THE RESTORING MAIN STREET INVESTOR PROTECTION ACT OF 2015

POINT BY POINT DESCRIPTION OF THE PROVISIONS

LED BY CONGRESSMAN SCOTT GARRETT AND CONGRESSWOMAN CAROLYN MALONEY

INTRODUCTION:

The proposed legislation has two main objectives. The first is to reaffirm the dominant Congressional intent of the Securities Investor Protection Act of 1970(SIPA) that the efficient functioning of U.S. securities markets required the restoration and maintenance of confidence by individual, non-professional investors in the reliability and integrity of market's broker/dealer system. The central mechanism to achieve that goal was the creation of a fund capitalized and maintained by industry assessments (the SIPC Fund), which, in the event of a broker/dealer failure, will provide to innocent investors defined, guaranteed protections for their losses not otherwise recovered in the firm's liquidation.

The second objective is a series of reforms of SIPA to achieve greater fairness for victims; to assure the prompt availability of SIPC Fund relief; to emphasize the intended independence and fiduciary responsibility of the Trustee; to reduce the likelihood of a "bailout" of private interests by the U.S. Treasury; and to strengthen the plenary oversight authority of the SEC over SIPC's administration of the Act.

A summary description of the bill's provisions with policy rationale is presented below.

NET EQUITY BASED ON LAST STATEMENT:

Net equity at closing is the amount the debtor firm owed the customer minus any amount owed by the customer to the firm. It represents the value on which SIPA protection for customer losses is based. *Section 2 (a) provides that a customer's net equity shall be determined using the information in the last account statement received by the customer prior to closing, plus any confirmations of sales or purchases in the customer's account since the last statement*.
There is a fraud exception, which denies this treatment to customer who knew of the debtor's fraud and any customer registered under either the Securities

Exchange Act of 1934 or the Investment Advisers Act of 1940, who knew or should have known of the fraud and failed to notify appropriate law enforcement agencies.

In the modern securities markets physical transfers of stock, options and other contracts are recorded and maintained digitally, now using the facilities of the Depository Trust and Clearing Corporation. Thus, a customer is totally dependent on information from the broker/dealer to know the current value and content of his/her investment account.

This express requirement to use customer final account statements is intended to emphasize the paramount importance of customer account integrity in the functioning of the Securities Investor Protection Act and, beyond that, in the regulation of the securities markets. To use any other method for determining net equity is to ignore the expectations and perspective of the customer- the one intended to be protected.

MANDATE FOR DEVELOPMENT OF INSPECTION PROCEDURES TO VALIDATE AUTHENTICITY OF CUSTOMER INFORMATION:

All member firms of SIPC are registered under the Securities Exchange Act and are subject to appropriate SEC regulations governing the operations. Compliance with regulatory requirements is checked through periodic inspections by the SEC and the Financial Industry Regulatory Authority (FINRA), an industry SRO.

Given the regulated nature of the registered broker/dealers, investors have every reasonable right to assume that broker/dealers are making a best effort to assure that customer account statements and other information, such as trade confirmations are accurate and that the SEC and the FINRA employ inspection procedures to validate the authenticity of this key customer information. The Madoff fraud and other Ponzi schemes would suggest that inspections have not been focusing on this important customer protection. For example, Madoff, himself, acknowledged his scheme would have been quickly discovered by a random confirmation of information with his account at the Depository Trust and Clearing Corporation.

Section 2(j) provides that the SEC and the SRO, of which the member of SIPC is a member, shall carry out periodic inspections to ensure that customer information is accurate. Within one year from date of enactment, the SEC shall report to the House and Senate Committees of jurisdiction on the implementation of this mandate.

This amendment will add to the efficacy of using final account statement for defining Net Equity under SIPA and should be effective in uncovering fraudulent broker/dealer behavior.

PROHIBITION OF CERTAIN CLAW BACK ACTIONS:

Section 2 (c) will prohibit claw back actions of transfers from the debtor to a customer, except a customer who knew of the debtor's fraud or a customer, as in Subsection (a), registered under the applicable securities statutes knew or should have known of the debtor's fraud and failed to report that information to appropriate law enforcement agencies.

Claw back of transfers, in the normal course of securities transactions, has already been restricted by securities legislation enacted subsequent to SIPA of 1970. Such actions under the Bankruptcy Code and SIPA are always discretionary, based on facts and circumstances. It is believed that that claw back from innocent individuals should be barred, as a general matter of equitable consideration, for the plight of innocent customers suffering unanticipated loss of life savings. In the Madoff case, it was the SEC's expectation that such suits would not be brought against innocent individual customers. In the entire history of SIPC, there are few cases in which claw back has been used. It is a practice imported from traditional commercial bankruptcy, where there is only one source of customer recovery, the property of the debtor estate and customers do not have the same reasonable expectations that are justified by dealing with a Federally-regulated and inspected business.

Another equitable consideration, justifying the prohibition of claw back of innocent customers, is the Trustee's vastly greater financial resources to litigate these law suits than the typical innocent individual customer. The Madoff liquidation vividly demonstrates the financial advantage of the Trustee in these actions against innocent individuals with nearly a half billion dollars having been expended on legal fees.

Claw back of transfers from the debtor to non-customers, currently permitted based on a claim of fraudulent conveyance, continue to be valid.

APPOINTMENT OF SIPA TRUSTEE AND ATTORNEY:

Under current law, the appointment of the Trustee charged with overseeing a SIPA bankruptcy liquidation and the Counsel supporting the Trustee are made by SIPC with the approval of the Bankruptcy Court.

Section 2 (d) changes this procedure to provide that the Bankruptcy Court shall make these two important appointments from a panel of qualified and disinterested individuals proposed by the SEC.

Removal of this authority from the SIPC is designed to better assure that the Trustee and Counsel are clearly independent of the SIPC which, with respect to customer advances and other outlays related to the bankruptcy liquidation, has financial interests which can present issues in conflict with the best interests of debtor's customers and other creditors.

ALLOCATION OF CUSTOMER PROPERTY TO CUSTOMERS:

The current provisions of SIPA provide that in the allocation of customer property that distribution shall be "ratable" based on the relative "net equity" values of the qualifying customers. Customer property is akin to a debtor's estate in a traditional commercial bankruptcy proceeding in which Trustee often, based on the circumstances of a particular case, give effect to equitable considerations in the allocations among creditors. Use of final statement values makes such equitable allocation of customer property among customers of a failed SIPA-member broker/dealer nearly impossible. There is no reason for that result.

Section 2 (b) provides an alternative procedure for the allocation of customer property when a Trustee finds compelling equitable circumstances for formulating a distribution plan permitting differential treatment based on equity. But the development of that plan is now, under the Second Circuit decision in the Madoff case, left solely to the discretion of the Trustee, an unfettered authority never intended by the Congress. The bill provides that the trustee must consult with the SEC; the plan must e submitted to the overseeing court, which is required to notify interested parties and receive their comments before approving, modifying or rejecting the plan. The Trustee may, if necessary, ignore final statement values to achieve a plan's equitable objective.

This is an enormously useful change to existing law, which permits a liquidation to fulfill SIPA's guarantee of protection from the SIPC Fund, while at the same time taking full account of differentiating customer circumstances in distributing customer property.

PROHIBITION OF TRUSTEE SERVING IN MULTIPLE LIQUIDATIONS:

Subsection 2 (d) (1) (E) provides that no SIPA Trustee shall serve two or more liquidations contemporaneously.

The rationale is the commonsense judgment that qualified talent is not in such short supply that one individual is, in fact, needed for two such assignments at the same time. Such multiple assignments feed the unwholesome view that those serving belong to an informal SIPC "club".

COMPENSATION OF TRUSTEE AND COUNSEL:

As noted earlier, present law has the Trustee and his Counsel selected by the SIPC and likewise their compensation is set by the SIPC, subject to Court approval, which in practice has become pro forma. That encourages an appearance (and perhaps a reality) of principal and agent - entirely contrary to SIPA's intent that the Trustee is an officer of the Court and an independent fiduciary to achieve objective administration of the liquidation.

Section 2 (d) (2) provides that matters of appropriate compensation for the Trustee and Counsel shall be solely within the province of the Court; and the

Court shall assure periodic publication of this compensation. As presently permitted the Trustee and counsel may be members of the same law firm.

These amendments, like those related to Trustee appointment, are to enhance the independent role of the Trustee and the fiduciary responsibilities of that post. Giving the Court responsibility for appointment and compensation should heighten the Court's oversight of the liquidation to assure its fulfilling its obligation to all of the innocent customers.

These changes regarding the appointment and compensation of the Trustee and Counsel will apply only to liquidations initiated after the date of enactment.

TIMING OF SIPC ADVANCES:

SIPA contains multiple references indicating that SIPC should be "prompt" in making available funds to the Trustee for distribution to customers as "advances" against losses suffered in the bankruptcy. Congress intended that the guarantee of financial protection up to $500,000 of account value should be handled promptly, recognizing that many (maybe all) customers will be in serious financial need. Yet the statute sets no timeline. *Section 2 (g) provides that before 90 days from the deadline for filing customer claims (six months from initiation of Trustee's notice) SIPC advances shall be distributed*.

In the event the distributions cannot be made within the designated timeline, there are provisions for the accrual of interest.

The Madoff case represents a sad example of the SIPC and the Trustee ignoring this instruction for prompt action. According to information provided to the Subcommittee, it appears the preponderance of SIPC advances were not distributed for over a year after the firm's closing. That delay was largely the result of the ponderous administrative requirements of the Trustee's Net Investment methodology for defining Net Equity.

COMMISSION AUTHORITY TO REQUIRE SIPC ACTION:

Years ago, the Supreme Court declared that the SEC had plenary authority over SIPC. Plenary is normally interpreted as comprehensive and absolute. In the Stanford Ponzi case, the SIPC and the SEC have had a policy dispute over whether SIPC should initiate a SIPA liquidation. Under the statute, as written, the SEC must apply to a Federal District Court to enforce it directive to SIPC. Remarkably, the Court has denied the SEC's application for enforcement in a suit brought by SIPC. That decision has been appealed by the SEC. This produces the absurd result that victimized customers are left to await a judicial resolution of an administrative disagreement between the SEC, the public agency which is the primary regulator of the securities industry, SIPC's designated plenary overseer, and SIPC, a non-public, industry member organization. Permitting a policy disagreement between two entities charged with responsibilities concerning the protection of consumer interests to require judicial resolution is clearly unfair to the affected consumers, as well as destructive of public confidence in the conduct of government.

The requirement for the SEC to seek approval of a Federal District Court to enforce an order for SIPC to initiate a SIPA liquidation would seem to have no practical justification. SIPC's authority to determine the adequacy of customer claims is not pre-determined by this order. Requiring SEC to obtain an enforcement order is, at best, superfluous and, at worst, an occasion for unacceptable delay, as has been demonstrated in the Stanford case. *Section 2(i) eliminates the requirement for a Court-approved enforcement order, thus making the SEC directive to the SIPC final and absolute. This will strengthen the SEC's oversight and hopefully make it more active in that role.*

DEFINITION OF CUSTOMER:

Section 2 (e) of the bill makes two additions to the definition of customer contained in Section 16 of SIPA.

The first provides an overdue clarification of the definition to codify rulings in two Court of Appeals cases, *In re Old Naples Securities, Inc., 223 F.3d 1296 (11th Cir. 2000) and In re Primeline Securities Corp.,* 295 F.3d 11000 (10th Cir, 2002). Those decisions hold that an investor, in certain circumstances, may be deemed to have deposited cash with a broker-dealer for the purpose of purchasing securities – and thus be a "customer" under SIPA –even if the investor initially deposited those funds with an entity other than the broker-dealer.

This definition stresses substance over form to give appropriate consideration to the investor's intention to purchase securities and to assure that SIPA's primary objective of customer protection is not defeated by a debtor's clever structural devices to accomplish a fraudulent conversion of customer cash or securities. It emphasizes circumstances in which the investor's cash (intended for purchase of securities) or securities are converted or otherwise misappropriated by a person operating through the debtor and is under common control with the debtor. And the debtor is, of course, an SEC registrant and a member of SIPC.

It is hoped that this more customer- focused definition will move SIPC away from a distressing pattern of practice, in which excessively narrow and limited interpretation of statutory terms ignore the perspective and expectations of the typical retail brokerage customer and, thus, defeat the remedial purposes intended by the Congress.

The second addition gives the SEC discretionary authority to include within the definition of "customer" of a broker-dealer for SIPC purposes any party that the SEC concludes, based on the specific facts and circumstances presented, should be deemed to be a customer for that purpose even if arguably that party falls outside of the technical requirements or is a borderline case. Such a party will likely be rejected by SIPC as a matter of SIPC's self-interest. The SEC, as the primary oversight agency for SIPC's administration of SIPA would thus be in a position to provide appropriate protection from arbitrary rejection by SIPC, which might then require the party to engage in expensive and time consuming

litigation to vindicate that party's entitlement to "customer" status. It would thus bolster and provide substance to the SEC's oversight and supervisory role for the benefit of aggrieved investors, as Congress so clearly intended.

LIMITATION ON TREASURY BORROWING TO RECAPITALIZE THE SIPC FUND:

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 such taxpayer-financed support. SIPA presently authorizes the SEC to request funding through Treasury borrowing to meet a deficiency in SIPC resources. That support is capped at $2.5 billion.

While SIPC is by statute charged with administering the SIPA 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. Thus use of Treasury funds is clearly a backstop of private financial institutions. However, given SIPC's public mission, it would be unwise to deny Treasury support in all circumstances. *The bill's provisions in Section 2(j) strikes a balance by requiring that Treasury funding only be available in circumstances where the Commission in consultation with the Secretary of the Treasury determines that SIPC is unable to borrow in the public debt markets on reasonable terms (both as to yield and maturity).*

Certainly, for the present and foreseeable future, it highly unlikely that SIPC will have any difficulty borrowing on reasonable terms. Additionally, the current level of assessments of SIPC member firms is more than reasonable. For 2012, the average annual assessment was $94,950; the median was $2,500; and for the five largest broker/dealer firms the average assessment was $23,147,000.

EFFECTIVE DATE:

Section 3 provides that, in general, the amendments made to SIPA shall be effective on the date of enactment for any liquidation proceeding still in progress and for any proceeding initiated thereafter. However, the bill's provisions related to the appointment and compensation of a trustee and counsel shall only be effective for proceedings initiated after the date of enactment.