

Rep. Scott Garrett
Statement for the Record
Accompanying Re-introduction of the Equitable Treatment of Investors Act

Late in the 111th Congress, I introduced, with co-sponsors, Mr. King of New York and Ms. Ros-Lehtinen of Florida, the Equitable Treatment of Investors Act (H.R. 6531). This bill reaffirmed and clarified the key protections for securities investors intended by Congress in the 1970 enactment of the Securities Investor Protection Act (SIPA) and major amendments to that Act in 1978.

Today I reintroduce that legislation with clarifying amendments. The central purpose of the legislation is to reaffirm the original Congressional intent on two key aspects of the administration of SIPA in the liquidation of a bankrupt broker-dealer firm. First, as a general matter, the determination of customer “net equity” shall rely on the final account statement received from the debtor prior to closing, plus any additional supporting documents, such as trade confirmations. Second, and again as a general matter, avoidance actions, or “clawbacks”, to recover property transferred to the customer prior to closing shall be prohibited. While I emphasize these clarifications simply reaffirm current law, the actions and interpretations of SIPA being made by the Securities Investor Protection Corporation (SIPC) and the Trustee appointed for the Bernard L. Madoff Investment Securities LLC (BLMIS) liquidation proceeding make the passage of this legislation important and necessary.

In this legislation, there are important exceptions to those two general customer protections that deny that beneficial treatment to any customer who knew of or was complicit in the fraudulent activity of the debtor and to any customer who, as a registered professional in the securities markets, with the requisite knowledge of these matters, knew or should have known of the debtor’s fraudulent activities and failed to notify appropriate regulatory authorities. This portion of the bill’s language is meant to assure that SIPC and the receivership Trustee have fully adequate legal powers to act against customers undeserving of SIPA’s investor protections.

While this clarifying legislation is intended to have general application to all broker-dealer bankruptcies involving debtor fraud, introduction at this time is directly related to the failure of SIPC and its Trustee to fairly and adequately act to provide statutorily mandated and intended SIPA protections to the several thousand innocent customers defrauded by Bernard Madoff in the operations of his investment advisory and broker-dealer firm, BLMIS. Compounding the grievous shortcomings of SIPC to respond promptly and usefully to these customers’ financial plight is the well-documented failures by the SEC and FINRA, the regulatory overseers of BLMIS, to detect and end the Madoff fraud over a period of 25 or more years.

Given the colossal regulatory oversight failure and SIPC neglect in assessing broker-dealer firms at a level commensurate with the dramatic growth of the securities markets and the participating broker-dealer firms, it would be reasonable to expect that SIPC and the SEC would have made exceptional efforts to make a rapid and comprehensive response to the financial needs of the Madoff victims. That has not been the case. Quite the contrary, in fact, has occurred. SIPC has denied protection to

over half the accounts at closing, in direct violation of the legal mandates of SIPA as currently in affect; provided full protection to only 25% of accounts; taken nearly two years to pay advances to the limited group deemed eligible; and threatened to claw back funds from roughly 1000 innocent customers.

So that my colleagues may judge for themselves the urgent need for this Congressional intervention, let me highlight key factors supporting this need for action.

The legislative record surrounding the enactments of the 1970 Act and the 1978 amendments is replete with statements from the legislative floor managers, active supporters, committee reports, the Treasury, the SEC, and securities industry spokespeople likening the intended SIPC protection to the bank customer protection offered by the FDIC. Likewise, the legislative history emphasizes protection of all innocent customers from brokerage failure, with particular mention of small, unsophisticated customers, and the need for prompt action by SIPC in payment of advances for relief of individuals, understandably devastated by the sudden loss of key financial assets.

Critically, Congress recognized the need for restoring investor confidence in the financial markets at a time when the financial industry was under tremendous duress and overwhelmed by the paperwork crunch caused by the processing of physical securities. Theft and misplacement of securities, failures of trade executions, and insolvencies were commonplace. Amidst the backdrop of several popular Ponzi schemes and brokerage failures was SIPC born.

For the customer of a bankrupt broker-dealer firm to qualify for SIPC protection, it is necessary for the customer's account at closing to have a positive "net equity" determined by subtracting any outstanding obligation of the customer to the firm from the amount the firm "owed" the customer. For the forty years of SIPC's existence, it has been the standard practice in making that simple calculation to use the firm's most recent account statement to the customer, usually supported by trade confirmations, if any, relevant to the final statement's presentation of holdings and values. Not surprisingly, this is the outcome required by law. Under the legal regime governing the relationship between brokers and customers, it is indisputable that the broker owes the customer the amount reflected on the customer's account statement. Indeed, a world where customers and, generally speaking, brokers do not hold physical securities, it could not be any other way.

Given the move away from the possession and trading ownership of actual securities to a "book entry" system based on the essential trust of validity of those account statements, no customer would, therefore, have any reason to believe they would not be protected based upon their account statements and confirmations. In the SIPC receivership for the Madoff firm, however, the practices have been inconsistent with the law and quite different and contrary to the repeated assertions of SIPC and its Trustee, never to the ultimate benefit of the innocent individual customer.

Rather than using the customer's final account statement – consistent with "reasonable expectations" of a customer - the SIPC Trustee has ignored the statutory requirement of

SIPA and has devised a “cash-in/cash-out” formulation (CICO) to determine a customer’s “net equity”. To suggest that the Securities Investor Protection Act would have the effect of denying customers their legal right to rely on their account statement is counterintuitive. This formulation was developed from a position of hindsight once the Trustee, his lawyers, and forensic accountants were inside the Madoff firm and learned that no trades had been made by the firm for customers.

Even though customers had regularly received monthly account statements showing trades and holdings in “real securities” (often blue chips in the Dow 100) that were supported periodically by trade confirmations in those stocks, the Trustee declared that all transactions were “fictitious” and that statutory words such as “owed” and “positions” had no meaning. He further has asserted that in a Ponzi scheme the customer has no basis for “reasonable expectation” – a public utterance which will destroy the public’s confidence in our securities markets at odds with SIPA’s primary policy objective.

To execute the Trustee’s CICO formulation it is necessary to examine every customer account over the entire term of the relationship (for many spanning 20 to 30 years) to sum up total deposits and total withdrawals (without providing any return on investment -- even a standard rate). If deposits exceed withdrawals the customer has a “net equity” and qualifies for SIPC protection under CICO. If withdrawals exceed deposits over the life of the relationship, the customer is declared ineligible for SIPC relief and may be targeted for “clawback” of the net withdrawals.

How, you may ask, could the Trustee ignore the SIPA definition of “net equity” and proceed to institute “clawback” actions? The answer lies in SIPA’s incorporation by reference of provisions and powers under the Federal Bankruptcy Code. However, the Bankruptcy Code does not permit “clawbacks” of amounts paid by a broker to a customer to satisfy the broker’s legal obligations to the customer – our securities system could not work any other way. Again, SIPC and the Trustee are disregarding the clear body of law to further harm the Madoff victims.

Let us now examine the results of this receivership to date to determine just how equitable its performance has been.

At closing, the approximately 4900 accounts of BLMIS that have filed claims for relief with SIPC had aggregate final statement values of roughly \$57 Billion. Of that 4900, well less than half of those accounts (2053) have been determined eligible for SIPA protection under the Trustee’s CICO formulation. Only 1207 of those eligible accounts will receive full SIPA relief benefits -- advance payment of \$500,000 and a priority status to the distribution of recovered “customer funds” up to the remaining balance of the CICO-approved claim. 846 of the approved claims will receive advance payments averaging \$200,000; and because the advances fully satisfy the CICO claim these accounts have no priority status with respect to customer funds. 2728 accounts receive no relief (advances or priority status) under SIPA.

These numbers, derived from SIPC responses to the House Financial Services Subcommittee on Capital Markets, portray an outcome distressingly out of step with Congress' intent for SIPA protection.

The overall record of performance in providing investment protection in this case is even worse. The bulk of advance payments to eligible accountholders were distributed in the last quarter of 2010, fully two years after the closing of BLMIS. There is absolutely no way to square that performance with the clear mandate in Section 9 (a) of SIPA for "prompt payment" of advances – a mandate which recognized that most customers, victimized by bankruptcy of their broker-dealer, will be in dire need of urgent financial relief.

Now let us turn our attention to the "clawback" suits against innocent customers who over the course of their investment relationship withdrew what they rightly believed to be earnings for normal real life purposes – income to support retirement, payment of Federal, State, and local taxes, helping a child with a home purchase, assisting a grandchild with college costs etc. – only now to find the Trustee demanding a return of some of those disbursements.

What the Trustee now suggests as relief for all the Madoff victims, those who have received no SIPA financial protection (over half) and those receiving inadequate and dilatory relief, is the opportunity to file fraud claims against the "general" bankruptcy estate, when and if assets are assigned to it. For most of the innocent customers, now in desperate financial condition and fraught with daily anxiety, such relief is temporally distant with challenging prospects for success. In a general bankruptcy proceeding these individuals, many of them aged, will be competing with claimants (financial institutions and the like) with far greater resources and top-line legal representation.

To his credit, the Trustee, with aid provided by the U.S. Attorney's office, has assembled some significant assets from parties complicit with the debtor. The innocent customers of Madoff should without question have the first and priority claim for relief in the distribution of those assets. That is the clear intent of SIPA in establishing claims to "customer funds" before assets move into the general bankruptcy estate. Had the Trustee, at the outset of this receivership, followed historic SIPC practices using customer final statements to determine "net equity", then all of these innocent customers would now be eligible for the distribution of "customer funds" under some equitable plan devised by the Trustee with the approval of the Bankruptcy Court. Moreover, they would be protected and assisted in their distress by full advances from the SIPC Fund, which has the resources to provide such relief.

Two additional matters need to be understood by my colleagues. Because the use of the CICO methodology reduced dramatically the number of customers qualifying for advances from the SIPC Fund (an entity funded by the broker-dealer community and expressly established for the early relief of customers), that Fund has benefited by a savings of over \$1 billion. To make this outcome more unacceptable, the failure to distribute those funds means that customer refund claims to the IRS for "theft losses" will be increased by some \$300 million. Thus the broker-dealer community's responsibility gets passed on to the American taxpayer.

The conduct of this receivership has been pitifully inadequate in fulfilling the protections of the Madoff victims contemplated by Congress in 1970 and 1978. The processes employed by the Trustee, from the standpoint of the typical customer, have been needlessly time consuming and remarkably expensive. In its most recent response to the Capital Markets Subcommittee, SIPC advises that the Trustee, his law firm, and other consultants have been paid some \$288 million over two years and contemplate billing for another \$1 billion over the next four years. All the while, many Madoff victims are scrambling to exist.

It is my earnest hope that an overwhelming majority of my colleagues will join me in supporting this legislation, which is so important, not only for the protection of many innocent investors, but also for encouraging investment going forward, which is critical to the economic renewal our country needs.