TheStreet.com

08/07/2000 : SIPC's Scroogelike Ways Draw Scrutiny

By Robert Kowalski
http://www.thestreet.com/story/1029090/1.html

Austin McCormack admits it probably wasn't the best idea to invest $10,000 of his retirement savings in stocks simply because they were recommended by a cold-calling broker from **Hanover Sterling**, a Manhattan brokerage specializing in penny stocks.

But when the brokerage collapsed in 1995, he thought that the quasigovernmental, nonprofit agency that insures brokerage accounts, the **Securities Investor Protection Corporation**, would cover his loss -- especially since the firm had shifted his money into another stock without telling him. After three years of haggling, he found out he was wrong.

"They dropped me on my head," says McCormack, a 77-year-old retired mechanical engineer, who lives in Dallas. "I didn't get one dime."

The plight of investors like McCormack has stirred criticism of SIPC from lawyers for defrauded investors and some state securities regulators. They argue that SIPC, created by **Congress** in 1970, has defined its role so narrowly that it doesn't use enough of its resources to help victims of broker fraud.

Critics also say it too frequently doles out lucrative contracts to a handful of lawyers who keep the purse strings tight when overseeing the liquidation of failed brokerages.

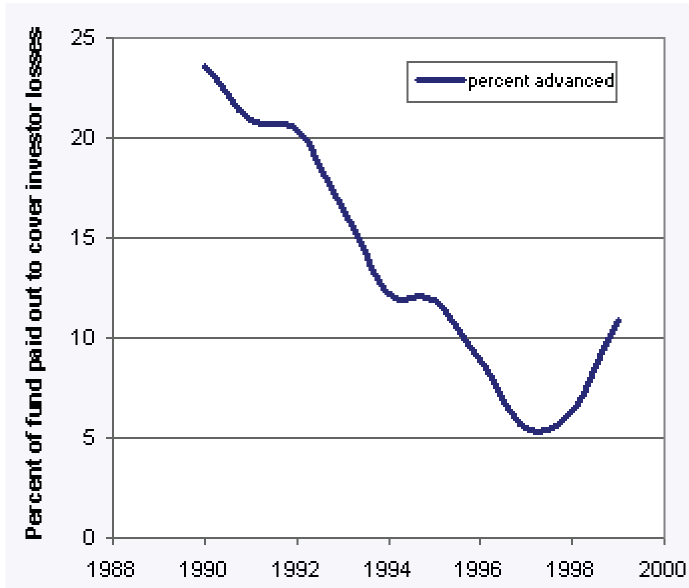
McCormack, like thousands of other investors, learned that SIPC coverage differs sharply from federal deposit insurance available for bank and savings-and-loan accounts. Surveys have shown that the public isn't entirely clear about the limits of SIPC coverage, even though all brokerage accounts come with pages of warnings for clients.

"That sticker gives the impression that each brokerage house is safe," says **University of California at Davis** Professor Thomas Joo. "It's just not true."

Whether investors understand SIPC's limitations is an important issue, says Rick Hillman, of the **General Accounting Office**, which is studying whether SIPC is helping investors enough and whether its mission now needs to change. "The extent to which you have FDIC protection for savings accounts and SIPC accounts for securities are very different."

Spendthrift?

SIPC spending on investor losses vs. asset base



Source: SIPC

The report, due to be completed next year, was requested by Rep. John Dingell, the ranking minority-party member of the **House Commerce Committee**. Dingell asked the GAO to review, among other things, how consistent SIPC is in compensating investors for losses. Any major changes in SIPC procedures would need congressional approval.

SIPC administrators and trustees say they are helping investors as best they can and argue that they are hamstrung by the 1970 law, which doesn't permit coverage of losses due to brokerage fraud.

"I feel bad for these people," says New York lawyer Irving Picard, of **Gibbons Del Deo Dolan Griffinger & Vecchione**. Picard is overseeing the liquidation of Hanover Sterling and, in fact, rejected the claim by McCormack and dozens of other investors who lost money through the brokerage. "The law doesn't let me help them."

Low-Ball Liquidators?

Investors' lawyers argue that, despite a $1.1 billion insurance fund, SIPC and the law firms it hires are in league to play hardball with clients of failed brokerages. "They're just ginning through fees instead of giving it to the people who get screwed," said Philip Aidikoff, a Beverly Hills, Calif., attorney who represents defrauded investors.

In the liquidation of clearing firm **Adler Coleman**, which failed in 1995, legal fees have reached almost $12 million, with an additional $1.1 million in expenses.

Picard, who SIPC has hired as a trustee on seven liquidations, is not the only lawyer to have won repeat assignments from the agency. Edwin Mishkin, of the New York law firm **Cleary Gottlieb Steen & Hamilton** has been trustee on at least three SIPC cases. And Harvey Miller, of the New York firm **Weil, Gotshal & Manges** has been trustee on at least two cases, including the huge liquidation of **Stratton Oakmont**, the Long Island boiler-room operation

SIPC has never handled a colossal failure. If it is forced to, the fund is bolstered by an additional $2 billion in bank credit lines and direct federal subsidies. Broker fees support the fund, but over time the assessments have been reduced to the current $150 fee per firm -- no matter the size -- because the treasury has grown so much.

SIPC and its trustees reject the argument that law firms get business if they keep payouts low.

"I think that's outrageous," said Picard, who maintains that the agency keeps bringing him back because of the quality of his work. "I'm personally offended."

"This is not a private corporation that's looking to make a profit," said SIPC General Counsel Stephen Harbeck. "We have no compunction whatsoever to use our corporate funds the way Congress intended."

But the record seems to support at least some concerns of SIPC critics.

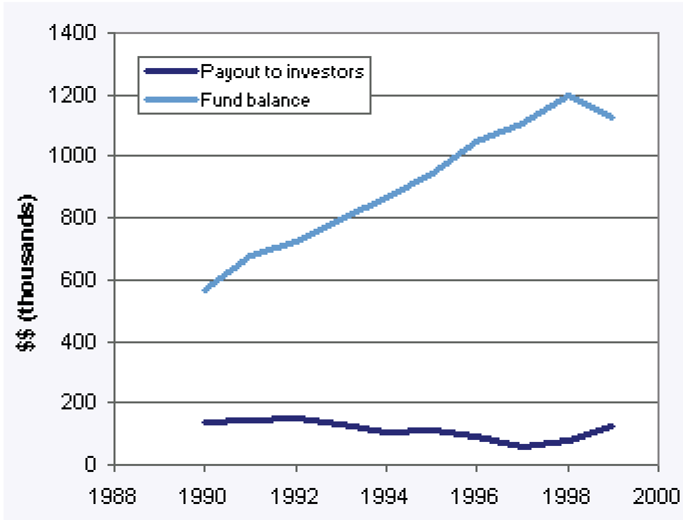
Consider:

- In 1990, the SIPC fund had $570 million and paid out $134 million, or almost 25% of its assets, to cover investor losses. That year it collected $65 million in fees from its members, based on a rate of 3/16 of 1% of each of their annual revenues.

- By last year, the SIPC fund had almost doubled to $1.1 billion, but with a similar caseload, the agency actually paid out less -- $122.7 million, or only about 11% of the value of its fund -- to cover customer losses.

Flatlining

Payouts stagnate even as SIPC fund grows



Source: SIPC

Harbeck said the amount SIPC pays out to cover investor losses each year is unrelated to its fund size. "I don't think there is or was intended to be a correlation between our usual expenditures and what the board of directors thought we ought to have [in the fund] in a time of crisis," he said.

Cash Cows

Although the desire for wider access to SIPC's treasury has growing appeal, securities experts suggest the need for lawmakers and regulators to move cautiously. Above all, they say, the system cannot be extended to cover market risks, and they worry liberalizing the rules will subject brokerage firms to claims from investors who want to be made whole for legitimate investment losses.

"It makes for very difficult policy-making," says Professor Henry T.C. Hu, who teaches securities regulation at the **University of Texas**. "To the extent that there is any ambiguity, I think you ought to clear it up."

Investors' lawyers also accuse SIPC of benefiting insiders in handing out liquidation business. In 1996, the bailout of **Old Naples Securities** in Florida went to Theodore Focht, the former SIPC president now living in that state.

Critics say Focht should not have been tapped. "It gives the appearance of impropriety and inherent bias,'' says Steven Caruso, a New York lawyer who has fought SIPC. "It's a rubber stamp, and no one's in a position to challenge them." Trustees are recommended to Bankruptcy Court judges by SIPC, and the agency's selections are rarely rejected.

Focht, who led the agency for a decade, denies favoritism. He says SIPC chose him because of his experience and the proximity of Old Naples litigation, adding that he is working for a relatively low hourly fee of $100.

Focht and plaintiffs attorneys have clashed in the Old Naples liquidation over about $1.3 million in claims that were denied because the investors did not qualify as customers under SIPC rules. The clients have fought back and won two interim court rulings, and the issue is before a federal appeals court.

SIPC officials say that even if they had the authority to cover fraud claims, the $1.1 billion fund is inadequate. Critics' answer to that: Require brokers to pay more than $150 each annually into the fund. "It's nothing," says Joe Borg, Alabama's chief securities regulator.

Some SIPC critics propose a penny assessment on every trade to bolster the fund, while some industry experts say a fund as big as $40 billion would be required to bail out defrauded customers. Critics say the figure is vastly overstated to kill any shakeup at SIPC.

Borg thinks SIPC ought to be recast to reflect today's Wall Street environment, a far richer, faster one than when SIPC began in 1970.

"The question is not whether SIPC is doing anything wrong. I think the way they're applying the rules and regulations are well within the law," Borg says. "But the question is whether the enabling statutes are incorrect in today's environment and I think that's where the problem is."