Network for Investor
Action and Protection

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 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). It 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. 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 <u>investors would then rely on statements and confirmations received from brokers to evidence the investors' holdings</u>. 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 solemn 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. Reading of the 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.

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.

The securities industry, as everyone is well aware, has grown exponentially to trades valued in the hundreds of billions of dollars in the late 1960s, to hundreds of trillions of dollars now traded annually, and helped transform the entire financial industry into one of the largest and most profitable in the US economy. Historians will surely point to the move to the book-entry account statement methodology as central to that success.

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 week 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 this testimony.

SIPC-RELATED ISSUES

The Madoff case, and SIPC's behaviors 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 clawbacks 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.

<u>OTHER CENTRAL ISSUES RELATING TO SIPC's POSITIONS</u>

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.

<u>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.</u> 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, first, these clearly 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. Second, no investor would willingly participate in a fraudulent scheme unless they were complicit or had knowledge or suspicion, and if they did participate, and received "unreasonable" returns, could be justly denied claims. Certainly, FINRA and the SEC must do 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. Again, no innocent investor would knowingly participate in a fraudulent scheme.

COMPREHENSIVE RECOMMENDATIONS:

THE BIGGER PICTURE:

The well documented failures of the SEC, SIPC, and FINRA beg for a thorough analysis of the effectiveness of the investor protection regime. Lack of transparency, poor integration and cohesiveness, lack of clarity about the expectation of investor protection among many other problems have been reported. 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 currently in place.

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 a cease and desist to SIPC and Trustee regarding clawback and mandating support of final account statement of net equity (via passage of a modified HR5032, for example). 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. Not doing this will only further compromise the ability to gain investors' confidence in investor protection going forward.

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 – the latter two desperately needing the level of scrutiny now being undertaken with respect to SIPC. 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.

SPECIFIC SIPC RECOMMENTATIONS

Having studied the intent of Congress in enacting and amending SIPC, and having studied the conduct of SIPC both over the long term (since 1970) and more recently (since late 2008), NIAP would proffer the following suggestions for reforms in SIPC if SIPC is to be retained rather than be abolished and an entirely new agency with entirely new personnel created in order to insure that Congressional intent is followed.

1. Congress should pass H.R. 5032 and H.R. 5058 before adjourning.

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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. 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.

NIAP commends the Committee's effort to enhance protections for investors, and would NIAP would be happy to be of further assistance to Committee's efforts, and any other efforts seriously committed to improving the investor protection system.

Sincerely,

Ron Stein, President
Network for Investor Action & Protection

September 21, 2010

Enc:
Gretchen Morgenson NY Times Article