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"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. <u>Avoidance Actions and Fraudulent Conveyances</u>. 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. <u>Beneficial or Indirect Investors</u>. 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. <u>Should SIPC trustee be subject to Bankruptcy Court approval?</u> <u>Have SIPC trustees been efficient and effective?</u> 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. <u>Is the standard for filing a SIPC claim too low?</u> 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. <u>Are SIPC's direct payment procedures effective and efficient?</u> I believe proposals may be forthcoming in this regard from the Task Force, but it is premature to comment at this stage.

e. <u>Does the statutory definition of "customer" eligible for SIPC coverage remains adequate?</u> 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. <u>Whether investment advisers should be included under SIPC and subjected to assessments or included a similar protection regime?</u> 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. <u>What other legislative changes could be made to clarify SIPA's provisions?</u> 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.