Statement
of
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Before the
United States House of Representatives
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
Committee on Financial Services

September 23, 2010

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the work of the Securities Investor Protection Corporation or "SIPC" and possible improvements to the Securities Investor Protection Act or "SIPA."[1] My name is Orlan M. Johnson and I am the Chairman of SIPC. I also serve as Chairman of the SIPC Modernization Task Force ("Task Force") which is conducting a complete review of SIPC's operations, as well as considering changes to SIPA.

Convened on June 17, 2010, the Task Force consists of a wide range of experts and is in the midst of its review and consideration of possible statutory, procedural and other reforms to SIPA and SIPC. At my confirmation hearing before the Senate Banking Committee last December, I made clear my intent to have this review undertaken. Chairman Kanjorski

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[1] 15 U.S.C. §78aaa et seq.

thereafter suggested a number of important topics for the Task Force to consider. Today I will briefly describe SIPC and the work of the Task Force, in addition to providing responses to the issues covered in the Subcommittee's letter of September 16 inviting me to appear at this hearing.

SIPC

SIPC is a non-profit membership corporation that was created under SIPA in 1970. With some narrow exceptions, every registered securities broker or dealer is a member of SIPC. Membership in SIPC is not voluntary; it is automatic upon registration as a broker or dealer. By statute, SIPC is not a government agency or establishment. Its policies are set by its seven-member Board of Directors, five of whom are appointed by the President of the United States and confirmed by the Senate. Three of the five Directors are selected from the securities industry and two are non-industry Directors. The remaining two Directors, respectively, are representatives of the United States Treasury and the Federal Reserve.

A central goal of SIPC is to protect customers of failed securities brokerage firms that are members of SIPC and that are in liquidation under SIPA. In this regard, SIPC works closely with the United States Securities and Exchange Commission and securities self-regulatory organizations. Because SIPC has no investigatory or regulatory authority, these entities must notify SIPC when a broker- dealer is in financial trouble and unable to meet its obligations to customers. Upon appropriate notification, SIPC may seek to have a firm placed in liquidation.

SIPC administers a Fund which is comprised of assessments paid by its members. The Fund is used to support SIPC's mission of customer protection and to finance SIPC's operations. Should the Fund become inadequate for its purposes, SIPC may borrow against a $2.5 billion

line of credit from the United States Treasury. That credit line was increased from $1 billion to the current limit as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In its nearly 40-year history, SIPC has never drawn upon the credit line.

With some narrow exceptions, every customer is protected by SIPC up to $500,000 against lost or missing cash and securities deposited with the broker or dealer for the customer's account. Of the $500,000, up to $250,000 may be used to satisfy a claim for cash only. SIPC advances also may be used to pay the expenses of administering the liquidation proceeding where the debtor's general estate is insufficient. To date, SIPC has overseen the administration of 322 customer protection proceedings which have involved the distribution, through 2009, of roughly $108.5 billion of assets for customers. Of the $108.5 billion, approximately $107.6 billion has come from debtors' estates and $866.9 million from the SIPC Fund.[2]

The Task Force

The Task Force draws its members from the ranks of state regulators, attorneys who represent investors, academia, the securities industry, a trustee in the largest insolvency in history, the Chairman of SIPC's Chinese counterpart, and an observer from the SEC. This diversity of viewpoints results in a rigorous analysis of the issues that concern investors in today's world. We have begun our work in earnest. We are examining the extent of SIPA protection, the problem of "indirect" investors, the use of bankruptcy avoidance powers, and other fundamental issues of concern to investors and Congress.

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[2]The figures are from SIPC's 2009 annual Report, and include $667,000,000 to customers in the Madoff case. SIPC continues to advance funds in that case. SIPC has now committed a total of $722,000,000 to customers in the Madoff liquidation.

We also have created a public input platform on the Web at www.SIPCModernization.org in which the public is invited to share its thoughts for all to see. SIPC is undertaking a major public outreach effort to ensure that as many investors as possible learn about the process and get a chance to participate in it.

Using that website, we conducted an open online forum on September 14th where members of the public submitted comments and questions. I responded to those comments and questions, as did another member of today's panel, Mr. Borg. We are organizing a second such forum, with other Task Force members in the near future.

I also hope to organize a live event so that members of the public can present their views directly to the Task Force.

After discussion of some of the issues, several members of the Task Force have volunteered to draft a number of Recommendations which will be presented to the SIPC Board. It is our goal to make a full set of Recommendations in the first quarter of 2011.

Issues of Concern

The remainder of this statement contains my responses to the questions included in the Subcommittee's letter of September 16 inviting me to testify.

Whether the SIPC Board should include a representative of the Securities and Exchange Commission and what, if any, other modifications to the governance structure may be appropriate.

SIPA already provides for substantial oversight of, and participation by the SEC with respect to, SIPC matters. An SEC staff representative is always invited to SIPC's Board Meetings and actively participates. In addition, the SEC may inspect SIPC and require reports or

records from it as it deems appropriate or necessary. 15 U.S.C. §78ggg(c)(1). SIPC also must file an audited annual report with the SEC and obtain SEC approval of any proposed SIPC rule or bylaw or change to its rules or bylaws. 15 U.S.C. §§78ggg(c)(2) and 78ccc(e). In light of the fact that the SEC is the only entity that can compel SIPC to take certain actions, it would be improper to have an SEC Commissioner or other representative on the SIPC Board. In SIPC v. Barbour, 421 U.S. 412 (1975), the Supreme Court held that only the SEC has the right to sue SIPC to require SIPC to begin a customer protection proceeding. See 15 U.S.C. §78ggg(b). Thus, having an SEC representative on the SIPC Board who would have decision making as well as oversight authority would present questions of conflict of interest and attorney client privilege. In addition, the SEC has never exercised its power to sue SIPC, which indicates that, in all disputed situations, there has been a satisfactory resolution.

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.

The Task Force has discussed the "How much is enough?" issue in a number of contexts. SIPC's current "target" of $2.5 billion is set by bylaw. In light of the SEC's ability to compel a SIPC bylaw change, the current mechanism seems adequate. This is true in view of the fact that the former $1 billion target has proved adequate to meet the requirements of all SIPA cases to date. The SIPC Board consistently reviews the adequacy of the SIPC Fund, as I am sure it will do when SIPC reaches the $2.5 billion target.

Whether any trustee appointed by SIPC should also be subject to Bankruptcy Court approval and whether trustees appointed in SIPA liquidations have been as efficient and effective as those appointed under similarly sized non-SIPA liquidations.

The Bankruptcy Court currently appoints trustees. The Court holds a hearing to determine if the persons designated by SIPC are disinterested. Pursuant to a suggestion from the SEC, SIPC maintains a geographically based file of possible trustees who are screened for the ability and expertise required to conduct a liquidation proceeding. SIPC typically receives less than two days' notice between the initial SEC notice that the firm is in distress and the filing by SIPC of court papers in the appropriate United States District Court. SIPC must also review potentially disqualifying conflicts of interest. Further, in light of the successful record of SIPC trustees and their counsel with respect to having interpretations of SIPA upheld by the courts, there is little doubt with respect to competence and compliance with the mandates of the statute. Since SIPC handles smaller cases using streamlined procedures, there is also little doubt that the small case process is efficient and economical as well.

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 customer that their claim is *bona fide*.

There is no indication that there have been a great number of frivolous claims in SIPA proceedings. In the best interest of investors, SIPC would prefer that any colorable claim be filed, since failure to file a timely claim is an absolute bar to recovery in such instances. In the Madoff case, many people who are not eligible for protection have filed claims, but SIPC and the trustee encouraged anyone with a colorable claim to file.

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.

The direct payment procedure is efficient and effective. SIPC had previously proposed legislation that would expand the Corporation's ability to use this tool. I believe SIPC will once again proffer an amendment to SIPA to expand the ability to use the direct payment procedure.

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 is examining the possible modification of the "customer" definition for some, but not all, so called "indirect" investors. I am confident that the resulting determination will expand protection in this area on a prospective basis.

Whether and how SIPA's definition of customer property should be amended in light of the changing nature of customer arrangements 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.

The customer property definition is adequate for most individual investors. However, more sophisticated investors, particularly large institutional investors, have more complex relationships with brokerage firms, and resolution of these evolving, interconnected relationships was clearly not contemplated in the original drafting of SIPA. The Task Force is studying this issue in detail, and may conclude that such mega-investors should be subject to a separate regime.

Whether and how SIPA's definition of net equity should be revised to address situations whereby a customer's 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 the statements they have received.

In the vast majority of cases this is not an issue. Thus, in the Lehman Brothers case, the MJK Clearing case, and most of SIPC's other major cases, the books accurately reflected what the customer is owed. It is, of course, an issue in the Madoff case. What all parties seek is a true and accurate picture of what the customer is owed. The current burden of proof allows a customer to provide other documentation to contradict the debtor's books. Thus, timely correspondence from a customer objecting to a transaction is frequently used to demonstrate that the books of a debtor are wrong.

SIPC, trustees and courts have consistently followed the principle that last statements reflecting fictitious profits should not be used to calculate a customer's claim. Rather, customer claims are calculated on the basis of the net equity in the customer's account as of the closing of the broker-dealer or, in other words, the amount of the funds that a customer invests through the broker-dealer minus any funds received from the broker-dealer. This method ensures that a criminal operating a fraudulent scheme of fictitious trades and profits does not determine the amount of money owed to customers after the collapse of the scheme.

Whether a 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 promptly satisfied.

Again, usually this is not an issue, particularly where there is an account transfer to a solvent brokerage. I have one thought about claims for securities which are not delivered within a six-month period. (This rarely happens, but it keeps a claimant at market risk without the

ability to take market action.) Perhaps the burden of the loss could shift at the six-month break, and the claimant could have the option of receiving either the filing date value of the portfolio or the securities themselves. As to cash, the general rule in bankruptcy is that cash claims, whether disputed or not, do not accrue interest. Given that, SIPA cases should be no different. It also must be noted that the reason for any delay in satisfying claims usually is not because a trustee and his staff are not zealous, but because the trustee lacks the books and records to compare claims against, the books and records are otherwise unreliable, or books and records cannot be easily accessed because they are in the custody of law enforcement authorities. In these circumstances, claims review necessarily is a time-consuming process and assessing interest could encourage incomplete or inaccurate claims review in the interest of speed.

Whether the avoidance powers granted to a trustee in a SIPA liquidation should differ from the U.S. Bankruptcy Code.

I believe that Congress gave these powers to a bankruptcy trustee for good and valid reasons. SIPA cases are no different. History has consistently shown that the avoiding powers accomplish equitable results.

Again, however, these powers are rarely used in SIPA cases. This is because a combination of customer property and SIPC advances usually means that it is very unusual that someone who withdrew assets during the avoidance periods would not have received exactly the same distribution had the withdrawal not been made; hence the avoiding powers do not pertain. The Madoff case is an obvious exception, but the Task Force has discussed this in great detail and will issue a recommendation on the subject.

Whether the mechanics for informing investors about the existence of and protections afforded by SIPC should be altered.

Investor education is a critical part of investor protection, and SIPC continues to focus on the development and implementation of new methods of educating investors about SIPC coverage. SIPC welcomes suggestions and assistance as to how to convey the complexities of a complicated statute in a sound bite or a video clip. The fact remains that this is very difficult. The Task Force is also reviewing this issue and I expect its work will result in recommendations.

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.

I doubt that the private sector could replace SIPA protection and maintain investor confidence. Despite the views of some of our critics, I genuinely believe that SIPC provides prompt and full protection to investors consistent with the law. I do believe there is a role for the private sector insurance industry with respect to things that SIPC does not, and in my opinion should not, cover. Thus, I am an advocate for a more strenuous broker blanket bond requirement with respect to fraud claims, particularly by introducing brokers which possess minimal capital. However, the reality is that even if the private sector were to provide primary protection, an entity to administer that process would still be needed. The existing entity, in the form of SIPC, as a governmentally established entity, takes into account and reflects the views not only of the private sector, but of the public sector as well. Thus, the Treasury, the Fed, and the SEC have an important say in the formulation of SIPC policy. Because of the potential implications of the failure of a brokerage on investor confidence and the economy as a whole, it is important that the

entity consider not only private, but public, interests. Moreover, private insurers that have provided so-called excess SIPC protection have not been beneficial to investors to date.

Whether the capital adequacy rules for broker-dealers are sufficient to prevent significant customer losses.

I believe the capital rules are generally sufficient to cover losses with respect to "custody" of customer securities. However, the capital requirements are not sufficient to cover possible other obligations an introducing firm may have.

Whether investment advisers should be scoped into and subject to assessments under SIPA or a similar protection regime.

By law, investment advisors may not hold customer assets at any time. I do not know the extent of investor losses with respect to the conversion of investor assets by investment advisors. If this is a serious problem, then SIPC protection could be considered. If it is not a serious problem, then perhaps an "Investment Advisors Blanket Bond" might be a solution.

Whether other legislative changes could be made to clarify SIPA's provisions and reduce the number of corresponding lawsuits brought about by ambiguities in SIPC coverage.

I am confident that the Task Force will reach a consensus on a number of legislative changes. I would note, however, that whenever a particular creditor's "status" in a bankruptcy is changed and affects the difference between being made whole, and receiving nothing, litigation may be inevitable. "Customer" status fits that model.

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In conclusion, I want to assure the Subcommittee that the Task Force is making progress and will continue its work aimed at developing and recommending reforms to SIPA and SIPC.

Thank you, and I would be pleased to answer any questions Members of the Subcommittee may have.