek to recover from the impoverished, but never does he put

people's minds at ease by specifically saying who it is that he will not seek claw backs from.

3. Because SIPC and the Trustee are using the cash-in/cash-out method rather than the final statement method to determine net equity, they are spending literally scores of millions of dollars to try to determine exactly what each investor's cash-in was and what his/her cash-out was. This can be very complex because of incomplete Madoff records, jointly held accounts, combined accounts, accounts that were split up, accounts that descended to heirs, and for many other reasons. Nor will the Trustee, after doing his calculations and demanding money from people, provide them with information that the Trustee, SIPC and their colleagues found and/or used to make determinations, so that investors are disabled from judging the correctness or incorrectness of the Trustee's work.

4. When calculating investors' cash-in and cash-out, the Trustee and SIPC do *not* credit investors with the interest Madoff earned on the money while it was in his bank account and was earning interest in the accounts or was earning money in money market mutual funds, Treasuries, or other investments -- which it often was. In this way SIPC and the Trustee have denied investors money that is rightfully theirs even under cash-in, cash-out.

5. By using cash-in/cash-out to deprive a huge percentage of direct investors -- probably a majority of investors -- of positive net equities, SIPC and the Trustee have ensured that they will be deprived not only of advances from the SIPC fund, but also of any share in customer property. Should the recoveries exceed the allowed claims, the Trustee has made explicit that one of his goals is to ensure that literally billions of dollars in customer property will go *not to victims of Madoff but to SIPC.*

6. In using the cash-in/cash-out rationale for denying claims, SIPC and the trustee are transferring the liability to the taxpayers as the Treasury will face millions of dollars in theft-loss claims. There is no way to describe this other than a taxpayer bailout of the SIPC.

ADDITIONAL ISSUES RELATING TO SIPC's POSITIONS

The trust and validity of the final account and confirmation statements are central to the efficacy of the investment system, and central to the discussion of both the current plight of Madoff victims and to the future protections of SIPC. There are a number of additional logical and practical arguments that underpin this necessity. We see SIPC's attempt to invalidate the final account statement net equity method as a threat to the entire investor protection apparatus.

Per Congress and SIPA law, whether funds are stolen, securities never purchased, lost, or misallocated is immaterial in terms of SIPC requirement for protection. Those are responsibilities and risks that must be borne first by the investor protection system, not the

investor under the paper account-statement-based book entry system. With the possession of a physical regulated security – the one sure means of protecting an investor from theft, or Ponzi fraud – taken from the investor, it is impossible for the investor to anticipate investment fraud of this nature unless he or she is complicit or has knowledge of the fraud.

As the investor can have no way of distinguishing between the type of scheme or behavior being perpetrated – whether a form of theft, or Ponzi-type scheme -- it is illogical and unfair to distinguish the level of protection afforded the investor after the fact, as SIPC is attempting to do. The account statement and confirmations must be the legitimate basis for determining the level of protection in the absence of ownership of physical securities.

There were no exceptions added to that protection by Congress. Investors have been led to believe that, just as investor depositors can rely on FDIC protection not only for their principal but their profits after contributions and withdrawals in their banks, so are investors in regulated broker dealers. This would have been essential to obtaining the trust of the American investor for a paper-based system.

There was never an asterisk to the protection. SIPC has never, in any of its literature, NASD, FINRA, nor have broker-dealers, in any of their literature indicated that investors would not be protected from the perils of theft, non-investment, Ponzi-type frauds, or that there would be a different treatment regarding recovery of brokerage assets for different investor groups, or that clawback could be a possibility. By SIPC taking a contrary position at this time is tantamount to changing the rules, and greatly injuring present and future investors by introducing a new set of risks.

The validation of the account statement was and remains essential for the trust of investors or depositors. It is inconceivable, in fact, that the investor community or Congress would have bought into any other agreement back in 1970 or 1978.

An equitable and stable financial system must be based around equal protection for all investors from institutional risks at all times else investors would be moving in and out of investments based on their changing net equity and loss of protection. To limit institutional and systemic risks, Congress understood that because the investor has given up the assurance of a physical certificate, it needed to create a level field for all investors. Whether early or recent investors, whether the investor withdrew more than invested, account statement values received equal protection, and that net equity is ascertained by the value of those statements.

Indeed, the Net Investment (cash-in-cash-out) Method currently advocated by SIPC could be disastrous and cause irreparable damage to the investment and banking industries and create a massive public policy hazard. First, it would mean that many investors would be unwilling to keep any profits in any institution at all, as any profits would represent an amount greater than the cash-in-cash-out (net investment method) method of determining net equity, causing massive relocations of assets. Second, it would imperil the oldest and most vulnerable in society: retirees living for some time on income from these accounts, the disabled dependent upon long term payments from special needs trusts. These are investors who could find themselves in an

unprotected, negative net equity situation, making vulnerable assets which could be clawed back, and leading many of those to liquidate their investments and move them elsewhere.

Moreover, both those who withdrew assets and those who did not are being treated unequally by the Trustee and SIPC under this method, as he is protecting those who chose not to withdraw over those who did. Those who withdrew their funds did so because they desired the funds for living expenses, or taxes, or chose to limit the amount of funds at risk. Those who left their assets in to accrue did so, again, because that was their preference, and they stood to enjoy a greater appreciation of their assets with the risk of subjecting a greater amount of funds to the investment. They were both, however, looking to the values of their account statements as what they, in fact, owned -- nothing more, nothing less. Neither would have had the expectation, should the brokerage fail, that one group would receive preferential treatment over the other.

Some would assert that the protection of fabricated values on statements represents an undue risk to SIPC of fraudulent brokers looking to game the system. Again, clearly these were obvious risks that all the stakeholders had to have been fully aware of before pressing forward with the rush to paper statements in 1970. It was, in part, why NASD was created earlier and why the SEC was given its responsibilities. Certainly, FINRA and the SEC must far more to limit the risks to investors and the reputation of the brokerage industry, but these are the responsibilities of the investment protection apparatus, not the investor. Moreover, no innocent investor would knowingly participate in a fraudulent scheme.

COMPREHENSIVE RECOMMENDATIONS FOR SIPC REFORM

The well documented failures of the SEC, SIPC, and FINRA beg for a thorough analysis of the effectiveness of the investor protection regime. After 30 years, given the recent debacles, it is time for Congress to revisit the efficacy of the entire system, particularly in comparison to the FDIC.

We recommend 4 overarching points to Congress – items that are needed in the short and intermediate term:

1. **Immediate relief to victims who are suffering due to lapses in FINRA & SEC oversight and SIPC practices.** Congress must help Madoff & Stanford Victims immediately with cease and desist to SIPC and Trustee regarding clawback and mandating support of final account statement of net equity (via passage of modified HR5032). It is essential that Congress demonstrate immediately that they will not turn their backs on innocent investors, and help minimize additional trauma to those who are suffering.

2. **A New Roadmap: Comprehensive Stress Testing of Investor Protection Regime with new Investors Bill of Rights.** Purpose is to comprehensively review FINRA, SEC, and SIPC, reviewing history of practices, establish strengths and weaknesses (and abuses) in the system, and press for appropriate change to laws and rules. This would require the use of an objective entity separate and apart from the existing

agencies and SRO's involved. (perhaps the new Consumer Financial Protection Bureau). It would mean assessing the number of investors not currently protected under SIPA law – such as through hedge funds, family partnerships, and private equity arrangements – and seeking to minimize risks to investors not suited for these investment programs. It would require independent review of SIPC, FINRA, and the SEC. It would require determining the costs of the measures needed.

3. **Massive PR Effort Focused on Education and Prevention.** With hundreds of instances of unmasked investment frauds in the last couple of years, American investors remain ready targets for scams and frauds, particularly those elderly and most vulnerable. In addition to massive step up on regulatory side, investors need to be made aware of the dangers of trusting "friends" involved in religious or club affiliations, and have easy ways of determining the legitimacy of regulated investment. SIPC has done little in this regard. America must do everything it can to protect investors.

4. **Ongoing Accountability and Modernization.** It is over 30 years since SIPA's last amendments. Given the dynamic nature of the investment markets, it is important that the entire investor protection system and its components be evaluated as needed, and no less often than every 5 years.

Additionally, Congress should update the Securities Investor Protection Act address the following issues:

1. It is vital that Trustees should no longer be selected by SIPC. Alternative methods should immediately be considered, such as selection by judges, *without any input from SIPC*. Perhaps there should be panels (as in bankruptcy) of (possibly) specially trained Trustees.

2. Congress should clarify that final statements from brokers should be the measure of net equity, and that there should be no claw backs, when an investor was not on notice of or complicit in a fraud that created a bankruptcy and when the investor therefore can and should be considered an innocent party.

3. SIPC (and Trustees) should be required to provide investors with information sought in discovery in litigation, except in unusual circumstances where there is the strongest possible reason not to provide the information.

4. SIPC should charge brokerage houses annual amounts sufficient to build the SIPC fund to a point where it could accommodate at least three simultaneous bankruptcies of large brokerage houses.

5. The current limit on advances from the SIPC fund is $500,000, an amount set in 1978. Inflation since then has been about 300 percent. Therefore, in order to protect investors and build confidence in markets, the maximum amount of an advance should be raised, retroactive to January 1, 2008, to a sum that will be roughly the

equivalent of $500,000 in 1978, or higher amount to enhance confidence in the financial markets.

6. The Subcommittee should give serious consideration to making indirect investors eligible for SIPC or other advances, since so much investment these days is done indirectly, through hedge funds and banks. For the last 10 years, there has been an explosion of assets invested into hedge funds, family limited partnerships, private equity, mutual funds, and entities, many of which have not been regulated. Tens, perhaps hundreds of thousands of investors have entered these markets, many without awareness of the risks involved, or lack of coverage involved. Many of these investors lack the professional experience or economic means to properly assess their risks, many of those marketing these investments are not held to a fiduciary standard that would seek to properly assess those risks to them.

NIAP commends the Committee's effort to enhance protections for investors, and would be happy to be of further assistance to Committee's efforts to assist the victims of recent high-profile Ponzi schemes as well as modernization of SIPA and SIPC.

Sincerely,

Ron Stein, President
Network for Investor Action & Protection

Attached: Appendix of Legislative History
"Investor Beware: Many Holes Weaken Safety Net for Victims of Failed Brokerages," Gretchen Morgenson, *The New York Times*, Monday, September 25, 2000

APPENDIX TO TESTIMONY OF NIAP

I. DESCRIPTION OF RELEVANT CONGRESSIONAL INTENT UNDERLYING SIPA AND ITS AMENDMENTS, TOGETHER WITH STATEMENTS AND EXCERPTS FROM THE LEGISLATIVE HISTORY.

A. The Congressional Intent.

Congress' intent when enacting and amending SIPA in 1970 and 1978 was to protect investors, especially small ones. All-important confidence in the securities market would thereby be built up.

The intent to protect investors, especially small ones, was not something stated only once or infrequently. *Rather, it was a constantly reiterated leitmotif throughout the legislative process.* It was regularly stated in 1970 hearings, in 1970 legislative reports, in 1970 floor debate, in 1975 hearings on amendments, in a 1977 House Report, in 1977 floor debate, in 1978 hearings, in 1978 legislative reports, and in 1978 floor debate.

The intent to protect investors was expressed by some of the most prominent Senators, Representatives and Executive officials of the 1970s. It was specifically expressed by President Nixon, Secretary of the Treasury Kennedy, Senator Muskie, Senator Harrison Williams, Senator Cranston, Senator Proxmire, Senator Hartke, Senator Bennett, Congressman Staggers, Congressman Anderson, Congressman Rostenkowski, Congressman Moss, Congressman Broyhill, Congressman Eckhardt, Congressman Boland, Congressman Vanik, Chairman Owens of SIPC, Commissioner Loomis of the SEC, and Chairman Haack of the New York Stock Exchange.[1]

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[1] Senator Muskie was Chairman of the Committee on the Budget and a member of the Committee on Banking and the Currency and the Subcommittee on Securities (and also ran for the Presidency); Senator Harrison Williams was Chair of the Subcommittee on Securities of the Committee on Banking and the

The Congressional intent repeatedly expressed by these leading legislators is vitiated by the cash-in/cash-out method (CICO) of determining net equity. The relevant items of Congressional intent,[2] and the destructive effect upon them of the cash-in/cash-out method, include:

- Congress intended to protect investors, but CICO has devastated thousands of them, especially small ones.

- Congress intended for SIPA protection to build up investors' confidence in the market. But because of CICO investors have *lost* confidence that they will be protected and have *lost* confidence in the market.

- Congress intended for investors to realize their reasonable expectations, which, it said, are based on the statements received from brokers. But SIPC and the Trustee say the investors cannot base reasonable expectations on statements from brokers.

- Congress intended for the Securities Investor Protection Corporation ("SIPC") to make payments promptly to investors. But CICO insures that payments will

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Currency; Senator Cranston was a member of the Committee on Banking and the Currency and served as the Democratic whip; Senator Proxmire was Chairman of the Committee on Banking and the Currency; Senator Hartke was a member of the Finance and Commerce Committees and Chair of the Committee on Veterans Affairs; Senator Bennett was a member of the Committee on Banking and the Currency; Congressman Staggers was Chairman of the House Committee on Interstate and Foreign Commerce; Congressman Anderson was a member of the House Rules Committee, was Chairman of the House Republican Conference and ran for President; Congressman Rostenkowski was a member of (and later Chair) of the Committee on Ways and Means; Congressmen Moss and Broyhill were members of the Committee on Interstate and Foreign Commerce; Congressman Eckhardt was a member of the Committee on Interstate and Foreign Commerce and the Subcommittee on Consumer Protection and Finance; Congressman Boland was Chair of the House Intelligence Committee and a member of the Appropriations Committee; and Congressman Vanik was a member of the House Ways and Means Committee and the Trade Subcommittee.

[2] Parts of the legislative history quoted or cited below are set forth in an Addendum (hereafter "Addnd.").

take years, since it takes years to reconstruct hundreds or thousands of brokerage accounts to determine their cash-in and cash-out.

- Congress intended SIPA to be an insurance program that protects investors in the same way that the FDIC insures bank deposits. SIPC and the Trustee claim SIPA is not insurance.

- Congress intended the SIPC fund -- from which investors with a positive net equity are to receive up to $500,000 -- to be a wholly separate fund from the fund of customer property. SIPC and the Trustee claim the two funds are just one fund.

- Congress intended investors to be paid money when victimized by theft and when securities had not even been bought by brokers. There was massive theft here, and Madoff did not buy the securities he claimed. But money was not paid to investors.

- Congress intended that, wherever possible, SIPC should acquire and give investors the securities that were in their accounts rather than mere cash. SIPC and the Trustee did not give investors such securities.

B. The Legislative History Showing The Congressional Intent.

The legislative history is continuous and overwhelming. It shall be set out in *extenso* in order to give its full overwhelming flavor.

1. SIPA Is Intended To Protect Investors, Especially Small Ones, And To Build Confidence in Markets.

1970 Hearings[3]: Treasury Secretary Kennedy quoted President Nixon as saying that "To further protect the *small investor*, I support the establishment of an insurance

[3] *Federal Broker-Dealer Insurance Corporation, Hearings on S. 2348, S. 3988, and S. 3989 before the Subcomm. on Securities of the S. Comm. on Banking and Currency*, 91st Cong. (1970) (herein "1970 Hearings") (Addnd., pp.1-13).

corporation with a Federal backstop to guarantee the investor against losses that could be caused by financial difficulties of brokerage houses." (Addnd., p.10 (emphasis added).) Kennedy himself said that "proposed legislation [was] to provide protection and insurance . . . to customers of brokers and dealers in securities." (Addnd., p. 10.) The SEC said that SIPC proceedings were "primarily for the protection of all customers of the broker dealer in question." (Addnd., p. 12.)

Major industry figures said that the bill's sponsor, Senator Muskie, had said it was "'to protect investors from loss because of the failure of broker dealer firms,'" and that they "accept the need to protect the individual investor from loss due to the failure of a broker or dealer." (Addnd., p. 9.) NYSE President Haack said concepts would "be blended in a way to increase the protection to investors." (Addnd., p. 6A.) Chairman Leslie of Bache & Co. said "I would like to say at the outset that the aims of the bill deserve support since an element of insurance protection would undoubtedly contribute to reinforcing public confidence in the securities industry." (Addnd., p.2.)

1970 House Report[4]: The Report said "The primary purpose of the reported bill is to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." (Addnd., p 14.) It further said that bankruptcies of brokerage houses "may lead to loss of customers' funds and securities with an inevitable weakening of confidence in the U.S. securities markets. Such lessened confidence has an effect on the entire economy . . . .[O]ne objective of the bill . . . is to provide investors protection against losses caused by the insolvency of their broker-dealer. The need is similar, in many respects, to that which prompted the establishment

[4] H.R. Rep. No. 91-598 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 5254 (herein "1970 House Report") (Addnd., pp. 14-19).

of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation." (Addnd., p. 15.)

1970 House Debate[5]: Chairman Staggers said the bill is "to provide greater protection for customers of registered brokers and dealers and members of national securities exchanges . . . ." (Addnd., p. 20.) Congressman Broyhill said "Contributions by the members would create a fund to protect customers when a broker-dealer fails to meet his financial obligations." (Addnd., p. 25.) Congressman Boland said this "legislation [is] to protect the *small investor*." (Addnd., p. 26, (emphasis added).) Congressman Rostenkowski said the bill "would protect investors from loss because of the failure of broker-dealer firms." (Addnd., pp. 27-28.) Congressman Anderson said "The purpose of this legislation, put quite simply, is to provide adequate protection for the investor in the event that his broker-dealer encounters financial difficulties." (Addnd., p. 27.) Congressman Vanik opined that "this legislation is essential in order to provide a greater degree of security for the investor." (Addnd., p. 27.)

1970 Senate Debate[6]: Senator Muskie said the Security Investor Protection Act of 1970 "would accomplish a similar purpose for securities investors [similar to FDIC insurance for bank deposits] by protecting them from losses because of the failure of their brokers." (Addnd., p. 30.) Senator Williams said that approval of the legislation "will go far toward restoring investor confidence in this country." (Addnd., p. 31.) Senator Williams further said that "The insolvency of a Goodbody or Dupont could create havoc in the securities industry due to the inter-relationship between broker-dealers. The real

[5] 116 Cong. Rec. 39345 (1970) (herein "1970 House Debate") (Addnd., pp. 20-28).

[6] 116 Cong. Rec. 40861 (1970) (herein "1970 Senate Debate) (Addnd., pp. 29-36).

losers would, of course, be our Nation's *small investors*, many of whom have invested a significant portion of their savings in securities. It is imperative that these investors, *who are the backbone of a healthy economy*, be fully protected, against brokerage firm failures." (Addnd., p. 32, (emphasis added).) Senator Bennett said "the primary purpose of the bill before us is to provide insurance protection for millions of individuals who are customers of brokers or dealers in securities throughout this country." (Addnd., p. 31.) Senators Hartke and Cranston both said that the bill would "protect securities investors against losses." (Addnd., pp. 33, 34.) Senator Proxmire said the legislation "will provide the customers of brokerage firms with protection in the event the brokerage firm fails." (Addnd., p. 35.)

1975 Hearings[7]: SIPC Chairman Owens said "Congress passed the 1970 Act . . ." to protect customers of failed broker/dealer against financial loss and, thereby restore investor confidence in the securities market." (Addnd., p. 38.) A representative of the NYSE said the purpose of proposed amendments "is the improvement of the protection afforded securities customers." (Addnd., p. 51.) Commissioner Loomis of the SEC said proposed amendments "will assure . . . speedier liquidations and better customer protection." (Addnd., p. 55.) A representative of the Securities Industry Association said that the proposed amendments would give "improved protection [that] provides for increased confidence in the use of markets." (Addnd., p. 57.)

[7] *Securities Investor Protection Act Amendments of 1975, Hearing on H.R. 8064 before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 94th Cong. (1975) (herein "1975 Hearings") (Addnd., pp. 37-59).

1977 House Report[8]: The Report said the proposed amendments "would provide investors with greater protection against the financial failure of stockbrokers, thereby enhancing investor confidence in the securities markets." (Addnd., p. 61.) It quoted Chairman Owens' statement that "In order to protect customers of failed broker/dealers against financial loss and, thereby, restore investor confidence in the securities markets, Congress passed the 1970 act. That statute . . . created SIPC and established a program whereby monies from the SIPC Fund would be available for the purpose of protecting customers of broker/dealer firms." (Addnd., p. 66.)

1978 Senate Hearings[9]: Senator Williams said "To restore public confidence in the securities markets and to protect public investors against the failure and insolvency of brokers and dealers, the Securities Investor Protection Act of 1970 was adopted." (Addnd., p. 71A.) Chairman Owens of SIPC said the 1970 law "established a program whereby monies from the SIPC fund would be available for the purpose of protecting customers of broker/dealer firms which encountered financial difficulty." (Addnd., p. 74.) SEC Commissioner Loomis, presenting the Commission's views, said "the SIPC Act is *most clearly directed" at "the small and frequently unsophisticated investor.*" (Addnd., p. 77, emphasis added.)

1978 Senate Report[10]: This Report said "The Securities Investor Protection Act of 1970 (SIPA) was enacted to provide to customers of securities broker-dealers

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[8] H.R. Rep. No. 95-746 (1977) (herein "1977 House Report") (Addnd., pp. 60-68).

[9] *Securities Investor Protection Act Amendments: Hearing on H.R. 8331 before the Subcomm. On Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 95th Cong. (1978) (herein "1978 Senate Hearings") (Addnd., pp. 71-77).

[10] S. Rep. No. 95-763 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 764 (herein "1978 Senate Report") (Addnd., pp. 78-83).

protection against losses which might occur as a result of the financial failure of broker-dealers." (Addnd., p. 78.)

1978 Senate Debate[11]: Senator Williams said "To restore public confidence in the securities markets and protect public investors against the failure and insolvency of brokers and dealers, the Securities Investor Protection Act of 1970 was adopted." (Addnd., p. 84.)

Brief Recapitulation: *The legislative history establishes overwhelmingly that SPA and its 1978 amendments were enacted to protect investors, especially small investors, and thereby build confidence in markets. The use of CICO, however, has devastated investors. And it has undermined their confidence in markets.*

2. SIPA Provides Insurance, In Emulation Of The FDIC.

1970 Hearings: Senator Muskie said "The United States now wisely insures bank deposits under the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation which are the models for the Federal Broker-Dealer Insurance Corporation. The FBDIC would give the investor, who leaves his savings with a broker, the same protection now afforded the depositor, who places his money in a bank." (Addnd., p. 3.) The Investment Company Institute said the legislation under consideration would "establish a system of insurance for customers of broker-dealers who are unable to meet their obligations to customers." (Addnd., p. 13.)

1970 House Report: The Report said that the need for protection of investors "is similar, in many respects, to that which prompted the establishment of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporations." (Addnd., p.15) The Report quoted the General Counsel of the Treasury

[11] 124 Cong. Rec. 11611 (1978) (herein "1978 Senate Debate") (Addnd., p. 84).

Department, who said that "on June 17, 1970, President Nixon . . . specifically endorsed the concept of insurance protection for investors in securities." (Addnd., p. 19A.)

1970 House Debate: Congressman Springer said ". . . we created what I would like to term the FDIC of the securities investors. The theory of FDIC, which is the Federal Deposit Insurance Corporation, which governs most banks in this country, is to create a fund to reimburse depositors of defunct banks. The temper of this legislation and the intent of this legislation, however, is exactly the same." (Addnd., p. 22.) Congressman Moss said "When we had bank failures in the 1930s, I remember I lost money in two banks and how happy I was to see when you had a Federal Deposit Insurance Corporation at least to guarantee your money, to whatever the figure was, around $10,000." (Addnd., p. 24.) Congressman Barrett said the legislation is "new insurance." (Addnd., p. 25.)

1970 Senate Debate: Senator Muskie said that SIPC "would administer an insurance fund," that the legislation calls "for an industry-financed insurance fund" (Addnd., p.30), that there would be "an insurance fund to protect the assets of investors," (*Ibid.*), and that "the insurance plan established by (the legislation) is a necessity." (Addnd., p. 31.) Senator Bennett said "the primary purpose of the bill before us is to provide insurance protection for millions of individuals who are customers of brokers or dealers in securities throughout this country."[12] (Addnd., p. 31.) Senator Cranston said

[12] The dismissive attitude of the Trustee and SIPC towards Senators and their effort to establish an insurance program was expressed at oral argument in the Bankruptcy Court by the Trustee's counsel; "if you look at the legislative history, one could be beguiled by some of the statements made erroneously by the senators there to the effect, yes there is insurance. They are wrong . . . ." (Addnd., pp. 94-95.)

that under the legislation "a nonprofit corporation would be set up to maintain and administer an insurance fund."[13] [14] (Addnd., p.34.)

3. An Investor's Reasonable Expectation Is That He Has What Is Shown In His Account Statement. And Congress' Legislation Encouraged Investors To Leave Their Securities In Street Name, So That They Had To Rely On Their Account Statements To Know What They Had.

1970 Hearings: Senator Williams said, and Peter Block replied, as follows: "I thought I understood Senator Muskie to suggest that under his bill there would be a greater ease in stock transfers through the encouraging of customers to leave their securities in street names with the brokers. Did that come out? Did I understand that correctly?" "That is correct." (Addnd., p. 9A.)

1975 Hearings: A representative of the Securities Industry Association said that the improved protection provided by the bill would "encourage customers to leave securities with the firm [i.e., in street name] rather than obtaining delivery," which was

[13] Because SIPA established an insurance fund, the SIPC fund was intended to be separate from the fund of "customer property." Thus, the 1977 House Report emphasized the distinction between customer property and the SIPC fund by saying that a customer "may file a claim against the general estate to the extent that his net equity exceeds his share of *customer property plus SIPC protection*, (Addnd., p. 65) (emphasis added). The Report quoted Chairman Owns of SIPC as follows: "In order to protect customers of failed broker/dealers against financial loss and, thereby, restore investor confidence in the securities markets, Congress passed the 1970 Act. That statute, which was signed into law on December 30, 1970, created SIPC and established a program whereby monies from the SIPC Fund would be available for the purpose of protecting customers of broker/dealer firms which encountered financial difficulty." (Addnd., p. 66.) Chairman Owens of SIPC said, in the 1978 Senate Hearings, that "customer property, briefly explained, consists of all cash and securities (*other than SIPC advances* and customer name securities) available to the trustee for the satisfaction of customer claims." (Addnd., p. 76 (emphasis added).) The 1978 Senate Report reiterated that "A customer may file a claim against the general estate to the extent that his net equity *exceeds his share of customer property plus SIPC protection*." (Addnd., p. 81) (emphasis added).) The Senate Report also said the legislation "provides that all cash and securities, *exclusive of SIPC advances . . . shall be deemed to be customer property*." (Addnd., p. 83 (emphasis added).)

[14] The dismissive attitude of SIPC and the trustee to the legislative history showing that Congress intended there to be two funds, not one, including a SIPC fund from which payments would be made, was expressed at the hearing in the Bankruptcy Court by the Trustee's counsel: "Your Honor, . . . let's not get confused over what we are dealing with here because we are in this case, because we are in Madoff, the world just doesn't go upside down. It stays right and steady. We stay with the fact that we are dealing with a fund, a fund of customer property, and it is out of that which distributions take place." (Addnd., p. 94.)

necessary in order "to provide an efficient national system for the clearance and settlement of securities transactions." (Addnd., p. 57.)

1977 House Report: The Report said "A customer generally expects to receive what he believes is in his account at the time the stockbroker ceases business." (Addnd., p. 61.) It also quoted SIPC Chairman Owens' statement that "customers generally expect to receive what is in their accounts when the member stops doing business." (Addnd., p. 67.)

4. Investors Are To Be Paid *Promptly*, Not After The Lapse Of Many Years.

1970 House Report: The Report said "Your Committee also believes that it is in the interest of customers of a debt or that securities held for their account be distributed to them as rapidly as possible in order to minimize the period during which they are unable to trade and consequently are at the risk of market fluctuations." (Addnd., p. 17.) It also said there was to be "prompt payment and satisfaction of the net equities of customers." (Addnd., p. 19.)

1975 Hearings: A task force report said there should be "prompt satisfaction of customer claims." (Addnd., p. 43.)

5. Investors Should Be Given The Securities That Were In Their Account Whenever Possible.

1970 House Report: The Report said "that it is intended that, to the extent possible, the Trustee will deliver to a customer against his claim for securities, the same securities (that is, securities of the same issuer, class and series) which were held for his account on the filing date." (Addnd., p. 17.)

1970 Senate Debate: Senator Bennett said that the legislation "assures a customer that he will receive securities he has purchased or cash he has left with a firm in the event that firm faces financial insolvency." (Addnd., p. 31.)

1975 Hearings: Chairman Owens of SIPC said that "The proposed amendments call for changes in the act which would enable the trustee, to a much greater extent than is now possible, to render accounts to customers in the same form as they stood when the firm went out of business." (Addnd., p. 55.) "If these recommendations are implemented, the current practice of paying cash in lieu of missing securities *would be eliminated for the most part.* Customers would receive, instead, the securities in their accounts. *Our expectation is that, in almost all cases, a customer's claim for securities would be satisfied by the delivery of securities*, and, where necessary, to accomplish this the trustee would go into the open market and purchase securities. We believe, however, that it is advisable to provide that the trustee would not be required to purchase securities where that could not be done in a fair and orderly market. One chief concern is that the trustee not be required to make purchases in a market which is being improperly controlled or manipulated . . . [O]ne of the principal goals of the proposed legislation is to make it possible for the trustee to render accounts to customers as they stood when the firm failed." (Addnd., p. 41, (emphasis added).) The Task Force said "A customer should receive securities to the maximum extent possible in satisfaction of a claim for securities. *Customers . . . should receive their accounts as they stood at the filing date,*" and for this purpose the trustee is authorized to "Purchase securities in the open market." (Addnd., p. 43, (emphasis added).) The Task Force further said "that customers' accounts should be reconstituted as they existed on the filing date with due regard for the limitations of

protection provided in the Act . . . [T]his policy best meets the legitimate expectations of customers . . . [It also] allows the customer to continue to exercise investment prerogatives with respect to his portfolio with minimal disruption." (Addnd., p. 44.) The Task Force also said "This subsection, carrying out one of the central recommendations of the Task Force, authorizes the trustee to purchase securities for the purpose of restoring customers, as far as possible to their positions as of the filing date (see TFR p.9). To the extent that he can do so in a fair and orderly market, the trustee would be expected to purchase securities to cover the deficiency remaining in a customer's account . . . ." (Addnd., p. 46.) SEC Commissioner Loomis said the amendments "would make it possible for SIPC to fulfill customer expectations, in almost all instances, restoring their securities to them rather than giving them cash in exchange for their claims, and would speed things up." (Addnd., p. 53.)

1977 House Report: *"One of the principal underlying purposes of these amendments, is to permit a customer to receive securities to the maximum extent possible instead of cash*, in satisfaction of a claim for securities. By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendments not only would satisfy the customer's legitimate expectations, but also would allow him to continue to exercise investment prerogatives and to avoid oftentimes adverse tax consequences." (Addnd., p. 61, (emphasis added).) "In order to increase the extent to which customer claims for securities are satisfied with securities rather than cash, the bill would authorize the trustee for a brokerage firm undergoing liquidation to make up for missing securities by purchasing shares, so long as this could be done in a fair and orderly market. The words 'fair and orderly market' are used to

assure that the trustee will not be forced to purchase securities in a market controlled by artificial influences. For example, a market might not be deemed fair and orderly where there were indications of manipulation by insiders or others." (Addnd., p. 62.) "The bill charges the trustee with the duties of a trustee under the Bankruptcy Act, plus special duties relating to the satisfaction of customer claims for securities by the distribution of securities to the maximum extent possible." (Addnd., p. 62.) "This section reflects *one of the essential features of the amendments*, namely the delivery of securities to customers to the greatest extent practicable in order to make customer accounts whole." (Addnd., p. 65 (emphasis added).) "In addition to authorizing the trustee to use SIPC funds to satisfy claims, this section authorizes a trustee to deliver securities in satisfaction of claims to the extent they are available. After the available securities have been distributed to satisfy such claims, the trustee shall purchase the balance of the shares in open market purchase. However, where there is no 'fair and orderly market' in which to purchase securities, the trustee is provided with authority to satisfy claims for securities with cash. Securities distributed to customers are to be valued as of the filing date." (Addnd., p. 65.) The Report quoted SIPC Chairman Owens' statement that "Our expectation is that, *in almost all cases*, a customer's claim for securities would be satisfied by the delivery of securities, and, where necessary, to accomplish this the trustee would go into the open market and purchase securities. We believe, however, that it is advisable to provide that the trustee would not be required to purchase securities where that could not be done in a fair and orderly market. One chief concern is that the trustee not be required to make purchases in a market which is being improperly controlled or manipulated." (Addnd., p. 68, (emphasis added).)

1977 House Debate: Congressman Eckhardt said the amendments would remedy the "failure to meet legitimate customer expectations of receiving what was in their account at the time of their broker's insolvency" (Addnd., p. 69), and that the legislation would "guarantee that customers' accounts are maintained as they existed prior to the liquidation. It would do this by allowing SIPC to go into the marketplace to replace securities if possible rather than returning cash to the customer." (Addnd., p. 70.)

1978 Senate Hearings: Senator Williams said the amendments move "toward a scheme of returning customers' accounts intact as they existed when the broker-dealer became insolvent. The benefits to the customers of firms in liquidation will be immeasurable since they will no longer be deprived for lengthy periods of the use of, or access to, their cash or securities." (Addnd., p. 71B.)

1978 Senate Report: The Report said "A *principal underlying purpose of the bill is to permit a customer to receive securities to the maximum extent possible* instead of cash, in satisfaction of a claim for securities. By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendments not only would satisfy the customers' legitimate expectations, but also would restore the customer to his position prior to the broker-dealer's financial difficulties." (Addnd., p. 79, (emphasis added).) "This section reflects *one of the essential features* of the amendments, namely the delivery of securities to customers to the greatest extent practicable in order to make customer accounts whole." (Appnd., p. 80 (emphasis added).) "A key objective of the bill is the satisfaction of a customer's claim for securities by the delivery of securities to the greatest extent possible. SIPC funds may be made available to the trustee to purchase securities to replace that part of a

customer's deficiency in securities whose value on the filing date did not exceed the limits of SIPC protection provided in subsection 9(A) of SIPA as amended." (Addnd., p. 81.)

1978 Senate Debate: Senator Williams said that the amendments would move "toward a scheme of returning customers' accounts intact as they existed when the broker-dealer became insolvent. The benefits to the customers of firms in liquidation will be immeasurable since they will no longer be deprived for lengthy periods of the use of, or access to, their cash or securities." (Addnd., p. 84.)

6. Theft And Missing Securities Were A Major Problem To Be Remedied By SIPA.

1970 Hearings: Senator Muskie said, "In addition to these problems, there have been huge thefts on Wall Street." (Addnd., p. 4.)

1975 Hearings: SIPC Chairman Owens said the proposed legislation is designed to remedy the problem that, although customers "generally expect to receive exactly what is in their accounts when the firm stops doing business," "that is not always possible because securities may have been lost . . . misappropriated, *never purchased*,[15] or even stolen." (Addnd., pp. 39-40, (emphasis added).)

1977 Report: The 1977 House Report says "A customer generally expects to receive what he believes is in his account at the time the stockbroker ceases business. But because securities may have been lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, this is not always possible." (Addnd., p. 61, (emphasis added).) The Report further quoted Chairman Owens as saying "customers generally

[15] Failure to purchase securities paid for by investors is the very hallmark of a Ponzi scheme, of course. Nor did Congress ever give the slightest indication that SIPA was not to apply full force to Ponzi schemes.

expect to receive what is in their accounts when the member stops doing business . . . But in many instances that has not always been possible because securities have been lost . . . misappropriated, *never purchased*, or even stolen." (Addnd., p. 67, (emphasis added).)

1978 Senate Report: The Report says, "Under present law, because securities belonging to customers may have been lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, it is not always possible to provide to customers that which they expect to receive, that is, securities which they maintained in their brokerage account." (Addnd., p. 79 (emphasis added).)

II. THE CONGRESSIONAL INTENT, NOT THE CONTRARY IDEAS OF SIPC AND THE TRUSTEE, NECESSARILY CONTROLS.

Under our system, Congressional intent, not the contrary ideas of SIPC and the Trustee, is dispositive. The use of the final statement method carries out the Congressional intent. CICO vitiates it. By using CICO, SIPC and the Trustee are poking a finger in the eye of Congress.

In implicit recognition that CICO vitiates Congressional intent, SIPC and the Trustee have presented, to the public and the courts, a plethora of arguments *not* based on Congressional intent. The arguments are irrelevant in the face of the contrary Congressional intent, and often are wrong or dubious on their own terms as well.

The major argument of SIPC and the Trustee to the public and the courts ultimately became that CICO should be used, rather than the final statement method, because the entire Madoff deal was phony (phoniness which required only mere statement, not page after page of elaboration apparently intended to psychologically affect the public and the courts).

But Congress did *not* intend that investors should be denied protection because relevant dealings were faked, never existed, or ceased to exist. On the contrary, the legislative history *explicitly* says SIPA applies where securities were "*never purchased* or even stolen," or were "misappropriated." (Addnd., pp. 61, 79 (emphasis added).; Statement of Chairman Owens (Addnd., p. 67.) (emphasis added). Nor did Congress say SIPA does not apply to Ponzi schemes -- which had been well known for decades when SIPA and its amendments were enacted. Ponzi schemes are, after all, merely a form of theft and embezzlement, and Congress' repeated statements that SIPA applies where securities were "never purchased," or were "stolen" or "misappropriated" shows that SIPA applies where there has been theft and embezzlement, as in Madoff.

SIPC and the Trustee also have said CICO should be used because it is not fair for people who took out more than they invested to receive payments from SIPC since this will diminish SIPC payments to others. This purported fairness argument further runs that people who have *not* taken out more than they put in are investors who came late to Madoff and whose claims are therefore for principal, but those who took out more than they put in are long term investors whose claims are for phony profits.

But the claims of many long term investors were extensively for principal, and it is *not true* that a payment from the SIPC fund to an investor diminishes SIPC fund payments to other investors. The SIPC fund is a separate fund raised by assessments on the financial industry and, if necessary, from lines of credit. If it lacks sufficient monies to pay all victims, the remedy is to increase assessments or to create or tap lines of credit.

The remedy envisioned by Congress is certainly *not* to deny SIPC payments to innocent victims.[16]

Nor does the argument of SIPC and the Trustee equate to fairness. Congress wanted to protect small investors, and, while SIPC and the Trustee know but refuse to disclose numbers, it is clear that hundreds or thousands of Madoff victims are older *small* investors who were with Madoff for ten to thirty years, and had to use their Madoff income for their living expenses and/or to pay their taxes on Madoff income. They planned their lives around their Madoff investments and income, had to rely on the brokerage statements they received from Madoff to know what was in their accounts, as Congress thought typically the case (they had no other way to know what was in their accounts), and are now wiped out financially in their 70s or 80s. Instead of being protected by receiving up to $500,000 from SIPC on which to live, these small investors are being devastated.

To deny SIPC payments to impoverished innocent small persons who are now in poverty is the very opposite of Congress' intent to protect small people. And, as said, SIPC and the Trustee possess but have not disclosed the number of people in this category -- the number could, of course, contravene their claims of fairness.[17]

Beyond this, not only are the now-impoverished who have negative net equities under CICO being denied payments from SIPC, but they will also be denied payments from customer property because only those with a *positive* net equity are eligible for such

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[16] Because the SIPC fund and customer property are two entirely separate funds, victims must be paid up to $500,000 out of the SIPC fund even if the Trustee does not recover a dime of customer property.

[17] In claiming fairness, SIPC and the Trustee ignore that any person or fund who took out all of his money from Madoff more than six years before Madoff collapsed is safe from clawbacks no matter how much he made from Madoff and no matter how wealthy he is.

payments. This could be *very* consequential because the Trustee has brought suits to recover somewhere between 13 and 15 billion dollars in customer property, and could recover many billions of the claimed amounts. In fact, in a National Public Radio interview of July 27th, the Trustee said that 18 to 20 billion dollars of cash-in is his "working number" of cash invested in Madoff as of December 11, 2008, and that "I'm hopeful that we can return upwards of 50 cents or even more on the dollar to people." (Addnd., pp. 106-107.) Moreover, recent numbers indicate that payments to those who are eligible under CICO to receive customer property will only be in the range of five billion dollars, and the Trustee has explicitly stated that he wants to give the remainder to SIPC. So not only will small investors get *no* payment from the SIPC fund under CICO and *no* share of customer property, but *SIPC* will get billions in customer property that would go to impoverished Madoff victims if the traditional final statement method were used.

CONCLUSION

SIPC's and the Trustee's use of the rarely used CICO threatens the efficacy of SIPA for *all* investors. For an investor cannot know in advance whether an investment is legitimate, or instead is a Ponzi scheme under which she withdraws money on peril of losing SIPC protection and being subject to clawback. Protection of customers, building confidence in markets, recognition of reasonable expectations, and all the other elements of Congressional intent which are contravened by CICO require rejection of CICO and use of the normal final statement method. Congress should therefore reaffirm that the final statement method is the proper way to determine an investor's net equity.

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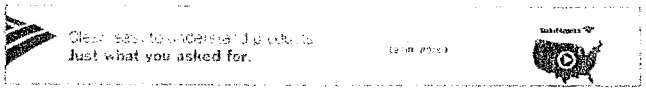

INVESTOR BEWARE; Many Holes Weaken Safety Net For Victims of Failed Brokerages

By GRETCHEN MORGENSON
Published: Monday, September 25, 2000

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Kevin Heebner, owner of a building supply store in Temple, Pa., got a call four years ago from his longtime stockbroker recommending an investment in short-term bonds. Assured the bonds were safe, Mr. Heebner invested $100,000.

Three months later, Mr. Heebner received a stunning phone call. The broker told him the money he had put into the bonds was gone. The president of the broker's firm, Old Naples Securities, had stolen it.

With his wife about to deliver their third child, Mr. Heebner, 36, reeled at the thought of a $100,000 loss. Then he remembered with relief that his account was insured by the Securities Investor Protection Corporation, created by Congress in 1970 to protect investors' brokerage accounts from just the sort of theft he had been a victim of. "I knew that if they didn't find the money from Old Naples Securities, I was insured through S.I.P.C.," Mr. Heebner recalled. The broker's "business card and letterhead all had S.I.P.C. logos on them; I figured S.I.P.C. would cover it."

Mr. Heebner figured wrong. For more than four years, the corporation maintained he was entitled to nothing -- even though three federal courts ruled that S.I.P.C. should pay him $87,000. Only last week, days after a reporter interviewed the lawyer representing the corporation about Mr. Heebner, did the investor receive a check in the amount of $87,000.

"I never got the sense that S.I.P.C. was in any way trying to help my client," said William P. Thornton Jr., a lawyer at Stevens & Lee in Reading Pa., representing Mr. Heebner against the corporation. "They are very aggressive in attempting to prove that investors' claims do not come within certain legal definitions within the S.I.P.C. statute. And the loser is the investor."

At a time when millions of United States citizens have taken their money out of federally insured banks and put it into brokerage firms, the Securities Investor Protection Corporation's charge of protecting the investing public has never been more important.

Officials of the S.I.P.C. defend the corporation's record and say they must be vigilant in protecting against invalid claims by investors.

But a close look at this little-understood organization shows that the safety net that investors believe the corporation offers is in fact full of holes.

Industry-financed but not government-backed, the corporation is a far cry from the

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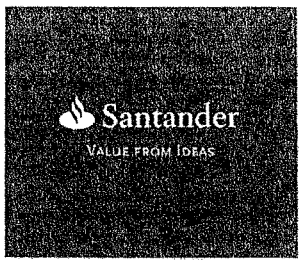

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agency on which it was loosely modeled, the Federal Deposit Insurance Corporation, which protects bank customers against losses.

Created three decades ago after a number of brokerage firm failures and securities thefts, the corporation is chartered to protect each investor with securities held at a member brokerage firm for up to $500,000; claims for cash are limited to $100,000 a customer.

But convincing the corporation to pay can be extremely difficult. The organization, requires investors to run a gantlet of legal technicalities that would challenge even those knowledgeable about securities law.

Some securities lawyers say this is because trustees overseeing the cases are chosen by, and paid by, the corporation. This differs from the independent trustees who are appointed by the court to handle corporate bankruptcy cases, and who are working for the people owed money.

Indeed, the trustees working for the investor protection corporation -- many of them from a coterie of lawyers who have made a lucrative specialty of such cases -- have received far more from representing the corporation than the corporation itself has paid to investors. Their critics say that trustees wanting repeat business from the corporation have an incentive to minimize payouts to investors. One trustee is the former president of the corporation.

In Mr. Heebner's case, the corporation made several arguments. First, because the investor had sent his money not to Old Naples but to a subsidiary, his investment was not covered. In addition, because the corporation could find no proof that bonds had ever been bought with the $100,000, the organization assumed Mr. Heebner had given the money to the brokerage firm as a loan. Lenders are not covered by the corporation.

"Although these legal arguments may follow the letter of the investor protection act, S.I.P.C.'s reliance on them is reminiscent of a private insurance company trying to use every conceivable esoteric legal stratagem to avoid customer claims," said Lewis D. Lowenfels, a lawyer at Tolins & Lowenfels in New York and a leading authority in securities law.

The list of what the corporation does not cover is long. For one thing, while $100,000 placed in a bank account insured by the Federal Deposit Insurance Corporation is covered regardless of why the bank failed, assets lost in a failed brokerage firm are not covered if the loss is a result of most kinds of securities fraud, including a failure to execute a purchase or sale of securities or misrepresentation in the sale of a stock or bond. Losses from unauthorized trading, a large problem among small brokerage firms in the 1990's, are covered only if an investor can prove to the satisfaction of corporation representatives that he complained promptly to the firm.

In addition, because the act that created the corporation covers only securities held by a failed brokerage firm, customers whose firms handle their trades through other brokerage firms may not have a claim for coverage by the corporation.

Additionally, cash held in a brokerage account that is not earmarked for a securities purchase is not covered by the organization. Nor is an investment in gold, other commodities or a limited partnership.

"The bottom line is S.I.P.C. is outdated and needs to be reviewed," said Joseph P. Borg, securities commissioner for Alabama. "It's been around since 1970, when one in 10 Americans were in the markets. Now everyone is in the markets. And everyone thinks that S.I.P.C. logo reads F.D.I.C., but the protection is very limited."

The corporation's president, Michael E. Don, disagrees with accusations that his organization does not put investors first.

"It simply is not true that protecting our fund is our interest," he said. "Our interest is to

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see to it that customers get paid." Mr. Doyt added that when the corporation considered an investor's claim invalid, it had no choice but to fight the investor in court, as it did Mr. Heebner.

The Beginning

Create an Equivalent Of the F.D.I.C.

The corporation started as an idea of Edmund S. Muskie, the former Democratic senator from Maine. He introduced a bill in 1969 to create a Federal Broker-Dealer Insurance Corporation that would insure brokerage firm customers against losses, as the F.D.I.C. does with bank depositors. A group representing the securities industry countered with a proposal that its chairman said would maintain public confidence in the securities markets without creating "a vast new governmental agency." The S.E.C. joined the group and drafted a proposal that was largely accepted by lawmakers.

The investor protection corporation and the F.D.I.C. are vastly different. While the F.D.I.C. is an agency of the federal government and its insurance fund is backed by the full faith and credit of the government, the corporation is financed by the securities industry and can borrow from the government, with special approval, only in emergencies. It also maintains a $1 billion line of credit with a consortium of banks.

And while bank examiners employed by the F.D.I.C. routinely monitor risks at banks, the corporation steps in only when a brokerage firm has collapsed or is close to failure.

Another difference is that a brokerage firm, no matter how large or troubled, pays just $150 a year to be a S.I.P.C. member, while payments into the F.D.I.C. insurance fund are based on a bank's size and financial health: the riskier the bank, the larger the fee. Although the healthiest banks have not had to pay into the fund for several years because it has grown so large and bank failures have been few, a financially vulnerable bank with $100 million in insured deposits would have had to pay $270,000 a year to the F.D.I.C. fund this year.

Not long ago, brokerage firms paid much more to be members of the corporation. Between 1991 and 1995, firms were levied an amount based on their net operating revenues. In 1995, for instance, members were required to pay 0.095 percent of such revenues and the organization received $43.9 million. But when the S.I.P.C. fund reached $1 billion, the corporation cut the levy to $150 a member. Last year, the corporation received $1.14 million in fees.

When a bank fails, the F.D.I.C. steps in to keep it operating or close it and return assets -- up to $100,000 per depositor -- to their rightful owners. The F.D.I.C., created in 1934, typically resolves bank failures by arranging for another institution to assume the crippled bank's deposits and other assets. This has the effect of keeping most failed banks open and operating, if under a new name.

When a brokerage firm fails, the wheels grind much more slowly. First, the corporation applies to the appropriate court to issue a protective order. If it does, the corporation chooses a trustee to oversee the liquidation of the brokerage firm.

The corporation has presided over the liquidation of 282 brokerage firms. In the 247 cases completed through the end of last year, the corporation had returned $3.38 billion to customers in cash and securities. More than 90 percent of this money -- $3.15 billion -- came straight from the accounts of customers of the failed firms.

The corporation itself has paid investors $233 million over almost 30 years. But that amount is far less than the money received by the lawyers that act as trustees and the firms that help them shepherd the cases through the bankruptcy courts, trying to recover additional assets from the failed brokerage firms and assessing customer claims for validity. Since 1971, trustees have received $320 million, 37 percent more than has been paid to wronged investors.

The money the trustee receives comes from two sources: the assets of the failed brokerage firm and the corporation itself. As is typical in most bankruptcy cases, the corporation's trustees are paid first, customers second.

The corporation made its biggest payout to investors last June when it paid $31 million to about 10,000 customers of Sunpoint Securities, a Texas brokerage firm that failed last November when some of its officials stole $25 million, according to prosecutors.

The corporation's move to repay Sunpoint customers was swift indeed. But according to people close to the case, the failure was unusual in its simplicity. Unlike most brokerage failures, which involve accounts that hold a variety of stocks and bonds, in the Sunpoint case the missing funds had been placed in a money market fund at the firm. As a result, all the customers' claims were identical and a result of the same theft, making it comparatively easy for the corporation's trustee to resolve.

Most brokerage firm liquidations drag on for years. For instance, the trustee was recently still billing for litigation in the 1985 failure of Donald Sheldon & Company, a New York brokerage firm. The corporation said that all the customers' claims it considered valid were paid early on, but that the trustee has been trying to recover assets from principals of the firm to defray the costs of administering the liquidations. Indeed, the trustee recently won $11 million from an insurance company that had underwritten officer and director insurance for the firm.

A Nasty Example

A Look at the Case Of Stratton Oakmont

The case of Stratton Oakmont, a small but notorious brokerage firm based in Lake Success, N.Y., has been particularly protracted and acrimonious. The firm was expelled from the industry by securities regulators four years ago, and the corporation stepped in after the firm was closed. Last fall, Stratton's two owners pleaded guilty to federal charges of securities fraud and money laundering; investors lost hundreds of millions of dollars during the 10 years the firm operated.

Nevertheless, of the 3,368 customers who submitted claims for S.I.P.C. coverage in the failure, as of last May only 34 had been deemed entitled, to a total of $2.1 million, according to the trustee overseeing the case. The corporation's executives and Weil Gotshal & Manges, the law firm representing the trustee in the case, argue that only 1 percent of the Stratton customers seeking remuneration from the corporation are entitled to payments.

Adam Rogoff, a partner at Weil Gotshal & Manges who is the lawyer for the trustee, Harvey R. Miller, also a partner at the firm, said: "We look for credible evidence that there was a contemporaneous reaction; we look for a letter to the company; for a complaint; for a lawsuit or an arbitration. Otherwise people take advantage of an opportunity to revisit trades and say they were unauthorized when they weren't."

Mr. Don, the corporation's president, said: "The Securities Investor Protection Corporation was not chartered by Congress to combat fraud."

While 34 investors had received $2.1 million, the professionals overseeing the case had received $7 million as of the end of May. Most of that amount -- $4.3 million in fees and expenses -- has been paid to Weil, Gotshal. The payments do not yet include the fees charged by the trustee, Mr. Miller.

Mr. Miller and his colleagues have spent a lot of time trying to recover assets of Stratton Oakmont principals. So far, success has been limited. According to bankruptcy court documents through May, Weil Gotshal, which has spent $8.8 million, has recovered $3.6 million in assets.

Mr. Rogoff, the lawyer for Mr. Miller, said: "You can't analyze it from a balance-sheet

perspective. There are costs attendant to administering the case. We have a staff, we have office space -- these are all costs relating to the process."

Asked whether the corporation is concerned about Mr. Miller's spending, Mr. Don said: "We have reason to believe that Harvey Miller has a reasonable shot at collecting substantial sums of money in this case. We take very seriously our responsibility to make sure that the trustees don't overspend the general estate's money and our money."

Indeed, Mr. Don argued that the fees charged by trustees are necessary to fend off false claims filed by investors and to locate hidden assets held by principals of failed firms.

Stephen Harbeck, general counsel at the corporation, said that trustees' bills were typically paid as submitted. "I don't believe we have made any substantial requests for adjustments because we believe the fees they have charged are appropriate to the task involved," he said.

A key problem with S.I.P.C. liquidations, some securities lawyers say, is that trustees overseeing the cases have allegiance to the corporation that appointed them, rather than to wronged investors. To be truly in the corner of investors, these people say, trustees in brokerage firm liquidations should be completely independent of the corporation, which naturally wants to protect its assets. Trustees are indeed independent in corporate or personal bankruptcy cases because they are appointed by the bankruptcy court.

Mr. Don denied that trustees work to deny claims on the corporation's behalf. "It is a false argument," he said. "Since 1970, S.I.P.C. has advanced $354 million in order to make possible the recovery of $3.3 billion in assets for an estimated 440,000 investors. S.I.P.C. estimates that more than 99 percent of eligible investors have been made whole in the failed brokerage firm cases that it has handled."

But it is impossible to say how many investors the corporation has considered ineligible over the years might have prevailed if they had had the money or tenacity to battle the corporation in multiple courts, as Mr. Heebner did.

A coterie of bankruptcy lawyers does get repeat business from the corporation. Irving H. Picard, a partner at Gibbons, Del Deo, Dolan, Griffinger & Vecchione in New York, has been appointed trustee in four brokerage firm failures the last nine years, and J. William Holland of Holland & Holland in Chicago has overseen three liquidations since 1990. Five other lawyers have overseen two or more liquidations for the corporation the last decade.

No surprise, Mr. Don said. "We look for trustees who have developed expertise in liquidating stockbrokers and satisfying customer claims," he said. "That's why we've gone back to Harvey Miller, Irving Picard and we went to Ted Focht, because there's probably no one in the country who knows more about liquidating a stockbroker than he does."

Theodore H. Focht is the trustee in the Old Naples case who kept Mr. Heebner at bay until this month. Retired and living in Florida, Mr. Focht was general counsel at the corporation when it was created and remained its chief lawyer for 24 years. According to Mr. Don, Mr. Focht wrote the 1970 statute that gives the corporation its charges. He was the corporation's president for a decade until he retired in 1995. The next year, he was appointed by the corporation to oversee the Old Naples liquidation. Mr. Focht hired the law firm of Foley & Lardner to help him litigate the case.

Mr. Focht denied Mr. Heebner's $100,000 claim for S.I.P.C. coverage from the outset. First, he said, Mr. Heebner erred by sending his investment money not to the brokerage firm but to a related entity, Old Naples Financial Inc. S.I.P.C. protection is afforded only to investors whose assets are held by the brokerage firm that fails.

In addition, Mr. Focht argued that the $100,000 Mr. Heebner had sent to his broker represented a loan to Old Naples and was not for the purchase of bonds, as the investor

said. Loans are not covered by the corporation.

Mr. Heebner's lawyer objected to the trustee's ruling, and at a hearing in February 1998 in federal bankruptcy court in Florida, the investor told his story. The next month a judge ruled that Mr. Heebner was entitled to S.I.P.C. insurance in the amount of $87,000, reflecting a reduction of $13,000 in interest the investor had earned on the investment before the failure of Old Naples.

Mr. Focht appealed to a Florida district court, which ruled for Mr. Heebner in February 1999. Mr. Focht then appealed the district court decision to the Federal Court of Appeals for the 11th Circuit, which heard arguments on the matter last May.

On Aug. 23, the appellate court ruled in favor of Mr. Heebner and two other customers with similar cases -- the other two lost a total of $610,000. Because the president of Old Naples had misappropriated clients' funds, the firm's failure was just the situation the corporation was supposed to protect against, the appellate court opinion stated.

Reached on Sept. 6, Mr. Focht said he was still deciding whether to appeal the ruling. Less than a week later, Mr. Heebner received a letter stating that he would be paid the $87,000.

Not counting Mr. Heebner and the two other investors that are now receiving remuneration on their claims, 21 of the 156 Old Naples customers seeking remuneration from the corporation had received $2 million since the firm failed.

As of last May, the most recent filing made in the case, Mr. Focht and Foley & Lardner had billed approximately $660,000 for their services.

The Catch

A Key Argument In Denying Claims

Some securities lawyers and regulators say that the arguments used by the corporation to justify the denial of Mr. Heebner's claim for more than four years are characteristic of the corporation's approach to investor protection. "It's part of the gantlet to make it as difficult as possible for an investor to make a recovery," said Mark Maddox, a former Indiana securities commissioner who is now a lawyer representing victims in the Stratton Oakmont case.

Indeed, one argument used to deny many investors' claims in the Stratton Oakmont case, if applied to all brokerage firm failures, would disqualify millions of investors from S.I.P.C. coverage even though their brokerage firms are members of the organization.

Mr. Miller, the trustee at Weil Gotshal, has argued successfully to the bankruptcy court that Stratton customers do not qualify for S.I.P.C. coverage because their assets were not held physically at Stratton, they were held at the firm that cleared Stratton's trades. The act of Congress that created the corporation states that the coverage extends only to customers of firms that hold their assets. Customers of a failed broker that used another firm to clear its trades and conduct administrative duties do not qualify.

This delineation may have made sense in 1970, when most brokerage firms cleared their own trades. But today, most of the nation's brokerage houses use clearing firms to carry out their customers' transactions and administer accounts. Using Mr. Miller's argument, customers of these firms, were they to fail, could get no satisfaction from the corporation.

"The argument may be technically correct under the law," said Mr. Borg, the Alabama securities commissioner, "but it insulates a lot of people who sell stocks. It indicates even more reason why S.I.P.C. has to be re-examined."

The corporation is overseen by a board of seven, five of whom are appointed by the president. Three of the five represent the securities industry and two, including the

chairman and vice chairman, are appointed to represent the general public. The two other directors are appointed by the secretary of the Treasury and the Federal Reserve Board.

The chairman, Clifford Hudson, is chief executive of the Sonic Corporation, an Oklahoma City operator of fast-food restaurants. Mr. Hudson, who has been chairman six years, declined to discuss specific cases. "My belief is that as the statute was originally intended, S.I.P.C. management does a good job of implementing it," he said. "There are people today who would like to see the nature of that coverage expanded. That could happen, but Congress would have to change the statute."

How the corporation compensates investors and whether it does so fairly is the subject of a study being done by the General Accounting Office that was requested by Representative John Dingell, Democrat of Michigan. The report is due next March.

Robert M. Morgenthau, the Manhattan district attorney, who has aggressively pursued fraudulent brokerage firms to help wronged investors recoup some of their losses, said: "The investor protection act has to be revisited for two reasons. It doesn't cover a majority of investors' losses, such as those incurred by fraud or malfeasance, and the red tape that is involved for investors trying to recover is incredible."

The corporation has been relatively free of scrutiny since it was created. In that period, the Securities and Exchange Commission has inspected the organization twice, once in 1985 and again in 1994. Three months ago, the S.E.C. began another regular inspection.

"We're telling people to go into the market; it's safe; it's transparent and that we're going to watch out for their interests," Mr. Borg said. "But S.I.P.C. does not provide for a lot of protection, and I think that's a defect of the law."

Photos: Harvey R. Miller of Weil Gotshal & Manges was the trustee in the Stratton Oakmont case. (Carol Halebian for The New York Times)(pg. A24); Kevin Heebner battled the Securities Investor Protection Corporation to recover part of an investment. (Sal DiMarco Jr. for The New York Times)(pg. A24) Chart: "Legal Rewards" Since 1971, the Securities Investor Protection Corporation has paid investors less than lawyers have received for their work. Investors -- $233 million Lawyers -- $320 million (Source: S.I.P.C.)(pg. A1) Chart: "How Investors Fared When They Sought Help Customers who file claims with the Securities Investor Protection Corporation sometimes ask to be reimbursed for assets they deposited with brokers that subsequently went out of business. Their claims are often denied by trustees hired by the corporation to oversee liquidations. Here are some cases the corporation has handled involving the failure of brokerage firms. In each case, the corporation says that all investor claims have been satisfied. BIGGEST CASES THAT HAD FINAL CLAIMS SETTLED IN 1999 BUT LITIGATION IS PENDING Donald Sheldon & Company TRUSTEE APPOINTED -- Aug. 1985 CUSTOMERS GETTING DISTRIBUTIONS -- 2,362 PERCENTAGE OF CLAIMS PAID -- 95.7 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- $7.40 AMOUNT RECEIVED BY TRUSTEES (millions) -- $ 11.70 Chicago Partnership Board TRUSTEE APPOINTED -- Dec. 1997 CUSTOMERS GETTING DISTRIBUTIONS -- 1,028 PERCENTAGE OF CLAIMS PAID -- 61.3 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 2.96 AMOUNT RECEIVED BY TRUSTEES (millions) -- 2.89 Hanover Sterling & Company TRUSTEE APPOINTED -- April 1996 CUSTOMERS GETTING DISTRIBUTIONS -- 148 PERCENTAGE OF CLAIMS PAID -- 12.6 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 1.98 AMOUNT RECEIVED BY TRUSTEES (millions) -- 1.48 A. R. Baron & Company TRUSTEE APPOINTED -- July 1996 CUSTOMERS GETTING DISTRIBUTIONS -- 66 PERCENTAGE OF CLAIMS PAID -- 11.9 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 2.34 AMOUNT RECEIVED BY TRUSTEES (millions) -- 6.33 Euro-Atlantic Securities TRUSTEE APPOINTED -- Oct. 1998 CUSTOMERS GETTING DISTRIBUTIONS -- 63 PERCENTAGE OF CLAIMS PAID 8.7-- AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 1.97 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.75 M. Rimson & Company TRUSTEE APPOINTED -- Sept.

1997 CUSTOMERS GETTING DISTRIBUTIONS -- 30 PERCENTAGE OF CLAIMS PAID-- 4.8 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) --0.36 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.59 CASES FINISHED FROM 1997-99, WITH ALL CLAIMS AND LITIGATION SETTLED Bell & Beckwith TRUSTEE APPOINTED -- Feb. 1983 CUSTOMERS GETTING DISTRIBUTIONS -- 6,964 PERCENTAGE OF CLAIMS PAID-- 100.0% AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- $23.70 AMOUNT RECEIVED BY TRUSTEES (millions) -- $13.20 Joseph Sebag TRUSTEE APPOINTED -- July 1981 CUSTOMERS GETTING DISTRIBUTIONS -- 3,853 PERCENTAGE OF CLAIMS PAID -- 89.9 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 6.51 AMOUNT RECEIVED BY TRUSTEES (millions) -- 9.73 First State Securities TRUSTEE APPOINTED -- July 1981 CUSTOMERS GETTING DISTRIBUTIONS -- 824 PERCENTAGE OF CLAIMS PAID -- 88.0 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.63 AMOUNT RECEIVED BY TRUSTEES (millions) -- 5.87 Omni Mutual TRUSTEE APPOINTED -- May 1988 CUSTOMERS GETTING DISTRIBUTIONS -- 372 PERCENTAGE OF CLAIMS PAID -- 91.2 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 1.70 AMOUNT RECEIVED BY TRUSTEES (millions) -- 3.91 First Securities Group of Calif. TRUSTEE APPOINTED -- Jan. 1992 CUSTOMERS GETTING DISTRIBUTIONS -- 233 PERCENTAGE OF CLAIMS PAID -- 43.1 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 5.00 AMOUNT RECEIVED BY TRUSTEES (millions) -- 1.34 First Ohio Securities TRUSTEE APPOINTED -- June 1990 CUSTOMERS GETTING DISTRIBUTIONS -- 117 PERCENTAGE OF CLAIMS PAID -- 56.3 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.86 AMOUNT RECEIVED BY TRUSTEES (millions) -- 1.23 First Lauderdale Securities TRUSTEE APPOINTED --Nov. 1994 CUSTOMERS GETTING DISTRIBUTIONS -- 49 PERCENTAGE OF CLAIMS PAID -- 39.5 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 2.30 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.16 Barrett Day Securities TRUSTEE APPOINTED -- June 1996 CUSTOMERS GETTING DISTRIBUTIONS -- 20 PERCENTAGE OF CLAIMS PAID -- 6.6 AMOUNT S.I.P.C. PAID TO INVESTORS (millions)-- 0.19 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.02 Sun Securities TRUSTEE APPOINTED -- March 1992 CUSTOMERS GETTING DISTRIBUTIONS-- 19 PERCENTAGE OF CLAIMS PAID -- 24.4 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.37 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.20 Portfolio Asset Management TRUSTEE APPOINTED -- Aug. 1993 CUSTOMERS GETTING DISTRIBUTIONS -- 17 PERCENTAGE OF CLAIMS PAID -- 1.8 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.59 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.67 U.S. Equity Management TRUSTEE APPOINTED -- Sept. 1995 CUSTOMERS GETTING DISTRIBUTIONS -- 15 PERCENTAGE OF CLAIMS PAID -- 83.3 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.65 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.26 Harrington Securities TRUSTEE APPOINTED -- Aug. 1995 CUSTOMERS GETTING DISTRIBUTIONS -- 13 PERCENTAGE OF CLAIMS PAID -- 11.1 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.05 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.08 Doviak Securities TRUSTEE APPOINTED -- Aug. 1993 CUSTOMERS GETTING DISTRIBUTIONS -- 12 PERCENTAGE OF CLAIMS PAID -- 41.3 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.11 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.54 Williams Financial Group TRUSTEE APPOINTED -- Dec. 1989 CUSTOMERS GETTING DISTRIBUTIONS -- 11 PERCENTAGE OF CLAIMS PAID -- 45.8 AMOUNT S.I.P.C. PAID TO INVESTORS (millions) -- 0.37 AMOUNT RECEIVED BY TRUSTEES (millions) -- 0.08 (Source: Securities Investor Protection Corporation)(pg. A24)

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