TESTIMONY OF IRA HAMMERMAN,
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SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON:
ASSESSING THE LIMITATIONS OF
THE SECURITES INVESTOR PROTECTION ACT

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I. Introduction

Chairman Kanjorski, Ranking Member Garrett, members of the Subcommittee:

My name is Ira Hammerman, and I am a Senior Managing Director and General Counsel of the Securities Industry and Financial Markets Association ("SIFMA")[1] and a member of the SIPC Modernization Task Force (the "Task Force") formed by the Securities Investor Protection Corporation ("SIPC"). I am appearing here today as a representative of SIFMA and not of SIPC. Thank you for allowing me to submit my full statement for the record.

The work of the Task Force to undertake a comprehensive review of the Securities Investor Protection Act ("SIPA") and SIPC's operations and policies and to propose reforms to modernize SIPA and SIPC has only recently begun. Therefore, my testimony will focus on SIFMA's preliminary recommendations regarding appropriate revisions to SIPA in light of issues emerging from recent SIPA liquidation proceedings and the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington D.C., is the U.S. regional member of the Global Financial Markets Association. (More information about SIFMA is available at http://www.sifma.org.)

SIPA's fundamental purpose is to promote investor confidence in the U.S. capital markets by protecting customers against the loss of cash or securities resulting from the failure of the broker-dealer holding such property. When a broker-dealer fails and enters liquidation under SIPA, SIPA provides for the distribution of the customer property held by the failed broker-dealer to its customers, *pro rata* based on the net value of the securities and cash in their respective accounts, known as their "net equity." To the extent the customer property held by the failed broker-dealer is not sufficient to satisfy the net equity claims of all of the customers of the failed broker-dealer — *i.e.*, to the extent some customer funds or securities are missing — up to $500,000 of SIPC's funds are advanced for each customer in order to replace the missing securities and funds (up to a maximum of $250,000 for missing cash). SIPC's funds as intended by Congress, however, are available only to replace missing customer property; they are not used to protect investors against any other risks.

SIPA is not intended to protect investors against losses ***on*** their investments, only against losses ***of*** their investments in the event of a broker-dealer failure. Investing in securities inherently exposes the investor to market fluctuations in the value of the securities. Investors who lose money because of a decline in the value of the securities purchased for their accounts are not protected by SIPA against such losses, whether the decline is due to market forces or even due to fraud. SIPA, for instance, would have provided no protection to investors who purchased Enron stock or bonds against the losses they realized through Enron's fraud and resulting bankruptcy (although it would have provided them protection against the loss of their Enron securities if their brokers failed). Under this principle, investors who purchased certificates of deposit in Stanford International Bank (an Antiguan bank that was allegedly operated as a Ponzi scheme) were not protected by SIPA against the possibility that those certificates of deposit were worthless. As such, SIFMA strongly opposes the SIPA amendment proposed by Representative John Culberson (R-TX) in the fiscal year 2011 Financial Services and General Government Appropriations Act as it would extend SIPC's protection to cover, for the first time, fraud by the issuer of certain securities (or in this case, certificates of deposit) purchased by the customer which are neither lost nor stolen but in fact in the holders' possession. The amendment would significantly expand SIPC coverage, for benefit of one narrow class of investors, and therefore, would undermine the efforts of the Task Force and this Subcommittee's consideration of appropriate SIPA modernization. Further, such action would likely deplete SIPC's recently increased targeted reserves of $2.5 billion (up from $1 billion) and even exhaust the additional $2.5 billion that SIPC is able to borrow from the SEC (and, indirectly, from the U.S. Treasury), leaving SIPC unable to protect securities investors until its funds are replenished.

SIPA's protection for broker-dealer customers differs from the Federal Deposit Insurance Corporation's ("FDIC's") insurance for bank depositors in the same way that securities investments differ from bank deposits. Bank deposits represent a debt of the bank to the depositor. They are generally intended to be a safe use of funds and to provide only a limited, but low-risk return. The FDIC insures the payment of the bank deposit, including accrued interest, in the event of a bank failure (up to the limits of the insurance coverage). Securities accounts at a broker-dealer, by contrast, are investments of the customer in securities (and related cash amounts). Customers invest in securities to benefit from increases in the value of the securities (and from dividends, interest or other distributions on the securities) but also take the risk that the value of the securities may drop, potentially to zero. SIPA is not intended to protect broker-dealer customers against declines in the value of their accounts due to changes in the

value of their securities investments, but only against the loss of their actual securities in a failure of the broker-dealer. SIPC's $500,000 advances are therefore only available to customers who do not receive their cash and securities investments in the distribution of customer property, not to customers whose investments go sour or turn out to be fraudulent.

SIPA's customer protection framework has been challenged like never before by two recent events: the massive Ponzi scheme perpetrated through Bernard L. Madoff Investment Securities LLC ("Madoff") and the insolvency of one of the country's largest broker-dealers, Lehman Brothers Inc. ("Lehman"). The Madoff Ponzi scheme was a massive, long-term fraud that inflicted significant harm on many investors, including individuals, families, and charitable and educational institutions. This fraudulent scheme highlighted questions about the scope and extent of customer protection under SIPA, especially as it applies to (i) the calculation of a customer's "net equity" in a Ponzi scheme and (ii) the application of SIPC's $500,000 protection to "indirect investors" who did not have accounts directly with a broker-dealer but invested in another entity (like a hedge fund or retirement plan) that had an account with the broker-dealer. The Lehman insolvency raised a large number of issues, including concerns about inconsistencies between the scope of customer protection under SIPA and the SEC's Customer Protection Rule. The modernization of SIPC should address both the scope and extent of SIPA's customer protection framework in the context of a Ponzi scheme and the inconsistencies between SIPA and the SEC's Customer Protection Rule.

II. "Net Equity" Calculation in the Context of a Fraudulent Scheme

In a SIPA liquidation, customers have claims for their "net equity" that are satisfied by a *pro rata* distribution of the failed broker-dealer's "customer property," plus, if that distribution is inadequate, up to $500,000 of SIPC protection (only $250,000 of which can relate to a claim for cash). A customer's "net equity" is calculated by taking the value of the long securities and cash in the customer's account and subtracting the value of the short securities positions in the account and any indebtedness of the customer to the failed broker-dealer. In the ordinary course, a SIPA trustee looks to a customer's account statements and the books and records of the failed broker-dealer to establish the securities positions and cash balances used to compute the customer's net equity. When a broker-dealer is operated as a Ponzi scheme, however, the customer account statements will themselves be fraudulent – it is the essence of a Ponzi scheme that the perpetrator reports false profits to the investors – and therefore the statements do not truly represent positions in the customers' accounts.

Instead of relying on fraudulent account statements to determine the net equity of Madoff's customers, the trustee appointed by SIPC to liquidate Madoff has used the "net investment" method. Under the net investment method, the fraudulent customer account statements are disregarded and a customer's net equity is determined solely by reference to the amount of money the customer entrusted to the Ponzi scheme operator and the amount of money the customer received from the Ponzi scheme. The customer's net equity is his or her net investment in the fraudulent scheme – the excess (if any) of the amount entrusted over the amount received. This method was originally developed with respect to fraudulent schemes outside of the SIPA context as far back as the 1920s and has been regularly applied by several trustees and courts in SIPA liquidations.

When a failed broker-dealer was operated as a Ponzi scheme, SIFMA believes that, as a matter of fundamental fairness, the net investment method should be used to determine net equity for purposes of the distribution of customer property held by the failed broker-dealer. The property held by a Ponzi scheme and used to make distributions to the "investors" in the scheme is simply the pooled property of all victims of the scheme, and making distributions based on anything other than their net investment would be fundamentally unfair – at best it would result in sharing the losses unevenly among the victims, and in some cases it would result in perpetuating the scheme by taking money from some victims and paying it to others to satisfy their claims for false profits.

Consider a simple example (summarized in the illustration below), where a Ponzi scheme has two investors. Each investor "invested" $2 million in the scheme. The first investor ("Investor A") opened his account early in the scheme, was credited $2 million of profits, and withdrew $1 million from his account around the same time the second investor ("Investor B") opened his account. Soon thereafter, the broker-dealer fails and is liquidated. Suppose also that the liquidation trustee is only able to collect $2 million in customer property (the remaining $1 million received from the two investors having been siphoned off and spent by the Ponzi scheme operator).

If the liquidation trustee distributed the $2 million recovered from the Ponzi scheme based on statement balances:

- Investor A will receive 60% of the $2 million, or $1.2 million, since Investor A's statement balance of $3 million is 60% of the $5 million total statement balances; and

- Investor B will receive 40% of the $2 million, or $800,000, since Investor B's statement balance of $2 million is 40% of the $5 million total statement balances.

If distributions are made in this manner, Investor A will actually make a profit of $200,000 on his investment in the Ponzi scheme (equal to the excess of the $2.2 million in distributions over his $2 million investment). Investor B, on the other hand, will suffer a loss of $1.2 million, which is the entire $1 million stolen by the Ponzi scheme operator and the extra $200,000 of profits paid to Investor A. This method results in the trustee perpetuating the Ponzi scheme by taking money invested by Investor B and paying it to Investor A.

In contrast, the net investment method will not result in the perpetuation of the Ponzi scheme:

- Investor A will receive one third of the $2 million, or $666,666, since Investor A's net investment of $1 million is 1/3 of the $3 million total net investment; and

- Investor B will receive two thirds of the $2 million, or $1,333,333, since Investor B's net investment of $2 million is 2/3 of the $3 million total net investment.

If distributions are made in this manner, Investor A will lose $333,333, or one third of his net investment, and Investor B will lose $666,666, which is also one third of his net investment. Because losses are shared *pro rata* among the victims, this method is consistent with SIPA's

basic principle of *pro rata* distribution. And, since each victim would lose the same portion of his net investment, this method would not result in the perpetuation of the Ponzi scheme by the liquidation trustee.

Illustration: Simple Ponzi Scheme

	Ponzi scheme / broker-dealer	Investor A	Investor B
Jan. 2008	Receives $2M	Invests $2 million	
Jan. 2008 to Jan. 2009	Siphons off and spends $1M	Credited $2 million of profits	
Jan. 2009	Receives $2M and distributes $1M	Withdraws $1 million	Invests $2 million
Feb. 2009	Fails and enters liquidation.		
	Has $2M of customer funds ($2M - $1M + $2M - $1M).	Statement balance: $3M	Statement Balance: $2M
		Net investment: $1M	Net Investment: $2M
Distributions *pro rata* on statement balance:		Receives $1.2M ($2M * $3M / ($3M + $2M))	Receives $800,000 ($2M * $2M / ($3M + $2M))
		Net profit of $200,000 ($1M + $1.2M - $2M)	Net loss of $1.2M ($800,000 - $2M)
Distributions *pro rata* on net investment:		Receives $666,666 ($2M * $1M / ($1M + $2M))	Receives $1,333,333 ($2M * $2M / ($1M + $2M)
		Net loss of $333,333 ($1M + $666,666 - $2M)	Net loss of $666,666 ($1,333,333 - $2M)

Whether SIPC's funds should be used to protect the fictitious profits shown in fraudulent statements produced by the perpetrators of Ponzi schemes does not involve the same issue of fundamental fairness, since providing SIPC's $500,000 of protection for fictitious profits would not perpetuate the Ponzi scheme. However, SIFMA notes that expanding SIPC coverage to protect these fictitious profits would have financial costs, in some cases, possibly in amounts exceeding SIPC funds. Ultimately, therefore, application of SIPC funds in such cases is a question of allocation of such costs among the victims of the Ponzi scheme and the other participants in the securities industry. Consideration should also be given to whether it is fair to protect the outsized fictitious profits credited to investors in Ponzi schemes when other investors in the securities markets receive smaller returns and take genuine risks of loss on their investments.

III. Indirect Investors

As mentioned above, each customer of a failed broker-dealer in a SIPA liquidation is eligible to have up to $500,000 of SIPC's funds used to replace their missing assets (but no more

than $250,000 for missing cash). This protection is extended only to investors that are customers of the failed broker-dealer. "Indirect investors," who did not have accounts directly with a broker-dealer but invested in another entity (like a hedge fund or retirement plan) that had an account with the broker-dealer, are not eligible for the $500,000 SIPC protection.

In this respect, SIPC's $500,000 protection for broker-dealer customers is generally similar to the FDIC insurance for bank depositors. The FDIC also generally insures only depositors; for instance, when a corporation, partnership or unincorporated association has a deposit account at a bank, the account is insured for $250,000, regardless of how many investors the corporation, partnership or unincorporated association might have. Unlike SIPC, however, the FDIC applies different rules to employee benefit plan accounts and irrevocable trust accounts. Employee benefit plan accounts receive pass-through coverage, where the interest of each plan participant is insured to up to $250,000. Subject to certain conditions, the FDIC gives similar treatment to the interests of beneficiaries in irrevocable trusts.

SIFMA believes that SIPC generally should not provide greater protection to institutional customers than to individual customers, and accordingly opposes any effort to increase the protection provided to customers that are hedge funds, corporations, partnerships or unincorporated associations by extending SIPC's $500,000 protection to their investors. This principle may not apply in the same way to trusts or employee benefit plans, which represent the interests of their beneficiaries or participants in a more straightforward way. However, amending SIPA to provide SIPC protection to beneficiaries of irrevocable trusts and participants in employee benefit plans would not be without cost to SIPC.

Before expanding SIPC protection on a pass-through basis to beneficiaries of irrevocable trusts and participants in employee benefit plans in a manner similar to the pass-through deposit insurance provided by the FDIC, Congress should consider whether such costs would be justified by increased investor confidence.

IV. Consistency between SIPA and the SEC's Customer Protection Rule

SIPA and the Securities and Exchange Commission's ("SEC") Customer Protection Rule should work together. The Customer Protection Rule requires each broker-dealer to maintain possession or control of its customers' fully paid and excess margin securities and deposit into a reserve account an amount generally equal to its net monetary obligations to customers or in respect of customer securities positions. When a broker-dealer enters liquidation under SIPA, the customer securities and the reserve account are available for distribution to customers. If SIPA and the Customer Protection Rule are harmonized (and the broker-dealer had complied with its obligations), the failed broker-dealer will have sufficient customer property to fully satisfy the net equity claims of all of the customers. Unfortunately, the two are not fully harmonized.

Perhaps the most significant divergence between SIPA and the Customer Protection Rule is the status of proprietary accounts of broker-dealers. A broker-dealer's net equity claim based on its proprietary account is eligible to share in the *pro rata* distribution of customer property under SIPA (although not eligible for SIPC's $500,000 protection), but the proprietary account of a broker-dealer is not treated as a customer account for purposes of the Customer Protection

Rule. As a consequence, there may be net equity claims entitled to share in the *pro rata* distribution of customer property for which no assets were set aside. In the Lehman liquidation, for instance, Lehman Brothers International (Europe) ("LBIE"), an English broker-dealer affiliate of Lehman, has filed customer claims for approximately $10 billion based on its proprietary positions but the Customer Protection Rule did not require Lehman to maintain possession or control of LBIE's securities or make deposits into its reserve account in respect of obligations to LBIE. Even though the entire $10 billion claim is not expected to be allowed as a customer claim, this gap between SIPA and the Customer Protection Rule may cause a sizeable shortfall in the customer property available for distribution to Lehman's customers.

The SEC has proposed to narrow this divergence by requiring broker-dealers to fund a separate reserve account with an amount generally equal to its net monetary obligations with respect to proprietary accounts of other broker-dealers or in respect of securities positions in such accounts. (The possession or control requirement, however, would not be applied to securities positions in these accounts, provided that written permission to use the securities is obtained.) While a step in the right direction – SIFMA has filed a generally favorable comment on this proposal – other divergences between SIPA and the Customer Protection Rule continue to exist. For example, a similar difference exists in the treatment of principal officers and directors of a broker-dealer, who are non-customers under the Customer Protection Rule but eligible for customer status under SIPA.

V. Clarity and Consistency in the Treatment of Securities-Based Swaps

SIFMA is also concerned that, as the SEC begins to develop the customer protection requirements applicable to broker-dealers that act as securities-based swap dealers, the divergences between the SEC's customer protection requirements and SIPA will only increase. The Dodd-Frank Act amended the stockbroker liquidation provisions of the Bankruptcy Code to treat accounts holding securities-based swaps as "securities accounts" but no similar amendment was made to SIPA, leaving unclear the treatment in a SIPA liquidation of customers' securities-based swaps (and related cash and securities margin). SIFMA believes that customers who have securities-based swaps in an account at a broker-dealer should have a net equity claim calculated based on the value of the securities-based swaps, any cash or securities in the account, and the value of any other positions (*e.g.*, securities or commodities futures or non-securities-based swaps) in the account.

SIFMA is concerned, however, that maintaining a single class of customers, which encompasses cash account customers, margin account customers, portfolio margin customers and securities-based swap customers, may unfairly impose risks of the newer and more complex types of accounts and transactions (*i.e.*, portfolio margin and securities based swaps) on the customers who have simpler accounts (*i.e.*, cash accounts). Accordingly, SIFMA recommends that broker-dealer customers be divided up into separate account classes, that the customer protection rules be tailored to each specific account class and activity and provide for a separate pool of customer property for each separate account class, and that, in a liquidation under SIPA or the Bankruptcy Code, the customer property for each account class be distributed solely to members of that account class based on net equity calculated based on all positions in the customers' respective accounts of that class. It may be appropriate to separate customer accounts into at least the following three classes:

- Cash accounts. These customers hold only fully-paid long securities positions and cash credit balances. The SEC customer protection rules would require the broker-dealer to maintain possession or control of all securities belonging to these customers and fund a reserve account in the amount of all of their credit balances. In a liquidation of the broker-dealer, accounts in this class and the related customer property should be easily and efficiently transferred to a solvent broker-dealer or a bridge financial company (either in bulk or individually at the direction of the relevant customer).

- Margin accounts. These more sophisticated customers could have long and short positions and debit or credit balances in margin accounts subject to Federal Reserve Board Regulation T. This account class could generally be subject to the current customer protection rules relating to possession or control of certain securities (but allowing other securities to be used by the broker-dealer to obtain financing related to customer positions) and requiring a reserve account to be funded on a formula basis.

- Portfolio Margin and Swaps Accounts. The most sophisticated customers have portfolio margin accounts and/or swaps accounts, containing long and short securities and options positions, securities-based and non-securities-based swaps, credit or debit balances and possibly also futures positions. This account class would also be subject to customer protection requirements relating to possession or control of customer securities and to the funding of a reserve account, but these rules would need to take into account the broker-dealer's use of funds or securities to carry swaps that hedge the customer swaps positions.

It may also be appropriate to develop additional account classes, or to modify the classes outlined above; the precise delineation of the separate account classes should be the subject of further review and careful study and should only be adopted after opportunity for public comment.

VI. Rule-Making Power

SIFMA believes that the best way to accomplish the harmonization of SIPA, the Bankruptcy Code and the SEC's Customer Protection Rule is to grant rule-making authority to the SEC similar to the authority of the Commodity Futures Trading Commission (the "CFTC") under Section 20 of the Commodity Exchange Act (the "CEA") to make rules regarding the commodity broker liquidation provisions of the Bankruptcy Code, and to instruct the SEC to make rules under both the Bankruptcy Code and SIPA regarding the scope of customer property, the determination of a customer's net equity and the method of liquidation of a broker-dealer that are consistent with the customer protection rules applicable to operating broker-dealers. In carrying out this instruction, the SEC could follow the CFTC in creating different "account classes" as outlined above, each with rights in separate pools of customer property that may be created by customer protection rules adapted to the circumstances of the account class. (The SEC has already started down the path of creating separate account classes by proposing different customer protection requirements for proprietary accounts of broker-dealers, including the creation of a separate reserve deposit for these accounts, but the separation is meaningless if

these accounts are lumped together with the securities accounts of public customers in a liquidation of the broker-dealer.)

VII. SIPC Assessments

The basis on which SIPC members are assessed contributions to SIPC has not been updated in a number of years (other than the Dodd-Frank Act change in the minimum assessment amount). Some elements of the calculation may not make sense when applied to the business of SIPC members as they operate today. As a result, a determination of "SIPC net operating revenues," the basis for each member's assessment, often does not accurately reflect actual revenues of such member. SIFMA recommends that the determination of the assessment base be reviewed in light of the manner in which members currently operate, including consideration of the following questions:

- How should the assessment apply to members that engage in transactions that involve taking positions in securities and offsetting positions in hedging products (*e.g.*, related futures contracts)? Is it appropriate to base the assessment on revenues that may in whole or in part be offset by losses that are not currently calculated as part of the assessment?

- How should accounting interpretations (*e.g.*, FAS 167), which may increase a firm's revenues and expenses by similar amounts, affect the assessment?

- Should the assessment base take into account the effects of interest expense, dividends on short positions and related revenue impacts?

VIII. Conclusion

In conclusion, SIFMA strongly supports the work of the Task Force and is committed to working constructively with the Task Force to review SIPA and recommend ways to modernize SIPA to better protect investors and thereby increase investor confidence in the financial markets. We appreciate the opportunity to testify and look forward to continuing to work with the Subcommittee on these important investor protection issues.