A SUMMARY DESCRIPTION OF THE GARRETT-MALONEY BILL TO REAFFIRM AND REFORM THE SECURITIES INVESTOR PROTECTION ACT OF 1970

Why Legislation Is Necessary

The investment frauds perpetrated through SIPC-member broker/dealer firms, controlled by Bernard Madoff and Allen Stanford, went undetected by the SEC and the industry SRO, FINRA for decades, leaving in shambles the financial affairs of over 12,000 innocent, non-professional investors. As though that were not a sufficient failure of public responsibility, over 10,000 of those innocent investors have been dealt a further devastating public rebuke by the failure of the Securities Investor Protection Corporation to provide the SIPC Fund assistance (or any other), as intended by the Congress in the 1970 Act.

The General Objectives of the Garrett-Maloney Legislation

Our legislative reforms seek to put the administration of SIPA on a proper course for the future, to fulfill Congressional intent that customer confidence in our national securities markets will be maintained through a reliable program of assured protection for innocent investors who suffer non-market financial loss by the failure (for whatever cause) of a SIPC-member firm. It reaffirms SIPA's overarching objective to facilitate the efficient functioning of the markets as an amendment to the Federal securities statutes, and uses the Federal Bankruptcy Code practices only to the extent of consistency with that dominant national purpose. Specifically, with respect to the Madoff and Stanford failures, the bill intends that relief be provided to the over 10,000 innocent customers, ignored by SIPC, and who remain unaided nearly five years after the firms closings. Other reforms seek to clarify the intended independence of the Trustee, make authenticity of customer information a priority in supervisory inspections, and remove any doubt as to the plenary authority oversight of SIPC by the SEC.

Brief Description and Purpose of the Bill's Provisions

Determination of Net Equity

The bill modifies the current case law in the Madoff case to provide that a customer's Net Equity, establishing eligibility for SIPA protection, shall be determined for innocent customers solely from values in the customer's final account statement, and related documentation, plus any relevant account information after issuance of the final statement delivered to the customer. In cases of debtor fraud, this Net Equity determination method is denied to a customer having actual knowledge of the fraud or a customer who is registered under the Securities Exchange Act or the Investment Advisors Act, who "knew or should have known" of the fraud and failed to notify regulatory or law enforcement authorities. Use of the final account statements accepts the practical reality of modern securities markets that these account statements represent the only means for investors to have a current, detailed knowledge of the value and content of their investments. It emphasizes the paramount importance of account integrity in maintaining public confidence in market reliability. Any other

method ignores the expectations and perspective of the innocent, non-professional investor, the prime beneficiary intended by SIPA.

Clarifying and Strengthening SEC's Plenary Oversight of SIPC

As enacted in1970, SIPA provided the SEC with express authority to direct SIPC to initiate the liquidation of a member firm, when SIPC had refused to do so by voluntary agreement. That statutory provision requires the SEC to make application to a Federal District Court for an order enforcing its directive. In the Stanford case, for the first time in the 43-year history of SIPA, SEC asserted its authority and applied for the enforcement order. Surprisingly, although consistent with its fondness for litigation, SIPC contested its plenary overseer and was upheld by the District Court. The case is on appeal. Irrespective of the Circuit Court decision, an appeal to the Supreme Court seems inevitable. Thus, 7,800 Stanford victims, buoyed by the support of the SEC, will be left for another year or more unaided.

Congress, in 1970, offered no explanation for requiring SEC to obtain a court-ordered enforcement of its plenary authority directive to SIPC. By eliminating the enforcement order no legitimate private party rights to contest a liquidation are denied, because to initiate a SIPA liquidation SIPC must make application to a Federal District Court for a protective decree, which among other purposes will bring such private interests under the Court's jurisdiction.

Given that SIPC is not a public agency, but rather an industry membership organization, comprehensive SEC oversight is not only justified, it is essential. Unquestionably, SIPC has potential conflicts with the Act's primary public objectives.

It is the sponsors' conclusion that requiring the SEC to seek an enforcement order serves no useful purpose, invites dilatory behavior by SIPC, and needlessly, weakens the SEC's necessary oversight authority. Accordingly, the bill provides that an SEC directive to initiate a SIPA liquidation shall be final and absolute.

Other Bill Reforms

Improved Inspection

In modern market electronic recording of transactions and ownership demands that special emphasis be given to the authenticity of information provided to investors by their broker/dealer. The bill mandates that SEC and FINRA develop inspection procedure, to better validate that authenticity, and report to the Congressional committees of jurisdiction on implementation one year after enactment. Such inspection will also help contain fraud. In Madoff, a simple confirmation of customer account statements, with Madoff trading records at the Depository Trust and Clearing Corporation, would have quickly uncovered the fraud.

Prohibition of Claw Back From Innocent Investors

In both conventional bankruptcy practice and expressly in SIPA's text, there is discretionary authority to use avoidance (claw back) actions to recover property for distribution to creditors. There is a disagreement between SEC and SPIC concerning whether SIPC has ever used claw back against innocent investors. A fair conclusion is rare, if ever. The issue largely involves cases of fraud by the debtor.

Such cases, under SIPA, will always involve devastating losses to investors. The sponsors believe permitting claw back to compound such injury is, for humanitarian reasons, flatly wrong. Another equitable reason for barring such actions against innocent investors is the vastly greater financial resources available to the Trustee to pursue such actions as compared with the financially-devastated investor to defend.

Alternative Valuation For Distribution of Customer Property

In the opinion of the Second Circuit, in its Net Equity decision in the Madoff liquidation, the Court agreed with the Trustee that use of final statement values prohibited the distribution of customer property on an equitable basis. While having some skepticism concerning Net Investment valuation's equitable competence, the sponsors do share the Court's view that there may be circumstances in a SIPC-member failure (particularly a fraud) which justify, for equitable reasons, using valuations for the distribution of customer property other than those used for determining Net Equity. The bill permits such an alternative. But unlike the prevailing case law, it takes that decision away from the sole discretion of the Trustee and establishes a step-by-step process designed to protect the interests of all interested parties.

Timing of SIPC Advances

Despite SIPA's numerous admonitions for promptness in the conduct of a SIPA liquidation, including the distribution of SIPC advances to customers often experiencing severe financial hardship, there is no well-defined parameters of timing. The bill establishes some time lines, which require the distribution within nine months of the Trustee's notice for claim filing. Later distribution is allowed for cause, but with the accrual of interest.

Trustee and Counsel Appointment and Compensation

Current SIPA text gives SIPC the power to appoint the Trustee and counsel and to set their compensation, with both actions requiring approval of the overseeing court. It is the clear intent of the statute that the Trustee shall conduct his responsibilities as a fiduciary, totally independent of the SIPC. However, there is the appearance of a principal-agent relationship, which is unwholesome considering SIPC's obvious potential conflicts of interest. Therefore, the bill places both appointment responsibility and the compensation decision in the Court, with the SEC recommending to the Court a panel of qualified individuals. The bill also prohibits an individual serving as Trustee in two SIPA liquidations contemporaneously as was the case in Lehman and MF Global.

A New Limitation on SIPC Reliance on Treasury Borrowing

The recent financial crisis, in which the Federal Government was called on in so many separate ways to financially backstop private institutions has created a legitimate public distaste for taxpayer-financed support of private financial institutions.

While SIPC is by statute charged with administering a program to protect customers of securities firms, in the event of failure (much like the FDIC), it is in fact a private, non-profit corporation entirely funded by assessments of its member broker/dealer firms. Given its public mission, it is unwise to deny aid from Treasury borrowing in all circumstances. But it makes sense to limit access to Treasury support to those exigent circumstances in which the Secretary of the Treasury and the Chairman of the SEC conclude that SIPC is unable to borrow in the public markets at reasonable terms (both as to yield and maturity).

Certainly for the present and foreseeable future, it is highly unlikely that conditions in the private debt markets will necessitate SIPC resort to Treasury assistance to meet any recapitalization requirements of the SIPC Fund.

Effective Date

With one exception, all of the bill's provisions are effective on the date of enactment for liquidations still in progress, and for liquidations initiated thereafter. The provisions relating to the appointment and compensation of the Trustee and counsel apply only to liquidations initiated after date of enactment.