TESTIMONY OF

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before the

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

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Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee:

I am Joseph Borg, Director of the Alabama Securities Commission and I welcome the opportunity to participate in your hearing focusing on the Securities Investor Protection Act (SIPA) and the Securities Investor Protection Corporation (SIPC). Today I appear as a member of the SIPC Modernization Task Force and in my capacity as Director of the Alabama Securities Commission (ASC). Our office has administrative, civil and criminal authority under the Alabama Securities Act and specifically with respect to investor fraud, ASC investigates Ponzi and pyramid schemes, illegal blind pools, fraudulent private placement offerings under Regulation D and other scams which have led to numerous enforcement cases and criminal prosecutions in this arena.

With about 55% of US households now investing in our capital markets, up from 1 in 18 in 1978 (the year of the last significant amendments to SIPA), financial fraud has a profound impact on a great number of working families.

With regard to SIPC, I was invited to participate on its Modernization Task Force in late May of 2010. Since that time, we have had a series of telephone conferences, three in-person meetings discussing various issues related to SIPA and SIPC, as well as dedicated website access to exchange information and ideas. I would like to take a few minutes and advise you of my position with regard to certain “modernization” issues which I have either proffered or have supported. These views do not necessarily reflect those of SIPC or of the Task Force. The Task Force discussions are concentrating on twelve particular areas as follows:

1. Adequacy of the SIPC Fund,
2. Audit Responsibilities,
3. Avoidance Actions,
4. Corporate Governance,
5. Customer Definition,
6. Customer Name Securities,
7. Customer Property,
8. Direct Payment,
9. Fictitious Securities,
10. International Relations,
11. Investor Education, and
12. Levels of Protection.

In order to move the process along in an efficient manner, the Task Force has been subdivided into two groups. Later, the subgroups will join together for discussions on the various subjects for final recommendations. I would like to take a moment to commend the SIPC staff for prompt responses to my specific requests for information, data, reports and source materials in order for the Task Force to become adequately informed in certain areas. My particular areas of concern are as follows:

1. UULevels of Protection. It is my belief that the level of protection with regard to the SIPC Fund should be increased from $500 thousand to $1 million. It is clear that in today's society, Americans are heavily invested in the markets and that a large portion of their retirement savings consist of securities investments in addition to savings in banks. Further, the $1 million level of protection would match SIPC's Canadian counterpart, the Canadian Investor Protection Fund (CIPF), which is currently at the $1 million (CAN). Secondly, I believe that the levels of protection should be indexed to inflation. Part of the public's concern with SIPC is the lack of adjustments over the years to the levels of protection, and indexing to inflation would allow some measure of increased protection going forward.
2. Fictitious Securities. A major issue is the treatment of claims based on a securities position which never actually existed. The Task Force is aware of the conflicts between decisions from the Second[1] and Sixth Circuit Courts of Appeals[2] in this area. I believe that the problem which stems from SIPA's distinction between cash and securities (currently $250,000.00 cash limit) could be eliminated by ending the

[1] *In Re: New Times Securities Services, Inc.*, 371 F.3rd 68 (2nd Cir. 2004)

disparate protection between claims for cash and claims for securities.[3] For example, a person selling their securities portfolio and receiving a check in excess of the maximum SIPC advance for cash claim where the brokerage firm failed before the check was cashed, would be limited to the cash limitation.[4] Therefore the current law may, in some cases, result in unintended and inequitable results. I would also note that the Canadian Investor Protection Fund (CIPF) eliminated a distinction between claims for cash and claims for securities in 1998. In a discussion with SIPC staff, it appears that a change in favor of eliminating the cash vs. securities distinction would not alter the risk models used by SIPC[5].

With respect to increasing the limit to $1 million and eliminating the cash vs. securities distinction, the banking industry and/or banking regulators could be expected to oppose such a change as there has been an apparent historical progression of matching levels of FDIC protection to SIPC limits even though the operation of FDIC insurance is completely different to the operation of SIPC as a securities replacement vehicle. Certainly discussions with the Securities & Exchange Commission (SEC), Treasury, Federal Reserve Board and views of the industry (SIFMA) and other authorities would be appropriate.

3. <u>Increase the Line of Credit from Treasury</u>. Considering the explosive growth of the markets and investor participation therein since the enactment of SIPA and the expected continuation of growth in the securities markets, a change in coverage to $1 million cash or securities and indexed to inflation may require an increase in the line of credit from Treasury. The Task Force has requested the staff of SIPC to review the effect of protections at the $1 million level. It is my personal feeling that a line of credit of $5 billion matched with reserves of $5 billion would be appropriate going forward. At the current level of assessments, it will take a number of years to reach those levels. However, I believe those levels to be realistic and planning for them should begin now.

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[2] *Plumbers & Steamfitters Local No. 490 Severance and Retirement Fund v. Appleton (In Re: First Ohio Securities Co.,* No. 93-3313, 1994 US App. LEXIS 31347) (6th Cir. Nov. 1, 1994)

[3] If Subsection (a)(1) of SIPA § 78fff-3 is deleted, the disparity would no longer exist.

[4] Investors do not routinely accumulate cash with a broker and an investor's position is only "caught" in a cash position when the brokerage firm fails.

4. Assessments. Prior to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), assessments by SIPC had a floor of $150.00 with a maximum of .25% of revenues. The SIPC staff has also informed the Task Force that there are some SIPC members under the new Dodd-Frank Act who now pay zero assessments.[6] It is my belief, as well as other members of the Task Force, that there should be a minimum assessment of some amount. I believe that minimum amount should be at least $1,000.00 and preferably in the range of $2,000.00 to $2,500.00. Based on information from the SIPC staff, SIPC receives about 80% of the assessment revenue from the larger firms and at current levels it will take approximately 5 years for the fund to reach the current target of $2.5 billion. I was surprised to learn that in computing assessments that revenues on mutual funds are not included. I am of the opinion that since all investors benefit from SIPC protection, that revenues on mutual funds should be included for assessment purposes as well.

   Regardless of the target level that the Task Force recommends or what target level of funding for SIPC is finally adopted, any time that a target level is reached, there should be another determination of whether assessments are adequate based on the current level of investors assets in the market and whether new targets should then be considered. Also, it appears to me that the current arrangement with the Treasury for a line of credit, which is a term loan, should actually be a revolving loan in order to ensure continuity and flexibility in the ability of SIPC to protect investors where and when needed.

5. Investor Education Efforts. It is clear that there is a general public misconception that SIPC is some type of insurance, akin to FDIC insurance for banks. It is also clear in SIPC's application of the law that SIPA was not intended to be insurance for fraud, but only for replacing cash, as well as securities missing from customer accounts not connected to the actual value of investment into the securities purchased or believed to have been purchased, and not based on a risk of loss fundamental. If

[5] It is my understanding that the sufficiency of the SIPC Fund Analysis is premised upon paying each claim up to the maximum limit for securities.

[6] Due to deductions for expenses, etc., in some cases, certain broker-dealers, based on net operating revenues, now pay zero due to elimination of any floor for assessments.

Congressional intent is to change SIPC into FDIC type insurance-based protection, then the parameters of the level of funding would change. The misconception has been historically exacerbated by references to FDIC as a comparison and by the broker-dealer community who tout the SIPC protection levels. Education initiatives to correct the misconception have proven to be inadequate. Therefore, I would suggest that to seriously educate investors with an understanding as to what levels of protection are available and the true nature of SIPC protection, a constant and systemic notification (education) effort will be required. I would suggest that every brokerage account statement that is sent to investors include a page or a section that clearly underscores what SIPC is and is <u>not</u>. I would also suggest that it include examples which change every quarter so that the public can see what to expect or not to expect from SIPC. The fact of the matter is that television advertisements, public presentations and newspaper reports are one-shot efforts that will not overturn a history of belief and expectation. I would also not recommend an insert into the account statements as they have a tendency to be discarded, instead, every account statement would have a portion of a page dedicated to SIPC coverage. It may take several years of constant message delivery to reverse the current tide of misconception. This is not to say that elimination of other types of investor education is desirable. However, for true education, the repetitive nature of account statement receipt should assist in disseminating correct information of the purpose and role of SIPC. I am also aware that SIPC does not have the power or authority to require this type of account statement inclusion and the matter would have to be implemented through the SEC and FINRA.

<u>Response to Issues Presented in the Subcommittee's Invitation of September 16, 2010</u>:

In the September 16, 2010 invitation to appear before this Subcommittee, there were certain issues that the panelists were invited to address. I will respond to them in the order presented.

1. <u>Whether the SIPC board should include a representative of the Securities & Exchange Commission (SEC) and what, if any, other modifications to the</u>

____________________________________. It is my understanding that SIPC reports to the SEC by way of required records and reports, as well as the filing of an audited annual report, and that SIPC must obtain SEC approval for changes to its operational rules and bylaws. Although I see little harm in having an SEC representative on the SIPC board, caution should be exercised. It appears that since SIPC, in essence, reports to the SEC, an SEC representative could possibly exercise undue influence over the board in its recommendations or positions which may, in some instances, become a conflict of interest. It appears that the question of an SEC representative should be addressed to an expert on corporate governance for a determination of possible conflicts in this area. In any case, an SEC representative should continue to attend each SIPC board meeting as an observer or adviser, which I am advised is currently done.

2. Whether the statutory minimum balance of the SIPC Fund should be adjusted in light of the recent increase in the target balance, and if so, explain how it should be adjusted. As I mentioned earlier, I believe the balance in the fund should be adjusted substantially upwards given the effect that a major case may have on SIPC's reserves. According to the SIPC staff, the former $1 billion balance has historically proved adequate to meet the requirements of SIPC cases, however, it is my belief that in light of the growth of the securities industry, plans should be made for a larger target and that is why I have recommended a target of $10 billion, composed of $5 billion in reserves and $5 billion revolving line of credit. I have no mathematical formula for this opinion. However, by increasing the coverage amount to $1 million, essentially a doubling of the current $500,000.00 limit, and looking at the possibility of the potential impact of future fraud cases, it appears prudent to be prepared so that assessments over time will be realistic and that the balance of the fund is also increased over time.

3. Whether any trustee appointed by SIPC should also be subject to bankruptcy court approval and whether trustees appointed in civil liquidations have been as efficient and effective as those appointed under similarly sized non-SIPC liquidations. It is my understanding that the bankruptcy court appoints the trustees in SIPC cases and that there must be a designation that the trustees are

4. Whether the standard to file a SIPC claim is too low and whether it results in frivolous claims that slow down the liquidation proceedings or otherwise creates an expectation on behalf of the customers that their claim is bona fide. I think it can be reasonably assumed that when people file claims with regard to any type of action, they believe they are entitled to some recompense. From that point of view there is a possibility that filing a SIPC claim creates an expectation, however, limiting a potential claim may cause greater harm in that the claimant who fails to file a timely claim but was eligible will be barred from recovery. From a public policy point of view it appears that encouraging investors to file a claim when they think they have a claim is preferable than trying to eliminate claims on the front end and then discovering that some with viable claims have not filed. Since this is a fine line, I would err on the side of encouraging anyone who believes they have a claim to make the appropriate filing. Although this may result in an increase in time and perhaps costs, covering the universe of potential claimants is preferable to inadvertently leaving someone eligible out of the claims process. We are advised by staff that they have no historical indication that there have been a large number of frivolous claims in SIPA proceedings. Understanding that the *Madoff* situation may be unique, the *Madoff* matter may be an exception to the general rule.
5. Whether SIPA's direct payment procedures result in an efficient and effective way to return customer property and whether and how such criteria ought to be modified. In discussions with the SIPC staff and reviewing SIPC's direct payment procedures, it is my opinion that the direct payment procedures appear to be efficient and effective in returning customer property.[7] I have suggested to the Task Force that the direct payment amount threshold should be increased[8] to

[7] SIPC records indicate that the direct payment procedure has been used in 35 of the 204 proceedings since 1978.
[8] Current law authorizes use of out-of-court direct payment procedure where aggregate claims are less than $250,000.00 [15 U.S.C. '78fff-(4)(a)].

utilize the efficiency of the direct payment procedures. The Task Force is currently discussing what that proper amount should be and I have recommended that the Task Force consider $2 million as the appropriate amount.

6. Whether the statutory definition of a customer eligible for SIPC coverage remains relevant given indirect investing increases via retirement plans and hedge funds. The Task Force has had initial discussions with regard to indirect investors. It is my opinion that certain retirement plans are appropriate for customer eligibility. I am unsure with respect to the hedge fund arena due to the nature of hedge fund investing, including lack of transparency, lack of oversight and higher risk strategies. However, this matter is on the agenda for further discussion with the Task Force. The Task Force is also aware that certain pension plans and employee benefit plans have been covered by FDIC and NCUA on a pass-through basis since 1978.[9] The limitation is that each beneficiary could only receive the "present vested and ascertainable interest of each beneficiary". Issues concerning deferred compensation plans and non-bank covered pension funds are issues for Task Force discussion. It appears to me that pension plans and employee benefit plans matching those covered by FDIA and FCUA would be appropriate for protection under SIPA.

7. Whether and how SIPA's definition of customer property should be amended in light of the changing nature of customer arrangement with their broker-dealer, including account balances tied to client commission agreements and innovative investment vehicles such as security based swaps and to-be-announced security transactions. There is a substantial difference between individual retail investors and large institutional investors (including large sophisticated investors) who have interrelated and complex agreements with brokerage firms. Clearly the original intent of SIPA in 1970 was protection of the retail market and it appears that the complex relationship investment arrangements implicit in the question were not contemplated at the time. While this area deserves study, truly sophisticated investors, especially institutional investors, are in most cases a

different type of investor and therefore it may be appropriate for these non Main Street large investors to be subject to a different standard than traditional SIPA protected investors.

8. <u>Whether and how SIPA's definition of "net equity" should be revised to address situations whereby a customer statement from their broker-dealer does not agree with the broker-dealer's books and records and the extent to which customers should be entitled to rely on a statement they have received</u>. Historically, customers net equity has been determined by the securities position shown on the customer's account statements. And again, historically, the account statements would show accurately the transactions that occurred, but the securities were then missing. In most cases, where statements are received the securities positions that had been purchased at the customer's instructions are accurate and those securities are expected to be in their accounts. It is a different matter, however, when securities positions are fictitiously created, as in the *Madoff* case. The Madoff customers expected that the money given to Madoff would be placed in legitimate trading circles. Concocting account statements with 20/20 hindsight is more akin to the type of Ponzi and pyramid schemes generally seen by state regulators in which no SIPC member is involved. The vast majority of these cases which occur on an alarmingly frequent basis cause the same monumental damage to individual investors as any *Madoff* or *Stanford* case. These situations have generally been handled through the cash-in cash-out method of calculating equity. In the 15 years my office has been handling cases involving Ponzi, pyramids and other schemes outside the SIPC arena, most cases only return pennies on the dollar with the assets marshaled through a receivership and distributed based on a cash-in cash-out basis. Where there are inflated account statements, they do not reflect actual cash in but a promise of expectation computed retroactively or completely fabricated. Where there are insufficient assets to pay all parties, the most fair determination has been to compute all cash in, all distributions out, resulting in the net loss, then

[9] Allowing for each beneficiary of a pension, profit sharing plan (401(d) of IRS Code) or individual retirement account (408(a) of IRS Code) – FDIA amended in 1991 to allow for 457 plans (deferred

determining the pro rata basis for payments of whatever assets have been marshaled. This is significantly different than a customer who directs a broker to buy a specific security, the trade is paid for and the broker sends a false confirmation. In a non-SIPC covered fraud, this would be of no effect since there is no coverage for said transaction. However, under SIPA, the customer's net equity would be the market value of the security the broker should have purchased that the customer actually paid for and the broker-dealer lied about having purchased. SIPC would then obtain the security in the marketplace or credit the customer with the actual market value as of the appropriate filing date. Utilizing the last inflated account statement would give a preference to earlier investors while disenfranchising later investors. It should be noted that the time-value of the funds is not considered in the non-SIPA cases generally handled by the states. Most Ponzi schemes do not last for decades, are relatively short in time and therefore the time value interest differential is generally not significant. It is my understanding that the SEC has taken a position with regard to the *Madoff* case that the calculations could include a factor with regard to time value or time equivalent (constant dollars)[10]. It would appear that each case would have to be reviewed for a determination based on the amount of investments and the <u>time</u> that the fraud was ongoing. I would respectfully suggest, based on our history of cases and prosecutions involving Ponzi schemes, that generally the cash-in cash-out is the most equitable method in most cases. However, cases involving a situation of long-standing ongoing fraud could consider a cash-in cash-out and a factor of time value or time equivalent conversion, *except* that each investor's claim should be measured from a date certain, whereupon an inflation factor would be applied. This type of time value of money approach appears to require a statutory change to SIPA as this variable treatment is not recognized under current law.

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compensation plans) and certain non-profits.

[10] U.S. House Committee on Financial Services, Subcommittee on Capital Markets – Testimony of Mr. Michael Conley, Deputy Solicitor, U.S. SEC, December 9, 2009.

Judging from the complexity and duration of certain current Ponzi schemes, some flexibility in the SIPA rules and SIPC administration is due to be considered and should be reviewed by the Task Force.

9. Whether the requirement for SIPC to pay interest on customer named securities and customer property not distributed within 60-days of filing the SIPA Liquidation Application is an effective way to ensure that customer claims are properly satisfied. In discussions with the SIPC staff, it appears that the issue of substantial delays rarely arises. We are advised that the typical liquidation involves a transfer to a solvent brokerage. However, provisions requiring SIPC to pay interest on property not distributed within 60-days may not be much of a motivating factor to encourage customer claims to be paid promptly and, further, could add to the complexity of the payment calculation. Questions may arise as to when the 60-days begin to run, or, if claimant waits until the end of the six month period to file a claim. Also, it appears that, in general, interest is not paid on bankruptcy claims. For these reasons, I believe a provision for the payment of interest would not effectively ensure claims are satisfied more efficiently. On the other hand, one issue to be considered is that under state law if an improper sale of securities has occurred or where a recission is ordered by the state securities regulator, each state may apply a statutory rate of interest. For example, in Alabama, a recission of a transaction order or a buy-back includes a 6% interest factor. Other states will have varying amounts of statutory interest. Whether this has any practical value in a SIPC claims situation has not yet been discussed by the Task Force.
10. Whether the avoidance powers granted to a trustee in a SIPA liquidation should differ from US Bankruptcy Code. The US Bankruptcy Code has been a primary vehicle with regard to determining avoidance powers and setting precedents. I see no reason to create a separate system for SIPA liquidations that differ from the US Bankruptcy Code. Not only will a different system cause confusion, but considering there is a national system in place under the US Bankruptcy Code, uniformity with respect to avoidance powers would be preferable. At the present

11. <u>Whether the mechanics for informing investors about the existence of and protections afforded by SIPC should be altered.</u> The issue with regard to investor education and the existence and levels of protection afforded by SIPC was discussed earlier and I would refer the Subcommittee back to Page 4 of this paper.

12. <u>Whether the private sector could provide primary coverage in the event that SIPA was modified to eliminate and replace SIPC's coverage with a requirement for broker-dealers to obtain private coverage comparable to the coverage currently provided by SIPC and whether excess SIPC coverage by the private sector is appropriate.</u> For all practical purposes, a meaningful broker blanket bond does not exist with respect to fraud claims. A number of brokers have minimal capital requirements to begin with. Problems will exist as to whether or not the broker who has placed itself in financial jeopardy would continue the blanket bond and whether the damage, already done to investors, would have any real recompense. Without a central entity, such as SIPC, the "coverage" is only as good as the insurance company behind the blanket bond, assuming that it remains in effect and generally, in the business community, fraud claims are either not covered or vigorously defended. I do not believe this would be a practical approach and in the current environment, private insurers are generally not interested in selling this type of coverage. If available, the cost could be prohibitive to most brokers thereby reducing the competitive nature of the industry. This is not an area that I have studied in any great detail and would leave to others more qualified to comment, however replacing SIPC which a private sector insurer does not appear workable or desirable.

13. <u>Whether the capital adequacy rules for broker-dealers are sufficient to prevent significant customer losses</u>. In my experience as a state regulator, the capital rules are generally insufficient to cover losses. This is an area for SEC and FINRA to utilize their experience to consider the capital rules in light of today's environment and issue a report and recommendation. In a situation where fraud

14. Whether investment advisers should be scoped into and subject to assessments under SIPA or a similar protection regime. In general, investment advisers do not hold customer assets, as the assets and the transactions involving those assets are held at a broker-dealer who would be a SIPC member. In light of the current switch of a significant portion of the investment adviser population from SEC to state level, the question by the Subcommittee has prompted my office to undertake a review of the activities of those investment advisers, between $25 million and $100 million, to determine the differences in their operations with respect to the investment advisers we have historically regulated (those under $25 million). I expect to share the results of my staff's examination with the Task Force. Until such time of the determination as to whether or not this is a significant issue, I am reserving an opinion.

International Relations.

In addition to the above discussion, I have been requested by the Task Force to look at SIPC's involvement in international relations. For a number of years I have been honored to represent NASAA[12] at the International Organization of Securities Commissions (IOSCO) and the Council of Securities Regulators of the Americas (COSRA). From 2004 through 2009 I served as a U.S. Delegate as an expert on securities fraud to the United Nations Committee on International Trade and Law (UNCITRAL). In reviewing SIPC's activities, it is apparent that SIPC has taken a more active role in international affairs as broker-dealers increasingly have overseas affiliates or subsidiaries, and, as demonstrated by the failure of Lehman Bros., these overseas affiliates and subsidiaries can have world-wide implications. The questions being asked by the Task Force include:

1. "Does SIPA adequately protect customers in the event of the insolvency of a member which is a multi-national corporation?"

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[11] Please also see related discussion in Item 12 above.

[12] NASAA (International Securities Administrators Association) is a voluntary association whose membership consists of 67 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

2. “How can membership in an international association of investor protection agencies be used effectively?”
3. “What lessons can be learned from the liquidation of Lehman Bros., Inc.?”

SIPC’s records show that it has entered into Memoranda of Understanding with a number of foreign regulators, including the Financial Services Compensation Board (United Kingdom), Canadian Investor Protection Fund, Securities and Futures Investor Protection Center (Taiwan), Korea Deposit Insurance Corporation, China Securities Investor Protection Fund Company, Ltd., and Egyptian Investor Protection Fund. Recently SIPC has joined IOSCO as an auxiliary member. The SEC is the primary member of IOSCO for the United States, followed by the North American Securities Administrators Association (NASAA) as an affiliate member, FINRA as an affiliate member, and SIPC as an auxiliary member beginning in 2009. Current discussions are underway concerning creation of a new organization to deal exclusively with investor protection in the context of cross-border financial intermediary collapse. It is therefore appropriate for SIPC to enter discussions with the Secretary General of IOSCO concerning a new international association of investor protection entities. There appears to be preliminary interest from the IOSCO Secretariat in the creation of this entity under the auspices of IOSCO. Such an international cooperation mechanism could formulate and develop policies as:

1. Formal rules on cross-border protection issues,
2. Create a dispute resolution mechanism with a team of experts available,
3. Develop a platform for exchange of information, and
4. Establish cooperative principles.

Work towards development of an international forum has already begun through the efforts of Mr. Chen Gongyan, Chairman of the China Securities Investor Protection Fund Corporation and a member of the Task Force. Discussions with SIPC to build an international cooperation mechanism were brought about primarily due to the *Lehman Bros*. case and Chairman Gongyan has indicated his willingness to co-sponsor an international forum together with SIPC and the Canadian Investor Protection Fund. Communications with the IOSCO Secretary General are underway to organize an open forum to discuss the issues and determine protocols for creation of such an international organization. Work in this arena is extremely preliminary and is subject to a number of factors, including relevant application of law to cross-border investor protection, varying laws involving bankruptcy, development of an information sharing platform and transparency with regard to the rules of compensation and protection to ensure that investors within the country and abroad have a fair chance to submit an application for compensation and access to relevant information.

I thank you again for the invitation and opportunity to appear before you today.

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