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

**HEARING ON:
THE SECURITIES INVESTOR PROTECTION CORPORATION:
PAST, PRESENT, AND FUTURE**

MARCH 7, 2012

I. Introduction

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

My name is Ira Hammerman, and I am Senior Managing Director and General Counsel of the Securities Industry and Financial Markets Association ("SIFMA")[1] and a member of the SIPC Modernization Task Force (the "Task Force") formed by the Securities Investor Protection Corporation ("SIPC"). I am appearing here today as an individual member of the Task Force and I am not speaking on behalf of my fellow Task Force members. Thank you for allowing me to submit my full statement for the record.

The Task Force undertook a comprehensive review of the Securities Investor Protection Act ("SIPA") and SIPC's operations and policies and proposed reforms to modernize SIPA and SIPC. The Task Force worked hard for approximately a year and a half, and recently presented its official Report and Recommendations to the Board of SIPC Directors. I would like to thank my fellow members of the Task Force, and SIPC's dedicated staff, for their hard work, commitment, and willingness to consider a variety of proposals. My testimony will focus on several of the Task Force's recommendations regarding appropriate revisions to SIPA.

II. Report and Recommendations of the Task Force

I want to begin by highlighting some of the important pro-investor changes recommended by the Task Force. The Task Force recommends expanding and increasing the protection available to customers of broker-dealers in three important ways. As you know, when a broker-

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1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington D.C., is the U.S. regional member of the Global Financial Markets Association. (More information about SIFMA is available at http://www.sifma.org.)

dealer is liquidated and the customer property marshaled by the trustee is inadequate to return to the broker-dealer's customers all funds and securities they entrusted to the custody of the broker-dealer, SIPC makes advances from its own funds to assure the return of the customers' property. Since 1980, these advances have been capped at $500,000 per customer. The Task Force recommends increasing the maximum advance amount from $500,000 to $1.3 million to adjust the limit to reflect inflation since 1980. SIPA also currently distinguishes between claims for cash and claims for securities, setting a lower $250,000 limit on advances to customers based on claims for cash entrusted to the broker-dealer. The Task Force recommends eliminating the distinction in levels of protection between investors' claims for cash and claims for securities, which has been a subject of controversy and a source of expensive and unproductive litigation. Finally, the Task Force also recommends a limited "pass through" of SIPC protection to make individual pension plan participants eligible for SIPC advances with respect to their share of the plan's account at a failed broker-dealer. These recommendations appropriately reflect SIPA's purpose of promoting investor confidence in the U.S. capital markets by protecting investors against a loss of cash or securities in a failure of the broker-dealer holding their property. They also reflect positive progress in the effort to modernize SIPA and SIPC.

While I support these recommendations, I wish to note that they were made without any real consideration of their cost to SIPC. This cost will be funded by the members of SIPC and, ultimately, by the investing public. Before implementing these recommendations, I urge Congress to obtain a reasonable estimate of the costs of the expanded protection and consider whether these costs would be justified by the increased investor confidence. As of this date, there has been no such analysis, and I believe an adequate analysis of the modernization of SIPA and SIPC is not possible without it, so as to ensure that well-intentioned investor protection and modernization measures do no inadvertently undercut SIPC's overall effectiveness in protecting investors.

III. SIFMA's Recommendations Not Fully Addressed by the Task Force

I am disappointed by the Task Force's failure to take action with respect to several critical areas previously identified by SIFMA. In particular, SIFMA believes it is essential to ensure consistency between SIPA and the SEC's Customer Protection Rule (Rule 15c3-3). When a broker-dealer fails and enters liquidation under SIPA, SIPA provides for the distribution of the customer property held by the failed broker-dealer to its customers, *pro rata*, based on the net value of the securities and cash in their respective accounts, known as their "net equity." Any mismatches between the Customer Protection Rule's reserve and segregation requirements and customers' net equity claims in a SIPA proceeding can result in an insolvent broker-dealer holding insufficient customer property to satisfy all customers' net equity claims. The current discrepancies between the Customer Protection Rule and SIPA were briefly addressed by the Task Force's report, which recommended further study. I believe the Task Force missed an opportunity to identify the specific discrepancies that currently exist and recommend resolutions. I also believe, however, that additional discrepancies are likely to arise as the SEC promulgates rules for the protection of securities-based swap customers, unless the SEC is given the power to make rules under SIPA that will harmonize the customer protection scheme and the liquidation process.

A. <u>Need For Consistency between SIPA and the SEC's Customer Protection Rule</u>

SIPA and the Customer Protection Rule must work together. The Customer Protection Rule requires each broker-dealer to maintain possession or control of its customers' fully paid and excess margin securities and deposit into a reserve account an amount generally equal to its net monetary obligations to customers or in respect of customer securities positions. When a broker-dealer enters liquidation under SIPA, the customer securities and the reserve account are available for distribution to customers. If SIPA and the Customer Protection Rule are harmonized (and the broker-dealer had complied with its obligations), the failed broker-dealer should have sufficient customer property to fully satisfy the net equity claims of all customers. Unfortunately, the two are not fully harmonized.

Perhaps the most significant divergence between SIPA and the Customer Protection Rule is the status of proprietary accounts of broker-dealers. A broker-dealer's net equity claim based on its proprietary account is a customer claim eligible to share in the *pro rata* distribution of customer property under SIPA (although not eligible for SIPC advances), but the proprietary account of a broker-dealer is not treated as a customer account for purposes of the Customer Protection Rule. As a consequence, there may be net equity claims entitled to share in the *pro rata* distribution of customer property for which no assets were set aside. In the liquidation of Lehman Brothers, Inc. ("LBI"), for instance, Lehman Brothers International (Europe) ("LBIE"), an English broker-dealer affiliate of LBI, has filed customer claims for approximately $10 billion based on its proprietary positions, but the Customer Protection Rule did not require LBI to maintain possession or control of LBIE's securities or make deposits into its reserve account in respect of obligations to LBIE. LBI's trustee has challenged the "customer" status of these claims, but if they ultimately are allowed as customer claims, the gap between SIPA and the Customer Protection Rule may cause a sizeable shortfall in the customer property available for distribution to LBI's customers.

The SEC has proposed to narrow this divergence by requiring broker-dealers to fund a separate reserve account with an amount generally equal to its net monetary obligations with respect to proprietary accounts of other broker-dealers or in respect of securities positions in such accounts. (The possession or control requirement, however, would not be applied to securities positions in these accounts, provided that written permission to use the securities is obtained.) While a step in the right direction – SIFMA has filed a generally favorable comment on this proposal – other divergences between SIPA and the Customer Protection Rule continue to exist and should be reconsidered. For example, a similar difference exists in the treatment of principal officers and directors of a broker-dealer, who are non-customers under the Customer Protection Rule but are eligible for customer status under SIPA.

B. <u>Clarity and Consistency in the Treatment of Securities-Based Swaps</u>

SIFMA is also concerned that, as the SEC develops the customer protection requirements applicable to broker-dealers that act as securities-based swap dealers, the divergences between the SEC's customer protection requirements and SIPA will only increase. The Dodd-Frank Act amended the stockbroker liquidation provisions of the Bankruptcy Code to treat accounts holding securities-based swaps as "securities accounts" (to the extent of any applicable customer protection or segregation requirement) but no similar amendment was made to SIPA, leaving unclear the treatment in a SIPA liquidation of customers' securities-based swaps (and related cash and securities margin). Although this issue was not addressed by the Task Force, SIFMA believes that customers who have securities-based swaps in an account at a broker-dealer generally should have a net equity claim calculated based on the value of the securities-based swaps, any cash or securities in the account, and the value of any other positions (*e.g.*, securities or commodities futures or non-securities-based swaps) in the account – at least to the extent of any applicable customer protection or segregation requirement.

SIFMA is concerned, however, that maintaining a single class of customers, which encompasses cash account customers, margin account customers, portfolio margin customers, and securities-based swap customers, may unfairly impose risks of the newer and more complex types of accounts and transactions (*i.e.*, portfolio margin and securities based swaps) on the customers who have simpler accounts (*i.e.*, cash accounts). Accordingly, SIFMA recommends that consideration be given to dividing broker-dealer customers into separate account classes, tailoring customer protection rules to each specific account class and activity in a way that provides for a separate pool of customer property for each separate account class, and, in a liquidation under SIPA or the Bankruptcy Code, distributing the customer property for each account class solely to members of that account class based on net equity calculated based on all positions in the customers' respective accounts of that class. It may be appropriate to separate customer accounts into at least the following three classes:

- Cash accounts. Cash account customers hold only fully-paid long securities positions and cash credit balances. The customer protection rules would require the broker-dealer to maintain possession or control of all securities belonging to these customers and fund a reserve account in the amount of all of their credit balances. In a liquidation of the broker-dealer, accounts in this class and the related customer property should be easily and efficiently transferred to a solvent broker-dealer or a bridge financial company (either in bulk or individually at the direction of the relevant customer).

- Margin accounts. More sophisticated margin account customers could have long and short positions and debit or credit balances in margin accounts subject to Federal Reserve Board Regulation T. This account class could generally be subject to the current customer protection rules relating to possession or control of certain securities (which allow some margin securities to be used by the broker-dealer to obtain financing related to customer positions) and requiring a reserve account to be funded on a formula basis.

- Portfolio Margin and Swaps Accounts. The most sophisticated customers have portfolio margin accounts and/or swaps accounts, containing long and short securities and options positions, securities-based and non-securities-based swaps, credit or debit balances and possibly also futures positions. This account class should also be subject to customer protection requirements relating to possession or control of customer securities and to the funding of a reserve account, but those rules would need to take into account the broker-dealer's use of funds or securities to carry swaps that hedge the customer swaps positions.

It may also be appropriate to develop additional account classes, or to modify the classes outlined above; the precise delineation of the separate account classes should be the subject of further review and careful study and should only be adopted after opportunity for public comment.

C. Rule-Making Power

The best way to accomplish the harmonization of SIPA, the Bankruptcy Code and the SEC's Customer Protection Rule is to grant rule-making authority to the SEC similar to the authority that the Commodity Futures Trading Commission (the "CFTC") has under Section 20 of the Commodity Exchange Act to make rules regarding the commodity broker liquidation provisions of the Bankruptcy Code, and to instruct the SEC to make rules under both the Bankruptcy Code and SIPA regarding the scope of customer property, the determination of a customer's net equity and the method of liquidation of a broker-dealer that are consistent with the customer protection rules applicable to operating broker-dealers. In carrying out this instruction, the SEC could follow the CFTC in creating different "account classes" as outlined above, each with rights in separate pools of customer property that may be created by customer protection rules adapted to the circumstances of the account class. (The SEC has already started down the path of creating separate account classes by proposing different customer protection requirements for proprietary accounts of broker-dealers, including the creation of a separate reserve deposit for these accounts, but the separation is meaningless if these accounts are lumped together with the securities accounts of public customers in a liquidation of the broker-dealer.)

IV. The Fundamental Purpose of SIPA Protection

Turning to the question of fraud committed by a broker-dealer, I would like to address two different but interrelated issues. As members of this Subcommittee know, SIPA's fundamental purpose is to promote investor confidence in the U.S. capital markets by protecting customers against the loss of cash or securities entrusted to the custody of the broker-dealer holding such property. To the extent the customer property held by the failed broker-dealer is not sufficient to satisfy the net equity claims of all of the customers of the failed broker-dealer, SIPC funds are advanced for each customer in order to replace the missing securities and funds. As intended by Congress, however, SIPC's funds are available only to replace missing customer property; they are not used to protect investors against any other risks.

I share in the sympathy with, and outrage on behalf of, the many innocent victims of massive frauds by the likes of Madoff and Stanford. Financial fraud undermines confidence in our markets and our regulatory system. However, SIPA is not intended to protect investors against losses ***on*** their investments, only against losses ***of*** their investments in the event of a broker-dealer failure. Investing in securities inherently exposes the investor to market fluctuations in the value of the securities. Investors who lose money because of a decline in the value of the securities purchased for their accounts are not protected by SIPA against such losses, whether the decline is due to market forces or even due to fraud. SIPA, for instance, would have provided no protection to investors who purchased Enron stock or bonds against the losses they realized through Enron's fraud and resulting bankruptcy (although it would have provided them protection against the loss of their Enron securities if their brokers failed). Under this principle, investors who purchased certificates of deposit in Stanford International Bank (an Antiguan bank that was allegedly operated as a Ponzi scheme) are not protected by SIPA against the possibility that those certificates of deposit are worthless. As such, SIFMA opposes efforts to extend

SIPC's protection to cover, for the first time, fraud by the issuer of certain securities (in this case, certificates of deposit) purchased by the customer which are neither lost nor stolen but in fact in the holders' possession. This extension would likely deplete SIPC's recently increased targeted reserves of $2.5 billion (up from $1 billion) and even exhaust the additional $2.5 billion that SIPC is able to borrow from the SEC (and, indirectly, from the U.S. Treasury), leaving SIPC unable to protect securities investors until its funds are replenished. Even more importantly, this extension would be an unprecedented expansion of the protection provided by SIPC and is in direct conflict with the fundamental purpose and intent of SIPA.

SIPA's protection for broker-dealer customers differs from the Federal Deposit Insurance Corporation's ("FDIC's") insurance for bank depositors in the same way that securities investments differ from bank deposits. Bank deposits represent a debt of the bank to the depositor. They are generally intended to be a safe use of funds and to provide only a limited, but low-risk return. The FDIC insures the payment of the bank deposit, including accrued interest, in the event of a bank failure (up to the limits of the insurance coverage). Securities accounts at a broker-dealer, by contrast, hold investments of the customer in securities (and related cash amounts). Customers invest in securities to benefit from increases in the value of the securities (and from dividends, interest or other distributions on the securities), but also take the risk that the value of the securities may drop, potentially to zero. SIPA is not intended to protect customers against declines in the value of their accounts due to changes in the value of their securities investments, but only against the loss of their actual securities due to a failure of the broker-dealer. SIPC's advances are therefore only available to customers who do not receive their cash and securities investments, not to customers whose investments go sour or turn out to be fraudulent.

V. "Net Equity" Calculation in the Context of a Fraudulent Scheme

In a SIPA liquidation, customers have claims for their "net equity" that are satisfied by a *pro rata* distribution of the failed broker-dealer's "customer property," plus, if that distribution is inadequate, up to $500,000 of SIPC advances. A customer's "net equity" is calculated by taking the value of the long securities and cash in the customer's account and subtracting the value of the short securities positions in the account and any indebtedness of the customer to the failed broker-dealer. In the ordinary course, a SIPA trustee looks to a customer's account statements and the books and records of the failed broker-dealer to establish the securities positions and cash balances used to compute the customer's net equity. When a broker-dealer is operated as a Ponzi scheme, however, the customer account statements will themselves be fraudulent – it is the essence of a Ponzi scheme that the perpetrator reports false profits to the investors – and therefore the statements do not truly represent positions in the customers' accounts.

Instead of relying on fraudulent account statements to determine the net equity of the customers of Bernard L. Madoff Investment Securities LLC ("Madoff"), the trustee appointed by SIPC to liquidate Madoff has used the "net investment" method. Under the net investment method, the fraudulent customer account statements are disregarded and a customer's net equity is determined solely by reference to the amount of money the customer entrusted to the Ponzi scheme operator and the amount of money the customer received from the Ponzi scheme. The customer's net equity is his or her net investment in the fraudulent scheme – the excess (if any) of the amount entrusted over the amount received. This method was originally developed with respect to fraudulent schemes outside of the SIPA context as far back as the 1920s and has been regularly applied by several trustees and courts in SIPA liquidations (including the Madoff liquidation, where it was recently upheld by the Court of Appeals for the Second Circuit).

When a failed broker-dealer was operated as a Ponzi scheme, SIFMA believes that, as a matter of fundamental fairness, this net investment method should be used to determine net equity for purposes of the distribution of customer property held by the failed broker-dealer. The property held by a Ponzi scheme and used to make distributions to the "investors" in the scheme is simply the pooled property of all victims of the scheme, and making distributions based on anything other than their net investment would be fundamentally unfair – at best it would result in sharing the losses unevenly among the victims, and in some cases it would result in perpetuating the scheme by taking money from some victims and paying it to others to satisfy their claims for false profits.

VIII. Conclusion

In conclusion, SIFMA appreciated the opportunity to participate in the work of the Task Force and is committed to working constructively to modernize SIPA to better protect investors and thereby increase investor confidence in the financial markets. SIFMA looks forward to continuing to work with the Subcommittee on these important investor protection issues.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Ira Hammerman	SIFMA
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2004 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2004 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.