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

**HEARING ON A LEGISLATIVE PROPOSAL
TO AMEND THE SECURITIES INVESTOR PROTECTION ACT**

NOVEMBER 21, 2013

I. Introduction

Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee:

My name is Ira Hammerman, and I am Executive Vice President and General Counsel of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for allowing me the opportunity to testify today.

I would like to begin by expressing my deepest sympathy for the victims of the Madoff and Stanford schemes. I have family and friends whose financial lives were forever adversely impacted on December 11, 2008 and for whom life "post-Madoff" is a tremendous burden. I know from up close and personal interactions the havoc caused to individuals, retirees and wonderful charities by Madoff and the feeder funds that never even disclosed they were investing with Madoff.

So I understand, and in fact applaud, the tenacity being expressed by Chairman Garrett and Ranking Member Maloney as they seek to help their constituents and the investing public at large. I also commend Chairman Garrett and Ranking Member Maloney for recognizing more generally the need to consider changes to the Securities Investor Protection Act ("SIPA") in order to better protect investors and increase investor

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to develop policies and practices that strengthen financial markets and encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association.

confidence in the financial markets. I served on the 2012 task force that undertook a comprehensive review of SIPA and the operations and policies of the Securities Investor Protection Corporation ("SIPC"), and I agree there are proposals for reform that warrant consideration. I am sure you are familiar with the recommendations made by the SIPC Modernization Task Force (the "Task Force") to SIPC's Board of Directors, and I will address some of the recommendations in my remarks as well.

However, while I supported the recommendations of the Task Force, I noted at the time that they were made without any analysis of their cost to SIPC, the members of SIPC or, ultimately, the investing public. This concern is even more pressing with respect to the proposed legislation. The draft bill would not make tweaks or adjustments to the law that's been on the books nearly 44 years, but rather would introduce a new public policy objective for SIPA and SIPC – namely, insuring investors against the risk of loss due to securities fraud. It is certainly within the prerogative of Congress to enact a bill that would represent such a tremendous departure from the legislative intent and historical practice of SIPA and would materially expand SIPC's mandate, but we believe the costs would be extraordinarily high.

We have some specific concerns about the proposed bill that I'd like to share with you today. More importantly, we urge Congress to consider the far-reaching impact of the proposed bill, and to consider whether the costs of the expanded protection that is proposed would be justified by the anticipated increase in investor confidence. We believe an analysis of the costs will be critical to ensure that well-intentioned investor protection and modernization measures do not inadvertently undercut SIPC's overall effectiveness in protecting investors.

II. Background of SIPC

To provide context for my remarks, I believe it is important that we consider the background and purpose of SIPA and the creation of SIPC. Following a period of great expansion in the 1960s, the period from 1967 to 1970 was one of crisis for the securities industry and the investing public. First, there was a so-called paperwork crisis, in which brokerage firms failed to upgrade their back-office infrastructures and adequately staff their trade processing and record-keeping functions to accommodate the significant increases in trading volume. As a result, errors became common, with firms losing securities or otherwise failing to complete trades and deliver cash and securities. In addition, instances of misconduct, such as thefts of securities, increased.

Second, the securities industry experienced a business contraction from 1969 to 1970 that, coupled with financial losses related to the paperwork crisis, led to the failure or instability of a significant number of brokerage firms. The cash and securities that customers had on deposit with failed brokerage firms were missing or tied up in lengthy bankruptcy proceedings, and investor confidence was eroding.

Congress responded in 1970 by enacting SIPA, an act with the stated goal of "provid[ing] greater protection for customers of registered brokers and dealers and members of national securities exchanges." Securities Investor Protection Act of 1970, Pub. L. 91-598, 84 Stat. 1636 (codified at 15 U.S.C. §§ 78aaa et seq.). Congress's intent was to prevent the failure of additional brokerage firms, restore investor confidence in our markets, and upgrade the financial responsibility requirements for registered brokers. *SIPC v. Barbour*, 421 U.S. 412, 415 (1975). In particular, SIPA was designed to create a new form of liquidation proceeding in order to complete the open transactions of otherwise solvent firms with firms that have failed and to provide for the efficient return of customer property. *Id*.

III. Task Force and SIFMA Recommendations for SIPC Modernization

The SIPC Modernization Task Force recommended a number of important pro-investor changes, including changes that would expand and increase the protection available to brokerage firm customers in three important ways. As you know, when a brokerage firm is liquidated and the customer property marshaled by the trustee is inadequate to return to customers all of the funds and securities they entrusted to the custody of the firm, SIPC makes advances to customers from its own funds. Since 1980, these advances have been capped at $500,000 per customer. The Task Force recommended increasing the maximum advance amount from $500,000 to $1.3 million to reflect inflation since 1980. The Task Force also recommended eliminating the current distinction under SIPA between claims for cash, which are capped at $250,000 per customer, and claims for securities. Finally, the Task Force recommended a limited "pass-through" of SIPC protection to make individual pension plan participants eligible for SIPC advances with respect to their shares of the plan's account at a failed broker.

In addition to these recommendations, SIFMA proposed at the time, and still believes, that consistency between the customer protection rule (Rule 15c3-3) of the Securities and Exchange Commission (the "SEC") and SIPA would benefit investors. The customer protection rule requires each broker to maintain possession or control of its customer's 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. However, a broker's proprietary account is not treated as a customer account for purposes of the customer protection rule, while a broker's net equity claim based on its proprietary account is eligible to share in the pro rata distribution of customer property in a SIPC liquidation. As a result, there may be net equity claims entitled to share in the pro rata distribution of customer property for which no assets were set aside. A similar difference exists in the treatment of the firm's principal officers and directors, who are non-customers under the customer protection rule but eligible for customer status under SIPA. Until SIPA and the customer protection rule are harmonized, even a failed broker-dealer that has complied with its regulatory obligations will not have sufficient customer property to fully satisfy the net equity claims of its customers under SIPA.

SIFMA also believes that separating customer accounts into classes would benefit individual investors. Maintaining a single class of customers – encompassing cash account customers, margin account customers, portfolio margin customers and securities-based swap customers – may unfairly impose risks of the newer and more complex types of accounts and transactions (*i.e.*, portfolio margin and securities-based swaps) on the customers who have simpler accounts (*i.e.*, cash accounts). Accordingly, SIFMA recommends that consideration be given to dividing customers into separate account classes, tailoring customer protection rules to each account class in a way that provides for a separate pool of customer property for each class, and, in a liquidation proceeding, distributing the customer property for each account class solely to members of that class based on net equity in that class.

With the caveat I noted at the outset that the cost of any changes to SIPA must be carefully considered, we continue to believe that the recommendations of the Task Force and the additional changes recommended by SIFMA appropriately reflect SIPA's purpose of promoting investor confidence in the financial markets by protecting investors against the loss of cash or securities in the event the brokerage firm holding their property becomes insolvent.

IV. Net Equity Based on Last Statement and Allocation of Customer Property

The proposed legislation would amend SIPA to provide that, in determining net equity, the assets of a customer reported to that customer as held by a failed brokerage firm would be determined based on the information contained in the last statement issued by the brokerage firm to the customer and any additional written confirmations after the last statement date. However, if the net value of the customer's assets on the firm's books and records is greater than the net value as determined using the customer's last statement, the proposed legislation would provide that the customer's net equity would be determined using the firm's books and records instead of the customer's last statement. Customer property in liquidation would be allocated based on customers' net equities as determined pursuant to these provisions, unless the trustee determined that another allocation would be necessary to reach a fair and reasonable result.

It is unclear how these provisions would operate in a situation involving fraud by the failed brokerage firm. For example, when a broker-dealer is operated as a Ponzi scheme, the customer account statements will themselves be fraudulent, as it is the essence of a Ponzi scheme that the perpetrator report false profits to investors, and therefore the account statements will not truly represent positions in the firm's customer accounts.

Instead of relying on fraudulent account statements to determine the net equity of the customers of Bernard L. Madoff Investment Securities LLC ("Madoff"), the trustee appointed by SIPC to liquidate Madoff used the "net investment" method. Under that method, 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 net investment in the fraudulent scheme – in other words, the excess (if any) of the amount entrusted over the amount received. This method has been used with respect to fraudulent schemes outside of the SIPA context as far back as the 1920s, and has been applied by several trustees and courts in SIPA liquidations, including the Madoff liquidation.

In upholding the use of the net investment method in connection with the Madoff liquidation, the U.S. Court of Appeals for the Second Circuit explained that, "notwithstanding the [Madoff] customer statements, there were no securities purchased and there were no proceeds from the money entrusted to Madoff for the purpose of making investments." *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 240 (2d Cir. 2011). As a result, any "[c]alculations based on made-up values of fictional securities would be 'unworkable' and would create 'potential absurdities.'" *Id*. at 241 (quoting *In re New Times Sec. Servs., Inc.*, 371 F.3d 68, 88 (2d Cir. 2004)). Moreover, changes to a firm's books and records after the last statement date may reflect fictitious transactions in anticipation of the generation of the next month's customer statements. In such a situation, basing net equity calculations on the firm's latest fraudulent entries in its books and records – as the proposed legislation would do for any customer for whom this resulted in a higher net value – would allow "the whim of the defrauder" to "control[] the process that is supposed to unwind the fraud." *Id*.

When a failed brokerage firm is 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 allocating customer property held by the failed firm.

The property held by a Ponzi scheme and used to make distributions to the "investors" in the scheme is simply the pooled investments of all victims of the scheme (less amounts misappropriated by the Ponzi scheme operator), and making distributions based on anything other than the victims' net investments would be fundamentally unfair.

We thus respectfully recommend that the proposed provisions relating to net equity and alternate allocation methodologies be replaced with a provision that specifically provides for the use of the net investment method in situations involving fraudulent account statements and brokerage books and records.

V. Definition of Customer Status

The proposed legislation would add to the definition of the term "customer" under SIPA: (a) any person whose cash or securities were misappropriated by the brokerage firm (or by any person who controls, is controlled by, or is under common control with the firm, if such person was operating through the firm), regardless of whether the firm held or otherwise had custody, possession or control of such cash or securities, and (b) any person whom the SEC, in its discretion and without court approval, deems to be a customer of the firm. SIFMA disagrees with both of these proposed amendments to the "customer" definition.

A. Persons With Assets Misappropriated by Brokerage Affiliates

Expanding the definition of the term "customer" under SIPA, as proposed, to include any person whose cash or securities were misappropriated by an affiliate of a brokerage firm operating through the firm would be inconsistent with SIPA's legislative history and purpose and contrary to public policy.

It is clear from SIPA's legislative history that Congress intended SIPA to remedy a specific problem: "provid[ing] financial relief to the customers of failing broker-dealers with whom they had left cash or securities on deposit" who "found their cash and securities" "tied up in lengthy bankruptcy proceedings." *Barbour*, 421 U.S. at 413, 415. Since its enactment in 1970, SIPA has been understood to protect an investor from the risk that he will be unable to regain his property from his brokerage firm in the event of the firm's insolvency, and customers have been expected to have, at the time of the firm's insolvency, cash or securities on deposit or otherwise entrusted with the brokerage.

The decisions in *In re Old Naples Securities, Inc.*, 223 F.3d 1296 (11th Cir. 2000), and *In re Primeline Securities Corp.*, 295 F.3d 1100 (10th Cir. 2002), apply this history and practice to the situation of an investor giving money to an agent of a brokerage firm who then stole the investor's funds instead of purchasing the securities that the investor believed he was purchasing with the funds entrusted to the firm via the agent. In those cases, the investors were deemed to be customers because they thought their assets were entrusted with the brokerage. *Cf*. *In re Bernard L. Madoff Inv. Sec. LLC*, 708 F.3d 422, 428 (2d Cir. 2013) (no "customer" status when the investors "could not reasonably have thought" that their funds were deposited with the broker).

SIPA was never intended to provide broad protection to investors against the risk of fraud or investments that turn out to be worthless – situations in which damage would have occurred to the investor even if the brokerage firm had remained solvent. The proposed expansion of the term "customer" to include any person whose assets were misappropriated by an affiliate of a brokerage firm would extend SIPA well beyond its core purpose and would have significant public policy implications. Such an expansion would have financial costs that could exceed the available SIPC funds and could have a detrimental impact on the viability of SIPC and firms across the brokerage industry. This could ultimately result in significant increases in the costs borne by investors (and, in some cases, result in investors losing access to the financial markets altogether).

B. Persons Deemed to Be Customers by the SEC

SIFMA also disagrees with the proposed expansion of the "customer" definition to include any person whom the SEC, in its discretion and without court approval, deems to be a customer of the failed brokerage firm. SIFMA believes that the authority to interpret SIPA and its definition of who is a customer should remain vested with the courts. Additionally, SIFMA believes the SEC may not be able to deem persons to be customers under SIPA without first providing notice and an opportunity for public comment.

VI. SEC Authority to Require SIPC Action

SIFMA disagrees with the proposal that the SEC be permitted, without court approval, to require SIPC to discharge its obligations under SIPA in the event of SIPC's refusal to act. Giving the SEC the authority to require SIPC to commence a liquidation proceeding would effectively replace the judgment of SIPC's board of directors – which includes among its members a representative of the Department of the Treasury, a representative of the Federal Reserve Board, three representatives of different aspects of the securities industry, and two members of the general public – with that of the SEC.

In drafting SIPA, Congress considered and rejected this alternative,[2] and SIPA's apportionment of responsibility reflects Congressional judgment at the time of enactment of SIPA that it should be SIPC's independent board of directors – not the SEC – that makes the decision whether a liquidation proceeding should commence.

This legislative judgment is supported by substantial policy considerations. In leaving the determination of whether a SIPA liquidation is required to SIPC, an entity with its own source of funding, Congress successfully insulated this decision from political pressure. The neutrality of the decision is especially important when private actors bear the cost of the liquidation decision. By contrast, allowing the SEC to substitute its judgment for that of SIPC would leave the decision subject to political interference – a situation best avoided.

VII. Inspection of SIPC Members

With respect to the proposed provision requiring the SEC to carry out periodic inspections of SIPC members, we note that SIPC's members are broker-dealers registered with the SEC and members of the Financial Industry Regulatory Authority, Inc. ("FINRA"), and thus are subject to inspections and examinations by the SEC and FINRA. While we believe broker-dealers are heavily supervised under the current regulatory regime, the proposed inspection provision brings to mind the interesting question that has been discussed in other contexts regarding registered investment advisers ("RIAs"), which are not members of FINRA and are infrequently examined by the SEC. RIAs also provide information to customers, and entities in many cases seek dual registration as both brokers and RIAs. In fact, both the Madoff and Stanford cases involved broker-dealers that were also RIAs.

VIII. Effective Date

The proposed legislation provides that its provisions would become effective with respect to any liquidation proceeding under SIPA that was in progress as of the date of enactment. This would significantly slow down the liquidation proceedings that are currently in progress and is simply not feasible.

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[2] An early version of SIPA contemplated the SEC Commissioners themselves serving as SIPC's board of directors with the power to determine when a SIPA liquidation should be commenced. *Cf*. S. 2348, 91st Cong. §3(b) (1969), with 15 U.S.C. § 78eee(a)(3)(A). Congress ultimately rejected this alternative at the SEC's urging. *See* Hearings on S. 2348, S. 3988, and S. 3989 Before the Subcomm. on Securities of the Comm. on Banking and Currency of the United States Senate, 91st Cong. 17 (1970) (statement of Hamer H. Budge, Chairman of the SEC) (explaining that the Commissioners should not serve as SIPC's board members because of potential conflicts posed between the roles of a SIPC board member and an SEC Commissioner).

Once SIPC determines that a member firm has failed or is in danger of failing to meet its obligations to customers, SIPC may file an application for a protective decree in a court of competent jurisdiction. The insolvent firm may consent to issuance of the protective decree or may contest it, in which case the court holds a hearing on the application. The court also appoints a trustee for the liquidation of the firm's business and attorneys for the trustee, and holds a hearing on their disinterestedness at which customers, creditors and stockholders of the insolvent firm may file objections.

The trustee will publish notice of the liquidation describing the proceedings and the procedure for claims and specifying the time period during which investors may assert their claims. The trustee will also mail notice to the insolvent firm's customers and creditors. The trustee will investigate the conduct, property, liabilities and financial condition of the insolvent firm, determine the allowable customer claims, marshal assets of the firm, and determine how to allocate customer property. Once the court has approved the trustee's determination of customer property and amount and timing of distributions, the trustee distributes assets to customers.

According to SIPC's website, there are currently seven active liquidation cases in which the six-month claims filing period is closed.[3] These include the Lehman Brothers Inc. liquidation, in which the trustee is in the process of completing 100 percent distributions on allowed securities customer claims, and the MF Global Inc. liquidation, in which the trustee's allocation motion has recently been approved. In addition, SIPC's website indicates that there is currently one active liquidation case with an open filing period, in which the claim form has already been distributed to customers.[4] It is unclear how the provisions of the proposed legislation would apply to these liquidations. Among other things, with respect to the proceedings in which distributions have already commenced, it is unclear whether customers would be required to return assets to the trustee so that the trustee could re-determine claims and allocation under the proposed legislation. The net effect would be to significantly slow down the progress of the proceedings that are currently active, if it were even feasible to apply the legislation retroactively.

IX. Conclusion

SIFMA supports the goals evident from the title of the proposed legislation – to restore Main Street investor protection and confidence – and, through our membership on the SIPC Modernization Task Force, have participated in reviewing SIPC's operations and policies and proposing reforms to modernize SIPA and SIPC. We

[3] http://sipc.org/Cases/CasesClosed.aspx (accessed Nov. 19, 2013).
[4] http://sipc.org/Cases/CasesOpen.aspx (accessed Nov. 19, 2013).

remain supportive of these goals, but strongly caution against the enactment of legislation that would result in an unprecedented expansion of SIPC's coverage without careful consideration of the effects of that expansion.

Losses from securities and commodities frauds in the United States, which include, among others, market manipulation, Ponzi and pyramid schemes, and broker embezzlement, total in the tens of billions of dollars each year.[5] Market manipulation schemes alone have been estimated to generate $6 billion in losses each year.[6]

These estimated losses vastly exceed the amounts available in SIPC's reserve fund, which amounted to $1.6 billion as of December 31, 2012,[7] and SIPC would be unable to continue operating for long if its purpose were expanded to provide compensation for investors with losses from securities fraud. Even if SIPC were to borrow in the public debt markets at reasonable terms, as is contemplated in the proposed legislation, or to tap its $2.5 billion line of credit with the federal government, SIPC would be unable to provide the necessary liquidity if SIPA were expanded to make SIPC the insurer against the risk of loss due to securities fraud.

It is unfortunate that financial frauds like the Madoff and Stanford schemes exist and will continue. Crooks will continue to use the financial system to find victims because, to quote notorious bank robber Willie Sutton, "that's where the money is." Criminals who steal investors' assets through fraudulent securities activities should be prosecuted and put in jail, and recoveries for victims of these frauds should be sought through the applicable criminal and civil forfeiture statutes. In addition, victims can seek to obtain recoveries by bringing claims under the Securities Act of 1933 or the Securities Exchange Act of 1934 – additional avenues Congress envisioned defrauded investors would take to recoup their investments.[8]

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[5] *See*, *e.g.*, FBI Financial Crimes Report to the Public, Fiscal Year 2006, available at http://www.fbi.gov/stats-services/publications/fcs_report2006 (accessed Nov. 19, 2013) (estimating losses of $40 billion per year from securities and commodities fraud). *See also* http://sipc.org/Who/NotFDIC.aspx (accessed Nov. 19, 2013) (stating that the Federal Trade Commission, Federal Bureau of Investigation, state securities regulators and other experts have estimated that investment fraud in the United States ranges from $10 billion to $40 billion per year).

[6] FBI Financial Crimes Report to the Public, Fiscal Year 2006, *supra*. *See also* http://sipc.org/Who/NotFDIC.aspx, *supra* (estimating investor losses from microcap stock fraud at $1 billion to $3 billion annually).

[7] 2012 Annual Report at 8, available at http://sipc.org/Portals/0/PDF/2012AnnualReport.pdf (accessed Nov. 19, 2013).

[8] "The Securities Act of 1933 requires that investors have adequate information to exercise sound judgment concerning the securities they purchase; and the Securities [] Exchange Act of 1934 insures that they will not be victimized by fraudulent, manipulative, or deceptive selling schemes. But neither statute prevents the investor from losing his entire investment if his broker fails because of operational and, ultimately, financial difficulties." See S. Rep. No. 91-1218, at 3 (1970). It was this gap that SIPA and SIPC were designed to fill.

But insuring all of us against the risk of fraud is quite another undertaking. As noted earlier, SIPC would be unable to provide the necessary liquidity if SIPA were amended so that it effectively provided such insurance. This expanded scope of coverage would cause SIPC's assessments on its member firms to increase astronomically. The cost to brokerage firms would likely be quite high, and could cause brokers to go out of business. Moreover, the cost would ultimately be passed on to customers and could negatively impact their financial returns and access to the financial markets. If such an insurance system is what Congress now desires to achieve, the anticipated costs and benefits should be carefully considered, and the ramifications for businesses and investors should be carefully analyzed and debated. While it may be meritorious to limit risk for investors, it will certainly not be free or without other consequences.

SIFMA looks forward to continuing to work with the Subcommittee on addressing these very important issues.

Thank you again for allowing me the opportunity to testify. I would be pleased to answer your questions.