

**Statement**

**Of**

**Sharon Y. Bowen, Acting Chair**

**Securities Investor Protection Corporation**

**Before the**

**Capital Markets and Government Sponsored Enterprises Subcommittee**

**of the**

**House Committee on Financial Services**

**March 7, 2012**

Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the important work of the Securities Investor Protection Corporation (“SIPC”). My name is Sharon Bowen, and I am the Acting Chair of SIPC. Because I also served as the Vice Chair of the SIPC Modernization Task Force, I will address the forward looking issues raised by the Task Force and Mr. Harbeck, President and CEO of SIPC, will address the operational and other matters the Subcommittee requested we cover in our testimony.

SIPC is a non-profit membership corporation created under the Securities Investor Protection Act (“SIPA”)<sup>1</sup> in 1970. With some narrow exceptions, every registered securities

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<sup>1</sup> 15 U.S.C. §78aaa et seq.

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 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. A firm is placed in liquidation upon an application by SIPC in federal District Court. 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. Once a District Court places a firm in SIPA liquidation and appoints a trustee to administer the liquidation, the case is removed to Bankruptcy Court where the matter proceeds like a bankruptcy case but with special customer protection features.

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. In its nearly 40-year history, SIPC has never drawn on the credit line.

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 324 customer protection proceedings which have involved the distribution, through 2010, of roughly \$109.3 billion of assets for customers. Of that sum, approximately \$108.2 billion has come from debtors' estates and \$1.1 billion has come from the SIPC Fund.

### **The Report and Recommendations of the SIPC Modernization Task Force Report**

Former Chairman Orlan Johnson promised Congress at his confirmation hearing that he would form a Task Force to conduct the first comprehensive review of the Securities Investor Protection Act ("SIPA"), and SIPC's operations, since the significant amendments to SIPA in 1978. The SIPC Modernization Task Force has completed its work, and the Report and Recommendations of the SIPC Modernization Task Force is attached as Exhibit A.

The Task Force was composed of professionals with differing backgrounds and approaches. The group contained investor advocates, state regulatory officials, an academic expert, a trustee experienced in the 'real world' problems of brokerage firm insolvency, the Chairman of SIPC's Chinese counterpart, and securities industry representatives. Their divergent views make for a balanced set of proposals worthy of serious consideration.

The Task Force conducted a live forum in New York to receive the personal views of individual investors, and held an internet "question and answer" dialogue with investors, as well. A website was also established to advise the public of the issues being considered and to solicit input from investors on those topics. In addition, the Task Force received presentations from investor education experts and representatives of the mutual fund industry, as well as a briefing from representatives of the Treasury and Federal Reserve Board.

For purposes of analysis, and to assist the Subcommittee, I believe it would be useful to divide the Task Force Recommendations into four categories, and summarize the conclusions of the Task Force. The categories are:

- Recommendations which will require legislation.
- Recommendations which will require SEC rule changes.
- Recommendations where the Task Force studied possible changes, but determined existing law should not be changed.
- Recommendations SIPC can implement now.

In particular, the Task Force reviewed issues raised by recent liquidations, and in some instances, the Task Force recommended changes to the outcomes under SIPA as currently enacted, while in other instances the group determined that the existing law should remain unchanged. I can tell the Subcommittee that all viewpoints were aired, discussed, and debated. In the end, each Recommendation represented the consensus of the group.

### **Recommendations Which Will Require Legislation**

#### **1. Increasing the maximum level of protection.**

The Task Force concluded that the SIPA should be amended to allow for inflation since 1980. In that year, the maximum SIPC advance was set at \$500,000. In inflation-adjusted current dollars, that level of protection would be \$1,300,000, and the Task Force concluded that sum should be periodically adjusted for inflation.

#### **2. Eliminating the distinction in the levels of protection for cash and securities.**

The Task Force was presented with numerous historical examples of cash being “caught” at a moment just prior to a securities purchase, or subsequent to a securities sale, and thus subject to lower protection. Because these results are arbitrary, the Task Force suggests a change to eliminate the disparate treatment of claims for cash and claims for securities.

**3. Protection for pension plan participants.**

SIPA was designed to protect small investors. Since such small investors often have so much of their wealth in pension plans, the Task Force recommends “pass-through” SIPC protection for pension plan participants not found in current law. I would note that the Task Force limited this suggestion to pension funds, and no other forms of collective “pooled” investments.

**4. Setting a minimum assessment of \$1,000 on SIPC members.**

In what I believe was an unintentional consequence of a Dodd Frank amendment to SIPA, some SIPC members actually had their SIPC assessments reduced. This recommendation resolves this oversight.

I would add that the four recommendations above have financial consequences not only for customers, but for SIPC members, and, possibly, for the Treasury, which can provide a credit line to SIPA. I will recommend a full analysis of the economic consequences of these proposals be considered by the SIPC Board before SIPC seeks legislative change.

**5. Expanded use of the “direct payment procedure” to assist customers expeditiously.**

SIPC has had considerable success since 1978 in using a streamlined procedure to pay victims swiftly and directly in smaller brokerage failures. This recommendation would amend SIPA to expand this very efficient and effective program.

## **Recommendations Which Will Require Rule Changes**

### **6. Auditors should file audit reports with SIPC.**

The Task Force reviewed situations where, arguably, audit reviews of SIPC members were severely deficient. SIPC and Trustees under SIPA have rarely sued such auditors. However, SIPC has been faced with a defense that SIPC had not relied directly upon the audit -- because it did not receive it and did not have access to its contents -- and thus had no standing to sue.

The Task Force recommends that SIPC receive and review those audits. SIPC would demonstrably rely upon those audits, and this fact would be known to auditors. SIPC would thus have standing to recover losses incurred from negligent or tortious conduct related to an audit.

### **7. Safeguarding customer assets by Rule.**

The heart of SIPC's protection to investors is to deliver assets left on deposit with brokerage firms. The Task Force recommends that the SEC issue an interpretive release clarifying SEC Rules on the segregation of customer assets.

I am very pleased to report that the Supreme Court of the United Kingdom has, last week, clarified British rules in this regard in the Lehman Brothers case. I urge the SEC to consult with SIPC in light of this recent ruling.

## **Recommendations where the Task Force studied possible change but determined existing law should not be changed**

### **8. Vesting SIPA Trustees with avoiding powers.**

The so-called "avoiding powers" possessed by bankruptcy trustees also apply in SIPA cases. Their powers have been highlighted in the Madoff case. After debate, the Task Force concluded that a Trustee in a SIPA case should have the same tools available to distribute limited assets as equitably as possible that any other bankruptcy trustee may have.

## **9 -12. Other Recommendations requiring no change.**

It bears repeating that SIPA was conceived and designed by Congress to protect small investors. In any bankruptcy, creditors will naturally seek the most protected status possible. In a SIPA case, “customer” status is such a preferred category. The Task Force reviewed a number of transactions and other situations involving institutional and sophisticated retail customers and determined that the outcome under existing law should not be changed. Thus:

- Participants in repurchase and reverse repurchase agreements should continue to be treated as general creditor claims.
- Open “to be announced” contracts should continue to result in general creditor claims.
- “Soft dollar” arrangements should continue to result in general creditor claims.
- Commission or underwriting fees should continue to result in general creditor claims.

## **Recommendations SIPC can implement now**

### **13. A study concerning asset segregation.**

The Task Force recommends that SIPC and the SEC consult on resolving discrepancies between SEC Rule 15c3-3 and the SIPA defined term of “customer property.” The object of this exercise is to reconcile the two regimes to avoid disputes as to what assets are to be segregated for investors.

### **14. International Relations.**

The Task Force recommends that SIPC assist in creating an international association of investor protection entities. While SIPC has memorandum of understanding agreements with a number of similar organizations, the Lehman and MF Global cases show that international issues will only increase in future cases. An organization addressing those issues on a regular basis seems prudent.

**15. SIPC should continue investor education efforts.**

SIPA is a complex statute. Describing both the protections and the limitations of those protections is important. The Task Force urged that SIPC continue to develop programs to do so.

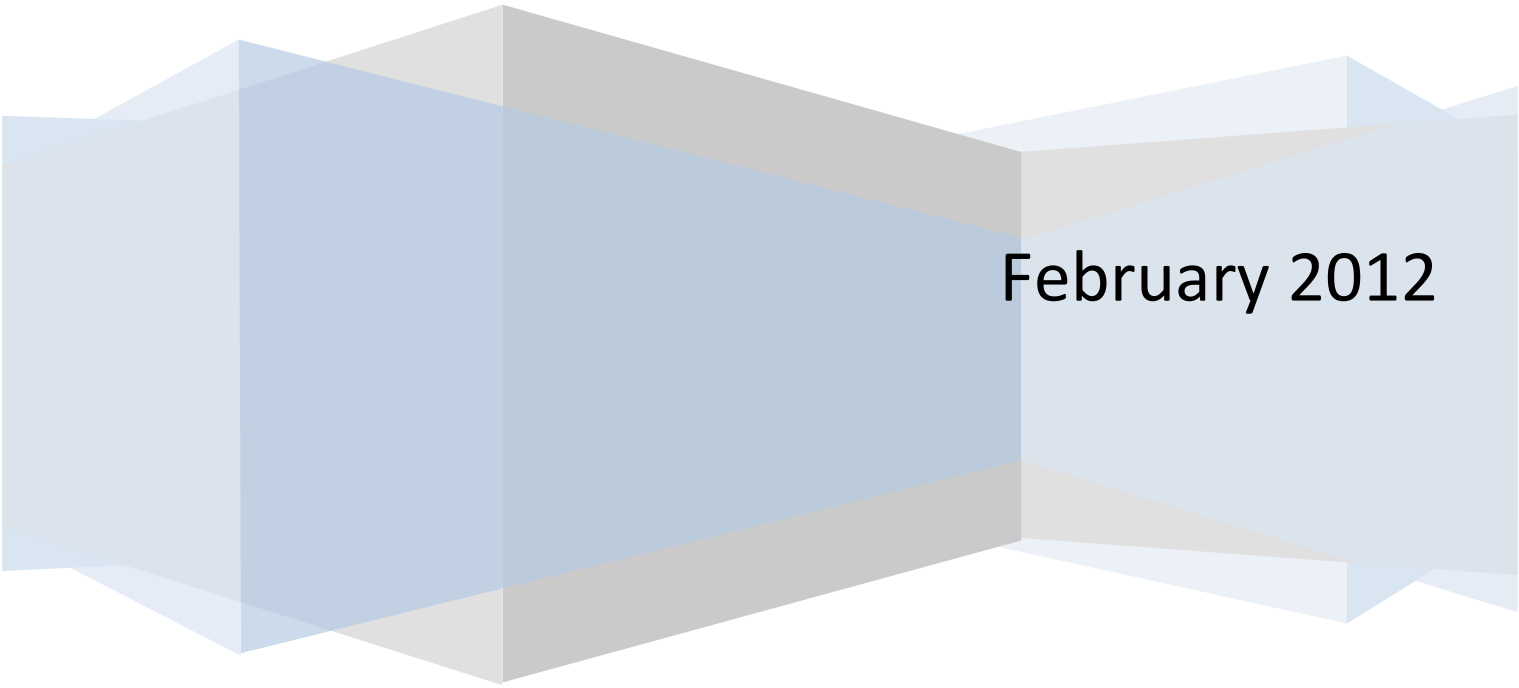
**CONCLUSION**

On behalf of SIPC, I would like to take this opportunity to thank the members of the Task Force for their thoughtful consideration of SIPC's work. I would be happy to discuss any particular Recommendation that is of interest to the Subcommittee.



# **Report and Recommendations of the SIPC Modernization Task Force**

**Presented to the Board of Directors  
Securities Investor Protection Corporation**

An abstract graphic composed of several overlapping, semi-transparent 3D rectangular blocks. The blocks are arranged in a way that creates a sense of depth and perspective. The colors are muted, including shades of light blue, grey, and off-white. The blocks are of varying sizes and are positioned to create a complex, layered effect.

**February 2012**

## **MEMBERS OF THE SIPC MODERNIZATION TASK FORCE**

### Chairman

Orlan M. Johnson, Chairman of the Board, SIPC  
*Saul Ewing LLP*

### Vice Chairman

Sharon Y. Bowen, Vice Chairman of the Board, SIPC  
*Latham & Watkins LLP*

Philip M. Aidikoff  
*Aidikoff, Uhl & Bakhtiari*

Joseph P. Borg  
*Director, Alabama Securities Commission*

Steven B. Caruso  
*Maddox Hargett & Caruso, P.C.*

Chen Gongyan  
*Former Board Chairman, China Securities Investor Protection Fund Corporation Limited*

John C. Coffee, Jr.  
*Adolf A. Berle Professor of Law, Columbia University School of Law*

James W. Giddens, Trustee of Lehman Brothers Inc., Trustee of MF Global Inc.  
*Hughes Hubbard & Reed LLP*

Ira D. Hammerman  
*Senior Managing Director and General Counsel,  
Securities Industry and Financial Markets Association (SIFMA)*

William H. Heyman  
*The Travelers Companies, Inc.*

Observer: Michael A. Macchiaroli  
*Associate Director, Division of Trading and Markets  
U.S. Securities and Exchange Commission*

**A Message from Orlan M. Johnson, Chairman of the SIPC Modernization Task Force:**

When I began my tenure as SIPC's Chairman in February 2010, SIPC faced challenges unprecedented in its 40 year history. The financial crisis had caused SIPC to initiate a liquidation proceeding in September 2008 for Lehman Brothers Inc., one of the world's largest brokerage firms. Barely three months later, in December 2008, SIPC was confronted with the stunning exposure of the long running fraud at Bernard L. Madoff Investment Securities LLC, reportedly the largest Ponzi Scheme in history. These two cases placed SIPC at the epicenter of both the financial crisis and the public eye.

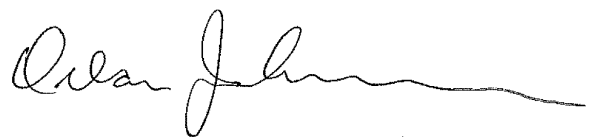
The last significant overhaul of the Securities Investor Protection Act ("SIPA") occurred in 1978. In February 2010, SIPC's Board of Directors authorized the formation of the SIPC Modernization Task Force to review SIPA and SIPC's operations and policies comprehensively, and propose reforms to modernize SIPA and SIPC.

The Task Force includes investor advocates, regulatory specialists, and academic experts. As a member of the Task Force, the Trustee for the liquidation of Lehman Brothers Inc. (and more recently, MF Global Inc.) offers the practical perspective of a trustee dealing with the complexities of a large scale brokerage failure. The failures of Lehman, Madoff, and now, MF Global, have profound international consequences. The addition to the Task Force of Chairman Chen Gongyan of the China Securities Investor Protection Corporation (who has moved on to become Chairman of the Securities Association of China) brings a unique perspective to the international aspects of brokerage failures.

In the Report, the Task Force has made a number of recommendations which will require further empirical study by SIPC's Board of Directors. The recommendation to eliminate the distinction between claims for cash and claims for securities is an example, as is the recommendation to protect individual participants in certain pension programs. SIPC will have to evaluate the financial and other consequences of those proposals before deciding whether to recommend possible legislation going forward. It is my pledge to the hard working members of the Task Force that SIPC will move promptly on those evaluations.

In addition to bringing together the Task Force, comprised of volunteers, SIPC commissioned an independent Corporate Governance Review by Professor Lawrence A. Cunningham, the Henry St. George Tucker III Research Professor of Law, of the George Washington University Law School. The thorough Review will, I am sure, guide the Board in a number of areas.

My heartfelt thanks go to the Vice Chairman, and each member of the Task Force, for their valuable contributions, and their selfless devotion of time and energy to the production of the following Report and Recommendations.

A handwritten signature in black ink, appearing to read "Orlan Johnson", with a long horizontal flourish extending to the right.

Orlan M. Johnson  
Chairman  
SIPC Modernization Task Force

# **REPORT AND RECOMMENDATIONS OF THE SIPC MODERNIZATION TASK FORCE**

## **INTRODUCTION**

At its inaugural meeting in June 2010, the SIPC Modernization Task Force considered a broad range of issues to determine which were appropriate for review. The Task Force separated into two working subgroups, each of which would undertake a review of half of the issues and make recommendations to the full Task Force. The Task Force decided that, as a whole, it would consider the following three issues: any change to the minimum assessment amount, the preservation of the avoidance powers of a trustee appointed pursuant to the Securities Investor Protection Act, 15 U.S.C. section 78aaa *et seq.* (“SIPA”), and the increased use of the Direct Payment Procedure.

Over the course of the next year, the subgroups met individually, both in person and by telephone conference, to discuss and debate the issues before them. The subgroups researched the issues, conducted briefings with experts on particular topics, and considered public comments. In addition, the Task Force met with outside guests, including SIPC’s Government Directors, investor education experts from the Securities and Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority (“FINRA”), and representatives of the Depository Trust & Clearing Corporation and the Investment Company Institute. In total, the Task Force held 14 meetings either in person or by telephone; each of the subgroups met four times, and the full Task Force met six times.

The Task Force was acutely interested in hearing from the public. To that end, the Task Force created a web site, [www.SIPCModernization.org](http://www.SIPCModernization.org), which explained the various issues to the public and solicited comments. Since its launch in June 2010, [www.SIPCModernization.org](http://www.SIPCModernization.org) received approximately 70 comments. In addition, the Task Force solicited and received numerous letters and emails. The Task Force also held two live events – a web event during which the public made comments and asked questions of Task Force members, and a live public forum held at the Grand Hyatt Hotel in New York City where attendees offered comments to Task Force members. The Task Force reviewed and discussed the various comments made by the public through the web site, individual letters, and the forums. Finally, in testifying before the House Financial Services Committee, Task Force members listened to concerns about the adequacy and effectiveness of SIPA, as expressed by various members of Congress during the hearing.<sup>1</sup>

After undertaking a comprehensive review of the issues, the subgroup voted on a resolution for each issue. The resolutions, whether approved or rejected by either of the subgroups, were presented to the full Task Force for a vote.

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<sup>1</sup> *Assessing the Limitations of the Securities Investor Protection Act: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services, 111th Cong. (2010)*

This Report sets forth the recommendations of the Task Force. The Report also includes a corporate governance review of SIPC, annexed hereto as Appendix A, which was undertaken by a corporate governance expert, Professor Lawrence A. Cunningham, Henry St. George Tucker III Research Professor of Law, The George Washington University Law School.

The Task Force Report and the recommendations therein are being presented to SIPC's Board of Directors for consideration. It is the Task Force's hope that the recommendations will be reviewed by the Board, and ultimately presented to Congress for adoption as appropriate. The Task Force wishes to stress that its recommendations are made in consideration of the purposes of SIPA as understood at the time of the formation of the group, namely, to protect public, retail customers of a member broker-dealer, within specified limits, against the loss of their customer property custodied with the broker-dealer. The recently raised issue of protecting investors against market loss or damages resulting from fraud, misrepresentation, or wrongful acts similar to the Stanford situation has not been considered. The recommendations of the Task Force should be evaluated by SIPC's Board in the context of the historical legislative purposes and judicial interpretations of SIPA, and changes may be necessary if Congress passes expansive legislation or courts determine that SIPA should be interpreted differently.

Respectfully submitted,

The SIPC Modernization Task Force<sup>2</sup>

Orlan M. Johnson, Chairman  
Sharon Y. Bowen, Vice Chairman  
Philip M. Aidikoff  
Joseph P. Borg  
Steven B. Caruso  
Chen Gongyan  
John C. Coffee, Jr.  
James W. Giddens  
Ira D. Hammerman  
William H. Heyman

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<sup>2</sup> After making significant contributions, particularly on the subject of investor education, Melanie Senter Lubin, Securities Commissioner, Office of the Attorney General, Division of Securities, State of Maryland, and Daphne Smith, Assistant Commissioner for Securities, Tennessee Department of Commerce and Insurance, Securities Division, withdrew from the Task Force, due to other pressing obligations.

Task Force materials were made available to representatives of the SEC and the Department of the Treasury who attended many of the meetings of the Task Force. On occasion, an SEC representative participated in the Task Force's discussions.

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**Recommendation No. 1:**

***Increase the Maximum Level of Protection to \$1.3 Million  
Index the Level of Protection to Inflation***

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**Overview**

The Task Force considered whether the current level of protection – a maximum of \$500,000, up to \$250,000 of which may be in satisfaction of a cash claim – is sufficient to protect customers and instill investor confidence in the securities markets. The \$500,000 maximum has not been increased since 1980. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929H (2010) (the “Dodd-Frank Act”), increased the cash maximum from \$100,000 to \$250,000, and created a mechanism for indexing the level of cash protection to inflation.

The Task Force has determined that the \$500,000 maximum should be meaningfully increased. Increasing the level of protection while continuing to index the amount to inflation furthers the important objective of modernizing SIPA.

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***Task Force Recommendation***

***The Task Force recommends that the maximum limit of protection be increased to \$1.3 million and that the limit continue to be indexed to inflation.***

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***SIPA’s Levels of Protection***

The SIPA limit of protection for cash claims has tracked the corresponding amount protected by the FDIC throughout SIPC’s history. The initial limits of protection in 1970 included advances from SIPC of up to \$50,000, with a maximum of \$20,000 for cash. The \$20,000 cash protection matched the level of FDIC protection at the time. Pub. L. No. 91-151, 83 Stat. 375 (1969).

In 1978, SIPA was amended to permit an advance of up to \$100,000 for each customer, with a maximum of \$40,000 for cash. Pub. L. No. 95-283, 92 Stat. 249 (1978). The increase in cash protection was designed to match a 1974 increase for depositors with institutions protected by the FDIC or the Federal Savings and Loan Insurance Corporation. See H. R. Rep. No. 95-746, at 40 (1977).



A similar increase in SIPA's levels of protection was enacted in 1980, when Congress raised the amount that SIPC could advance for a customer to up to \$500,000, of which a maximum of \$100,000 could be based upon a claim for cash. Pub. L. No. 96-433, 94 Stat. 1855 (1980). FDIC protection had been increased to \$100,000 as well. Pub. L. No. 96-221, 94 Stat. 147 (1980).

On July 22, 2010, pursuant to the Dodd-Frank Act, the cash level of protection under SIPA was increased to \$250,000. The Dodd-Frank Act also made permanent the FDIC protection increase to \$250,000. *See* Dodd-Frank Act § 335.

### ***Policy Considerations***

The Task Force looked at various factors to determine the appropriate level of protection. Ultimately, the Task Force was strongly influenced by the following considerations in arriving at its Recommendation:

- The level of protection should be sufficient to protect 90% or more of retail customer accounts. *See Securities Investor Protection: Hearings on H.R. 13308, H.R. 17585, H.R. 18081, H.R. 18109 and H.R. 18458 before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce, 91st Cong. 339-340 (1970) (Statement of Hon. Hamer H. Budge, Chairman, Securities and Exchange Commission) (explaining that the level of protection was set at \$50,000, which was sufficient to protect fully 94.5% of cash and margin accounts);*
- The level of protection should be consistent with the rate of inflation, and \$500,000 in 1980 is worth \$1.3 million in 2011, *see* Consumer Price Index Inflation Calculator, available at the Bureau of Labor Statistics website, <http://data.bls.gov/cgi-bin/cpicalc.pl>;
- In 1980, James F. Keegan, Chairman, Board of Governors, National Association of Securities Dealers, Inc., stated that SIPC should protect 100% of customer claims: “We believe that the coverage provided by the SIPC fund should ultimately extend to all customer claims and that [the increase in the level of protection to \$500,000] will take us one step further toward the realization of that goal.” *See Securities Investor Protection Act Amendment: Hearing Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce, 96th Cong. 27 (1980); and*
- The level of protection should “be consistent with one of the fundamental principles guiding the establishment of SIPC, and that is that it protect the small investor, but not the professional.” *Id.* at 5.

An increase in the level of protection also may increase the amount of claims asserted against the SIPC Fund. The Board of Directors may wish to study the additional amount that the SIPC Fund will be required to absorb as a result of such a change, and whether the target level of the SIPC Fund will need to be increased as well.

The Board of Directors also may wish to consider this increase together with a recommendation to eliminate the distinction between claims for cash and claims for securities. Should the distinction be eliminated, the protection for cash claims would increase from \$250,000 to \$1.3 million. On the other hand, if the limit on claims for cash remains at \$250,000, the disparity between protection for cash claims and securities claims will increase.

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**Recommendation No. 2:*****Eliminate the Distinction in the Levels of Protection for  
Cash and Securities***

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***Overview***

The Task Force examined whether the current distinction in the levels of protection for cash versus securities claims adequately protects customers and is appropriate in light of the way that customer assets are kept at modern broker dealers. Currently, the level of protection per customer is capped at \$500,000, up to \$250,000 of which may be in satisfaction of a customer's cash claim.

The Task Force has determined that the distinction between the protection based on claims for cash and claims for securities should be eliminated. This distinction leads to arbitrary resolution of claims as between customers, may no longer reflect the way that cash and securities are held at broker dealers, and has created confusion over the way that claims based on fictitious securities are treated.

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***Task Force Recommendation***

***The Task Force recommends that the distinction in the level of protection  
between claims for cash and claims for securities be eliminated.***

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***The Method of Satisfying Claims for Securities***

A goal of a SIPA proceeding is to restore customers to their accounts as nearly as possible as the accounts existed on the "filing date," as defined in SIPA section 78lll(7). *See* SIPA § 78fff-2(d). *See also* S. Rep. No. 95-763 at 2 (1978), *reprinted in* 1978 U.S.C.C.A.N. 765 ("By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, [the 1978 amendments to SIPA] . . . would restore the customer to his position prior to the broker-dealer's financial difficulties."). As such, customers who are owed securities typically receive securities in satisfaction of their claims. *See, e.g.,* H.R. Rep. No. 95-746, at 21, 41 (1977) ("Our expectation is that, in almost all cases, a customer's claim for securities would be satisfied by the delivery of securities . . ."). If the fund of customer property does not include enough securities to satisfy customer claims, the trustee will purchase

securities that are available in a fair and orderly market. SIPA § 78fff-2(d).<sup>3</sup> If replacement securities are not available in a fair and orderly market, however, the trustee may satisfy a claim for securities by providing cash equal to the market value of the security on the filing date. SIPA § 78fff-2(b).

### ***The Cash Sweep***

At the time that SIPA was drafted, cash for the purpose of purchasing securities generally was held in customers' securities accounts. Since the 1970s, however, the use of money market funds has increased dramatically,<sup>4</sup> with many customers now having their brokerage cash swept overnight into money market funds or bank deposit accounts. *See, e.g.,* Jane J. Kim, *Wall Street Cuts Yields on Investors' Cash*, Wall St. J., August 31, 2005, available at [http://online.wsj.com/article/NA\\_WSJ\\_PUB:SB112545003610027383.html](http://online.wsj.com/article/NA_WSJ_PUB:SB112545003610027383.html). Customers of broker dealers using such sweeps are more likely to have cash in their brokerage accounts only when it is "caught," that is, when a customer deposits cash into his account immediately before the firm's failure, or his securities have been liquidated and, at the time of the brokerage failure, the customer has not yet reinvested the cash or withdrawn the cash sales proceeds. Because of this random timing, the customer is left with a claim for cash and lesser protection than if his assets were held in securities.

### ***Courts are Divided on Whether a Claim for Fictitious Securities Is a Claim for Cash or a Claim for Securities***

Currently, two federal courts of appeals are divided over whether a claim for fictitious securities is a claim for cash or a claim for securities under SIPA. The Sixth Circuit, in *Plumbers & Steamfitters Local No. 490 Severance and Ret. Fund v. Appleton (In re First Ohio Secs. Co.)*, 1994 U.S. App. LEXIS 31347 (6th Cir. Nov. 1, 1994) ("*First Ohio*"), ruled that certain claims involving fictitious securities should be treated as claims for cash, while the Second Circuit, in *In re New Times Sec. Servs. Inc.*, 371 F.3d 68 (2d Cir. 2004) ("*New Times*"), ruled that certain claims for fictitious securities should be treated as claims for securities. This distinction is

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<sup>3</sup> The trustee's authority to satisfy claims in either cash or securities is preserved in certain circumstances. *See* H.R. Rep. No. 95-746, at 41-42 (1977) ("One chief concern is that the trustee not be required to make purchases in a market which is being improperly controlled or manipulated."). Likewise, if a claim for securities is not timely filed, the trustee may satisfy the claim in cash or securities, or both, as the trustee decides is most economical. SIPA § 78fff-2(a)(3).

<sup>4</sup> By 1978, total net assets held in money market funds had grown to over \$5 billion. *See* Marcia Stigum, *The Money Market: Myth, Reality and Practice*, 534 (1978). However, in 1978, money market funds "still play[ed] a relatively small role." *Id.* According to the Investment Company Institute, for the week ended February 1, 2012, the total net assets for money market funds was \$2.69 trillion. *See* Weekly Money Market Mutual Assets, available at <http://www.ici.org/research#statistics>.

important because claims for securities have a higher limit for the SIPC advance than cash only claims: the overall SIPC advance is limited to \$500,000, but the cash portion is limited to \$250,000, subject to an inflation adjustment. SIPA § 78fff-3(a), (d).

The *New Times* interpretation is inconsistent with how claims for securities are to be satisfied under SIPA. Under SIPA, customers who are owed securities receive either the securities or their filing date market value. Thus, it is impossible to deliver securities or a filing date market value of securities when the “securities” are fictitious. Nevertheless, the *New Times* position holds that the customer who is owed fictitious securities has a claim for securities, the claim is protected up to \$500,000, and the value of the “securities” is not the market value of zero, but the amount of cash deposited by the customer with the broker to pay for the “securities.” The *New Times* position therefore requires a trustee to satisfy a claim for fictitious securities differently than claims for legitimate securities.

### ***Problems with the Cash/Securities Distinction***

The cash/securities distinction has been problematic throughout SIPC's history. Examples include the following:

1. A customer sold her entire securities portfolio and ordered the proceeds to be sent to her. That portfolio exceeded the then current maximum of \$20,000 SIPC could advance for a cash claim. She received a check, but it was not honored because the brokerage firm failed before she could cash the check. A sympathetic bankruptcy judge held that the customer was “an involuntary cash depositor,” in an attempt to avoid the clear limit of protection.<sup>5</sup> On appeal, the United States District Court reversed, noting that the court below had disregarded the explicit language of the statute.<sup>6</sup>
2. A pension plan ordered its portfolio liquidated, and the brokerage firm complied. The pension plan sought to avoid the consequences of the sale so that it could have a claim for securities, but the court ruled, correctly, that the pension plan had a claim for cash.<sup>7</sup>

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<sup>5</sup> *In re Weis (Estate of Irene H. Tuchler, Claimant)*, No. 73 Civ. 2332, slip op. at 14 (S.D.N.Y. Nov. 7, 1975) (Babitt, B.J.)

<sup>6</sup> *In re Weis (Estate of Irene H. Tuchler, Claimant)*, No. 73 Civ. 2332, slip op. at 1 (S.D.N.Y. Dec. 28, 1977) (Knapp, D.J.)

<sup>7</sup> *In re Morgan, Kennedy & Co., Inc.*, 3 Bankr. Ct. Dec. (CRR) 15 (Bankr. S.D.N.Y. 1977)

3. Customers who had sold their securities tried to avoid the consequences of that sale by arguing that the brokerage firm had never delivered the securities to the buyers. This argument was unsuccessful.<sup>8</sup>

The pattern in the foregoing cases is inescapable. When confronted with a “claim for cash” that exceeds SIPA’s capacity to satisfy, claimants attempt to shoehorn their particular fact pattern into a “claim for securities.” The law as plainly written requires opposition to such attempts.

### ***Policy Considerations***

Eliminating the distinction between claims for cash and claims for securities resolves potential disparate treatment of customers, as well as the split between the courts of appeals over whether fictitious securities give rise to claims for cash or claims for securities. In addition, it increases the amount of protection available to customers of broker-dealers. As a result of this increase in protection, however, the amount of claims against the SIPC Fund also may increase commensurately. The Board of Directors may wish to examine the additional amount that the SIPC Fund would be required to absorb as a result of such a change.

It is also worth noting that if the distinction between claims for cash and claims for securities is eliminated, SIPC will offer greater protection against the loss of cash than the FDIC. This would depart from the practice of the cash limit under SIPA tracking that of the FDIC. Accordingly, the Board of Directors may wish to study whether an increase in the amount of cash protection will result in customers holding more cash at broker dealers, taking into consideration, among other things, the different purposes for which cash is left on deposit with each institution and the modern-day practice that favors sweeps of funds out of the brokerage.

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<sup>8</sup> *Murray v. McGraw (In re Bell & Beckwith)*, 821 F.2d 333 (6th Cir. 1987).

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## **Recommendation No. 3:**

### ***Protect Participants in Pension Funds on a Pass-Through Basis***

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#### ***Overview***

Currently, under SIPA, persons without accounts at the brokerage, but invested with a plan or a fund with an account at the brokerage, are not eligible for separate SIPC advances. In that situation, the fund or the benefit plan is the “customer,” and it alone is eligible for SIPC advances.

The Task Force examined whether pass-through protection should be provided for individual claimants without an account. Among other things, the Task Force considered the possible expansion of protection in conjunction with a review of the trust and fiduciary provisions under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.* (“ERISA”).

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#### ***Task Force Recommendation***

***The Task Force recommends that SIPA be amended to provide pass-through protection for individual participants in the following ERISA-qualified plans: defined benefit pension plans, defined contribution plans, and deferred profit sharing plans. Each individual participant should be subject to the SIPC protection limits. The combined net equities of all plan participants should not be greater than the net equity of the plan’s assets held by the SIPC member.***

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#### ***Overview of SIPA’s Treatment of Claimants Without an Account***

In a brokerage firm liquidation under SIPA, SIPC funds may be used to replace missing assets for each brokerage “customer,” as that term is defined in section 78III(2) of SIPA. Currently, persons without accounts at the brokerage, but invested with a plan or a fund with an account at the brokerage, are not eligible for separate SIPC advances. In that situation, the fund or the benefit plan is the “customer,” and it alone is eligible for SIPC advances.

Most claimants who do not have an account at a brokerage firm in their name (or as beneficiaries of a nominee or agent) are not treated as separate “customers” under SIPA. *See, SIPC v. BLMIS*, 454 B.R. 285 (Bankr. S.D.N.Y. 2011), *aff’d*, *In re Aozora Bank Ltd.*, (*SIPC v. BLMIS*), 2012 WL 28468 (S.D.N.Y. Jan. 4., 2012); *Plumbers & Steamfitters Local No. 490 Severance and Retirement Fund v. Appleton (In re First Ohio Sec. Co.)*, 1994 U.S. App. LEXIS

31347 (6th Cir. Nov. 1, 1994); *SIPC v. Morgan Kennedy & Co.*, 533 F.2d 1314 (2d Cir.), *cert. den. sub nom., Trustees of the Reading Body Works, Inc. v. SIPC*, 426 U.S. 936 (1976). SIPA creates an exception to this general rule for customers and broker dealers of banks where the broker dealer or bank is the account holder. In that situation, customer status “passes through” to a customer of a broker, dealer or bank that, acting on behalf of such customer, has a net equity claim against the debtor. When a broker, dealer or bank has a net equity claim against a debtor arising out of a transaction on behalf of its customers, each such underlying customer is considered to be an individual “customer” of the debtor. SIPA § 78fff-3(a)(5).

### ***Categories of Investors Without an Account at the SIPC Member Broker Dealer***

The following are currently not eligible for pass-through protection, and the Task Force is recommending no change to their treatment:

1. *Individual shareholders, where a corporation is the account holder;*
2. *Individual limited or general partners, where a partnership is the account holder;*
3. *Individual members of an unincorporated association, where the association is the account holder; and*
4. *Investors who own shares of a hedge fund, fund of funds, or mutual fund, where the fund is the account holder.*

The Task Force determined that the treatment of claimants in these categories should not change. The investors in these categories have no relationship with the broker and may have recourse against their corporation, partnership, or association to the extent that their investment was not proper. In addition, much of the information concerning the underlying investors and the size of their investments is proprietary, and generally is unavailable to the broker. Without access to the books and records of the underlying funds, it is impossible to ascertain the amount of additional exposure to the SIPC Fund if protection is extended to this group. Accordingly, the Task Force recommends that these investors be educated that their investments are not protected.

The following are currently not eligible for pass-through protection, but the Task Force is recommending that treatment of these individuals be changed:

1. *Individual participants of a defined benefit pension plan, where the plan is the account holder;*
2. *Individual participants in a defined contribution plan, where the plan is the account holder (whether or not the broker sends statements to each of the participants);<sup>9</sup> and*

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<sup>9</sup> If the defined contribution plan is the account holder and sole customer, and the broker does not send account statements to each of the participants, the individual participants normally would not separately be eligible for SIPC advances. On the other hand, if the broker sends account statements to each participant, and each participant exercises authority to make trades in his or her account, each participant currently is treated as a separate customer.



3. *Individual participants in a deferred profit sharing plan, where the plan is the account holder.*

Privately sponsored pension plans hold the assets of over 40 million active participants, 10 million of which are retirees. *See, e.g.,* Lee T. Polk, ERISA Practice and Litigation 1:5 (2010). Over the past 50 years, there has been a shift in the way that savings are held and an increased use of retirement accounts by typical retail investors. *See Finances of Employee Benefits, 1960–2003*, Employee Benefits Research Institute, *available at* <http://www.ebri.org/pdf/publications/facts/0205fact.b.pdf> (explaining that payments to individuals from private employer pension and profit sharing plans increased from \$1.7 billion in 1960 to \$320.4 billion in 2003). The Task Force believes that this recommendation would be an important modernization to SIPA, particularly because these investments typically represent the retirement accounts and life savings of many indirect investors who do not have a choice in where their plans' assets are held.

***Carve-Out for Avoidance Actions***

In making this Recommendation, the Task Force does not intend to suggest that a SIPA trustee should not be allowed to pursue avoidance actions against any claimant in any of the categories listed above. In the case of defined benefit plans, beneficiaries may have benefited from the receipt of avoidable transfers, and a defined benefit plan should not be allowed to recover the amount of its *pro rata* share of customer property *and* retain the avoidable transfer. As such, it should be made clear that the full amount of any avoidable transfer should be deducted from the amount of a fund's distribution to the extent that the avoidable transfer was not recovered by the trustee.

***Policy Considerations***

Because of the way that pension fund assets are currently held, the Task Force expects that most pension funds, particularly large pension funds, will continue to keep their cash and securities in banks even if they execute trades through their brokerage accounts. However, as the scope of protection is increased, the amount of claims asserted against the SIPC Fund may also increase. As part of any change to the scope of protection, the Board of Directors may wish to consider whether a commensurate increase to the target level of the SIPC Fund is necessary.

It also will be important to consider how the specific mechanisms of protection would work, such as which parties will be required to file claims and the level of proof that is necessary to determine whether a claimant is actually a participant in the fund and the extent of its participation. The Task Force is not making a recommendation as to these procedural issues.

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**Recommendation No. 4:**

***Amend the Minimum Assessment to the Greater of 1) \$1,000; or  
2) the Amount Set by SIPC Bylaw Not to Exceed 0.02% of the  
Member's Gross Revenues from the Securities Business***

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**Overview**

Under SIPA section 78ddd(d)(1)(C), SIPC may impose upon each of its members a minimum assessment in an amount to be set from time to time by SIPC Bylaw within limits set by Congress. Under the Dodd-Frank Act, § 929V, Congress amended the minimum assessment amount to be no greater than 0.02 percent of gross revenues from the securities business of each member. Prior to the enactment of the Dodd-Frank Act, the minimum assessment was no greater than \$150 per annum. *See* SIPA § 78ddd(d)(1)(C) (2009).

Currently, members are assessed on 0.25% of their net operating revenues from the securities business. In 2009, for approximately 25% of the membership, 0.25% of net operating revenues was between \$0 and \$150. Prior to the enactment of the Dodd-Frank Act, these members would have paid a flat \$150 assessment fee. After the amendment, these members pay less than \$150 – and in some cases, \$0. Thus, under the Dodd-Frank Act, in some instances, the assessments actually have decreased or been eliminated.

Because all SIPC member broker-dealers benefit from the SIPC program, the Task Force has determined that all members should pay an assessment fee.

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***Task Force Recommendation***

***The Task Force recommends that all SIPC members pay an assessment fee which is the amount set by SIPC Bylaw and the minimum amount of which shall not be more than 0.02% of the member's gross revenues from the securities business, but if the aforementioned amount is less than \$1,000, the member shall pay a minimum assessment fee of \$1,000.***

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**Recommendation No. 5:**

***Allow for the Use of the Direct Payment Procedure in Cases in Which the Total Amount of Claims Aggregates Less than \$5 million***

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**Overview:**

The Task Force considered whether the use of the Direct Payment Procedure should be updated and/or expanded. Currently, a Direct Payment Procedure is available only if SIPC determines that:

- the SIPC member cannot meet its obligations to customers;
- one or more of the conditions specified in SIPA section 78eee(b)(1) are present;
- the claim of each customer is within the limits of protection under SIPA;
- the cost of satisfying customers in the Procedure will be less than the cost under a liquidation proceeding;
- the member's broker-dealer registration has terminated or the member has consented to use of the Procedure; and
- the claims of all customers of the member total less than \$250,000.

The \$250,000 claim limit has not been adjusted since 1978.

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***Task Force Recommendation***

***The Task Force recommends that the Direct Payment Procedure be available in cases in which the aforementioned conditions are present except that the total amount of claims should aggregate less than \$5 million instead of \$250,000.***

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***Direct Payment Procedure***

The Direct Payment Procedure includes notice and claims procedures similar to those in a judicial liquidation proceeding, but limits bankruptcy court involvement to the review of the determination of any "customer" claim as to which proper objection has been filed in court within six months of the date SIPC mails the determination. Significantly, it is the claimant who initiates court involvement by the filing of an objection. All allowed claims are satisfied from SIPC advances; there is no collection of customer property.

The Direct Payment Procedure is designed to enable SIPC quickly, and inexpensively, to make customers whole, without the use of the more time-consuming and expensive procedures of a judicial liquidation proceeding. In SIPC's experience, Direct Payment Procedures have cost less, have provided an efficient mechanism for returning missing cash and securities to customers, and are advisable where the brokerage is judgment proof and there is little or no customer property to be had.

The Task Force has determined that the Procedure affords customer protection in a manner that is cost-effective and time-efficient. The Task Force recognizes, however, that because the Procedure is conducted out of court, it is only suitable in certain instances.

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**Recommendation No. 6:*****Require Auditors of SIPC Members to File Copies of Audit Reports With SIPC***

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***Overview***

For more than sixty years, in order to safeguard customers' assets, the SEC, by means of its Rule 17a-5, 17 C.F.R. § 240.17a-5, has required an independent public accountant to provide certain assurances regarding financial information reported by the broker-dealer. *See* Exchange Act Release No. 3338, 7 Fed. Reg. 9917 (Dec. 1, 1942). Toward that end, the accountant must perform an "examination of accountabilities and responsibilities of a firm resulting in a report to regulatory bodies concerning that firm's fiduciary obligations to customers." *See* SEC, *Study of Unsafe and Unsound Practices of Broker-Dealers* ("SEC Study"), H.R. Doc. No. 92-231, at 152 (1971). The information is filed with the SEC and the securities self-regulatory organizations. The information provides these authorities "with a sufficiently early warning to enable them to take appropriate action to protect investors before the financial collapse of the particular broker-dealer involved." *Touche Ross & Co. v. Redington*, 442 U.S. 560, 570 (1979) (footnote omitted).

The purpose of the accountant's audit report is the same as that of SIPA: to provide greater protection to customers. The accountant's audit report includes detailed information regarding the SEC's net capital requirements (Rule 15c3-1) and customer reserve requirements (Rule 15c3-3). Non-compliance with these Rules requires the SEC to inform SIPC for the benefit of customers. *See* SIPA § 78eee(a)(1). However, SIPC does not receive a copy of accountants' audit reports. As a result, SIPC cannot rely directly on these audit reports and thus has been held by courts not to have standing to sue an auditor for any negligent or tortious conduct related to the audit.

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***Task Force Recommendation***

***The Task Force recommends that SIPC members be required to file audit reports with SIPC concurrently with their filing with the SEC. The purpose of such a requirement would be to allow SIPC to rely on the audit report and provide SIPC with standing to sue an auditor for any negligent or tortious conduct related to an audit.***

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### ***Related Litigation in SIPA Liquidation Proceedings***

SIPC and/or SIPA trustees have taken action against accounting firms based on the firms' audit responsibilities in six liquidation proceedings. Settlements were reached regarding the actions in three of those proceedings.<sup>10</sup> In the other three liquidation proceedings, the courts held that the accountant could not be held liable to SIPC. *See SIPC v. BDO Seidman (In re A.R. Baron & Co.)*, 245 F.3d 174 (2d Cir. 2001); *SIPC v. Munninghoff Lange & Co. (In re Donahue Securities, Inc.)*, 2004 WL 3152763 (Bankr. S.D. Ohio Nov. 23, 2004); *SIPC v. Cheshier & Fuller (In re Sunpoint Sec., Inc.)*, 377 B.R. 513 (Bankr. E.D. Tex. 2007), *aff'd sub nom., Richardson v. Cheshier & Fuller LLP*, 2008 WL 5122122 (E.D. Tex. Dec. 3, 2008). In *Sunpoint Securities*, the court explained that "[b]ecause SIPC was never aware of the contents of the audit reports, it cannot demonstrate that it justifiably relied on any statement made by the auditors in those reports, and it cannot recover against C&F upon a theory of negligent misrepresentation." 377 B.R. at 561.

### ***Proposal to Change Applicable SEC Rule***

Presently, SEC Rule 17a-5(d)(6), 17 C.F.R. § 240.17a-5(d)(6), provides that the audit report is to be filed with the SEC in Washington, D.C., the SEC's office in the broker-dealer's region, and the principal office of the broker-dealer's designated examining authority. While the report is thus available for regulators' use in monitoring the broker-dealer's financial health, the report is not provided to SIPC even though it ultimately may trigger the start of a liquidation proceeding. *See* Rule 17a-5(e)(3).

Against this background, SIPC has proposed recommending that SEC Rule 17a-5(d)(6) be changed to require that the audit reports also be filed with SIPC.<sup>11</sup> Including SIPC as a

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<sup>10</sup> The three liquidation proceedings were (1) R.D. Kushnir & Co.; (2) Rocky Mountain Securities and Investments, Inc.; and (3) NEBS Financial Services, Inc.

<sup>11</sup> The proposed rule change would revise SEC Rule 17a-5(d)(6) to add SIPC as a designated entity to receive a copy of the annual audit report filed with the SEC. The rule is set forth below, and the proposed revision is italicized.

The annual audit report shall be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, D.C., and the principal office of the designated examining authority for said broker or dealer. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member, *and to the Securities Investor Protection Corporation ("SIPC")*.

The addition of SIPC to Rule 17a-5(d)(6) would require a technical amendment to SEC Rule 17a-5(e)(4), striking the reference to the "Securities Investor Protection Corporation," and substituting "SIPC" in its place.

designated recipient would further the goal of investor protection by providing another layer of review of the report by an organization directly affected by its contents. In addition, including SIPC as a recipient would help to address the persistent concern that any signs of “financial weakness, as by non-compliance with net capital requirements or otherwise, [be] watched very carefully and followed up” in order to augment the financial responsibility requirements SIPA was intended to enhance, and to provide greater investor protection. *See SEC Study, supra* at 25.

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**Recommendation No. 7:*****Affirm the Obligation of Banks and Other Custodians to Safeguard Rule 15c3-3 Accounts and to Reaffirm That Such Accounts Are Subject to Trustee Control Upon Broker-Dealer Liquidation***

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***Overview***

SEC Rule 15c3-3, 17 C.F.R. § 240.15c3-3, also referred to as the Customer Protection Rule, like SIPA, is designed to ensure, among other things, that customers who entrust cash or securities to a broker-dealer for the purpose of effecting securities transactions are able to recover that property, even if the broker-dealer fails financially.

Under Rule 15c3-3, banks and other custodians acknowledge or agree in writing (for example, by way of a “no lien letter”), with respect to accounts opened by broker-dealers in order to comply with Rule 15c3-3 (“Rule 15c3-3 Accounts”), that the accounts are not subject to any “right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.” The Task Force has determined that it should be made clear that banks and other custodians are not permitted to hypothecate or subject to a lien any assets carried in Rule 15c3-3 Accounts. It also should be made clear that, in the liquidation of a broker-dealer under SIPA, banks or other custodians carrying the broker-dealer’s Rule 15c3-3 Accounts are required to turn over to the liquidation trustee all property in a Rule 15c3-3 Account, and that a failure to turn over such property may subject the bank or other custodian to sanctions for violating Sections 362 and 562 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*,<sup>12</sup> as well as any applicable court order, and may expose them to sanctions (potentially including punitive damages for a willful refusal) for violating such sections (and, where applicable, any order).

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***Task Force Recommendation***

***The Task Force recommends that SIPC request that the SEC issue an interpretive release with respect to Rule 15c3-3 that makes clear that***

- after providing an acknowledgment or agreement (including without limitation a “no lien letter”) that an account used for compliance with Rule 15c3-3 is not subject to any right, charge, security interest, lien, or claim of any kind in favor of such bank or custodian or any***

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<sup>12</sup> Under SIPA section 78fff(b), specified sections of the Bankruptcy Code apply in a SIPA liquidation to the extent not inconsistent with SIPA.



*person claiming through the bank or custodian (a “Claim”), a bank or other custodian may not subsequently create a Claim against such account, and*

- *a request by a trustee for the liquidation of a broker-dealer for control of such an account or any property on deposit therein shall put the bank or custodian on notice that its failure to comply with such a request may subject the bank or custodian to possible sanctions and/or penalties for violating Sections 362 and 542 of the Bankruptcy Code, or aiding and abetting a violation of, Rule 15c3-3.*

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## **Background**

SEC Rule 15c3-3 provides, in relevant part:

(c) *Control of securities.* Securities under the control of a broker or dealer shall be deemed to be securities which: . . .

(5) Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities to the broker or dealer does not require the payment of money or value and the bank having acknowledged in writing that the securities in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank; or . . .

(f) *Notification of banks.* A broker or dealer required to maintain the reserve bank account prescribed by this section or who maintains a special account referred to in paragraph (k) of this section shall obtain and preserve in accordance with § 240.17a-4 written notification from each bank in which he has his reserve bank account or special account that the bank was informed that all cash and/or qualified securities deposited therein are being held by the bank for the exclusive benefit of customers of the broker or dealer in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker or dealer with the bank, and the broker or dealer shall have a written contract with the bank which provides that the cash and/or qualified securities shall at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

Notwithstanding the notification to banks and other related provisions of SEC Rules, bank custodians at times have refused to release to the SIPA trustee property in Rule 15c3-3

Accounts. In some cases, the refusal was purportedly based upon assertions of a subsequently granted right, charge, security interest, lien, or claim of any kind in favor of a bank or any person claiming through the bank (a “Claim”) against the Rule 15c3-3 Account. It would facilitate and expedite the recovery of customer property by the trustee for the benefit of customers if it is made clear that banks and other custodians may not create Claims over Rule 15c3-3 Accounts, that property in a Rule 15c3-3 Account is subject to the SIPA trustee’s control and disposition upon the commencement of a SIPA liquidation proceeding, and that the trustee shall be authorized to recover from the custodian any property improperly released, seized or hypothecated by the bank in violation of its agreement. This clarification would further the enforcement of Rule 15c3-3 and reaffirm existing applicable case law. *See, e.g., Dowden v. Cross County Bank (In re Brittenum)*, 97 B.R. 503 (E.D. Ark. 1987) (holding that a Rule 15c3-3 deposit is not subject to bank’s setoff claim).

In that regard, the Task Force believes that this proposed clarification with respect to the treatment of customer property by a custodian is best accomplished through the issuance of an interpretive release by the SEC respecting Rule 15c3-3. The following language is suggested to be made part of an SEC release:

Upon the commencement of a liquidation under the Securities Investor Protection Act, 15 U.S.C. § 78aaa *et seq.* (“SIPA”), of any broker or dealer, funds or securities deposited by or on behalf of such broker or dealer in any bank account at any point acknowledged or agreed by the bank not to be subject to any “right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank” including without limitation by way of a “no lien letter” (a “Rule 15c3-3 Account”) shall be subject solely to the control and direction of, and disposition by, the trustee appointed for the liquidation of such broker-dealer (the “Trustee”). A broker-dealer violates Rule 15c3-3 if it creates any right, charge, security interest, lien, or claim of any kind in or over a Rule 15c3-3 Account (or the assets from time to time on deposit therein) in favor of the bank or any person claiming through the bank (a “Claim”) against a Rule 15c3-3 Account; therefore any bank accepting or acting on the basis of such a subsequently granted Claim shall be deemed to be aiding and abetting a violation of Rule 15c3-3. A request to a bank by the Trustee for control of funds or securities in a Rule 15c3-3 Account carried by such bank shall put the bank on notice that its failure to comply with such request will violate Sections 362 and 542 of the Bankruptcy Code and/or aid and abet a violation of Rule 15c3-3, and may subject the bank to sanctions (including punitive damages).

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**Recommendation No. 8:*****Continue to Vest the SIPA Trustee with the Same Avoidance Powers as a Trustee in a Case under the Bankruptcy Code***

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***Overview***

The Task Force considered whether the avoidance powers available to a trustee under SIPA should be modified. Currently, the avoidance powers vested in a SIPA trustee are the avoidance powers available to a trustee in a case under the Bankruptcy Code.

The Task Force has determined that avoidance powers are an important tool for returning customers as nearly as possible to their accounts as they existed prior to the commencement of the liquidation proceeding. Allowing a trustee to avoid certain transfers ensures that creditors are treated equally and that certain creditors are not favored over others. Avoidance actions are particularly important when, for example, the debtor broker-dealer has transferred customer assets to a third party (including a customer) within a specified time period preceding the date of liquidation and other than in the ordinary course of business. If these transfers are not recovered by the trustee, the third party or customer who received the funds pre-filing is able to receive 100% of the money transferred, to the detriment of other customers for whom fewer assets remain in the broker's possession for distribution. The avoidance powers, however, allow trustees to recover under specified conditions amounts transferred and to redistribute those assets to all customers, so that all customers share equally.

The Task Force recognizes that in light of SIPA's close interrelationship with the Bankruptcy Code, any change to the avoidance powers should first be made under the Bankruptcy Code. Because under SIPA, the avoidance provisions of the Bankruptcy Code automatically apply to a SIPA case, unless inconsistent with SIPA, such changes would apply without the need for an amendment to SIPA.

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***Task Force Recommendation***

***The Task Force recommends that SIPA trustees continue to be vested with the same avoidance powers as trustees in cases under the Bankruptcy Code. To the extent that any adjustments to the avoidance powers are warranted, the adjustments should be made to the avoidance provisions of the Bankruptcy Code, and thereby incorporated by reference into SIPA. The Task Force does not recommend that the avoidance powers of a SIPA trustee be limited, as they would be under the proposed Ponzi Scheme Investor Protection Act.***

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### ***The Proposed Ponzi Scheme Investor Protection Act***

Pending legislation in the draft Ponzi Scheme Investor Protection Act of 2011<sup>13</sup> (“Draft Bill”), which, on May 25, 2011, was referred to the House Committee on Financial Services, seeks to limit a trustee’s avoidance powers in SIPA liquidations involving Ponzi schemes. The Draft Bill was introduced after the Ponzi Scheme Investor Protection Act of 2010<sup>14</sup> died in Committee.

Section 8A(f) of the Draft Bill states that the “trustee of a Ponzi scheme may not seek to recover money, including profits, from any investor in the Ponzi scheme unless such investor (1) was complicit in the Ponzi scheme; or (2) was registered, or should have been registered, with the Commission under the securities laws as an investment adviser, broker, dealer, or other person with a fiduciary duty to the customers or investors of the person.” As explained above, divesting a trustee of his power to avoid transfers inevitably results in inequitable distributions to customers by favoring some customers over others. This is particularly troublesome in the case of a Ponzi scheme where no actual investments are made and funds that have been paid to certain customers consist of other customers’ money. Customers who received no transfer of funds from the broker-dealer before its failure would be subject to a potentially more limited distribution in the SIPA liquidation proceeding.

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<sup>13</sup> H.R. 1987, 112th Cong. (2011).

<sup>14</sup> H.R. 5032, 111th Cong. (2010).

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**Recommendation No. 9:**

*Continue to Treat Claims Arising from Repurchase and Reverse Repurchase Agreements as General Creditor Claims*

**Recommendation No. 10:**

*Continue to Treat Claims Arising from Open TBA Contracts as General Creditor Claims*

**Recommendation No. 11:**

*Continue to Treat Claims Arising From Credits Received Pursuant to Soft Dollar Arrangements as General Creditor Claims*

**Recommendation No. 12:**

*Continue to Treat Claims for Fees Earned in Connection with Underwriting or Other Transactions Effected by a Syndicate as General Creditor Claims*

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*Recommendations 9 through 12 were considered together, as they each rely on common legal principles and policy considerations. Specifically, each Recommendation addresses a potential claim by either institutional customers or sophisticated retail customers, which are customers not intended to have their claims satisfied out of funds advanced by SIPA by the original drafters of SIPA. In addition, each of these Recommendations depends upon the definition of key terms under SIPA such as “customer,” “customer property” and “security.” The below summary of the law therefore applies to each of the Recommendations.<sup>15</sup>*

***“Customer” and “Customer Property” Under SIPA***

“Customer” status under SIPA is limited. Customer status is only available to those persons who, on the “filing date,” have a claim to securities or cash held in custody by the broker for the customer as an investor in securities. In determining the nature of a claimant’s status in relation to the debtor, the court must look at the claimant’s account, as it existed on the books and records of the debtor on the “filing date.” In order to be a “customer” under SIPA, a claimant in a SIPA liquidation proceeding must have a claim to securities or cash custodied in a

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<sup>15</sup> Mr. Hammerman indicated that his approval of Recommendations 9 through 12 reflected SIFMA’s view that the recommendations were meaningful recommendations for the improvement of SIPA, but were prospective only and should not be used to inform the current state of the law.

securities account in his, her or its name and must have established a relationship with the debtor as a securities investor. Thus, under the definition of “customer” in SIPA, customer status is imparted on persons pursuant to their “transactional relationship:” broker-investor transactions are distinguished from the ordinary debtor-creditor relationships.<sup>16</sup>

Courts have held that the actual entrustment of securities or cash into the possession of a debtor is a “bright line” test that separates customer claims from all other claims. As the Fifth Circuit stated in *In re Stalvey & Assocs., Inc.*, “in ‘the absence of actual receipt, acquisition or possession of the property of a claimant by the brokerage firm under liquidation,’” a claimant is not entitled to customer protection under SIPA.<sup>17</sup> For purposes of customer status under SIPA, entrustment means both the transfer of possession of property to the broker, and that this transfer be “in the ordinary course of its business as a broker or dealer.” SIPA § 78III(2). This contemplates a “public” customer who tenders securities “for the purpose of having them traded” by the broker.<sup>18</sup> Thus, at a minimum, to qualify for “customer” status under SIPA, claimants must demonstrate that cash or securities were entrusted to the debtor for the purpose of effecting protected securities transactions. Such entrustment of property for the purpose of trading creates the broker-customer fiduciary relationship that is the essence of customer status under SIPA.

### ***Contracts, Loans, and Executory Contracts are Not Protected by SIPA***

As the court explained in *In re Weis Securities*, SIPA only protects customers “with ‘an unrestricted right to receive on demand these [*sic*] securities which belong to them.’”<sup>19</sup> For example, in *In re Adler Coleman Clearing Corp.*, the court rejected broker-dealers’ attempts to attain “customer” status for commissions held at the firm, concluding that the account did not contain “customer property” as defined in SIPA § 78III(4).<sup>20</sup> Accordingly, claims for fraud and breach of contract are not protected by SIPA.<sup>21</sup> Likewise, lenders<sup>22</sup> and parties to executory contracts<sup>23</sup> are not protected by SIPA.

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<sup>16</sup> See, e.g., *Stafford v. Giddens (In re New Times Securities Services, Inc.)*, 463 F.3d 125, 128 (2d Cir. 2006), citing *SEC v. F.O. Baroff*, 497 F.2d 280, 284 (2d Cir. 1974).

<sup>17</sup> 750 F.2d 464, 469 (5th Cir. 1985), quoting *SEC v. Kenneth Bove & Co.*, 378 F.Supp. 697 (S.D.N.Y. 1974).

<sup>18</sup> *In re Hanover Square Secs.*, 55 B.R. 235, 240 (Bankr. S.D.N.Y. 1985).

<sup>19</sup> 1977 WL 1043, at \*4 (S.D.N.Y. Sept. 29, 1977), quoting H.R. Rep. No. 91-1613 (1970).

<sup>20</sup> 216 B.R. 719, 724-25 (Bankr S.D.N.Y. 1998).

<sup>21</sup> See, e.g., *In re MV Secs., Inc.*, 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985) (“SIPA does not protect customer claims based on fraud or breach of contract.” (quoting *SEC v. Howard Lawrence & Co., Inc.*, 1 Bankr. Ct. Dec. 577, 579 (Bankr. S.D.N.Y. 1975)).

## ***Policy Considerations***

Only investors who qualify as “customers” under SIPA share in “customer property,” that is, the cash and securities custodied with the broker for its customers. By limiting the investors who share in such property to “customers,” the interest of such investors in a limited pool of customer assets is not diluted by non-customer claims against it. Thus, if the definition of “customer” were expanded, the only beneficiaries to share in customer property would be persons with non-customer claims against the broker.

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<sup>22</sup> *In re New Times Sec. Servs., Inc.*, 463 F.3d at 129 (“The promissory notes held by [claimants] . . . are just the type of debt instruments whose possession brings claimants within the category of unprotected lenders.”); *In re Hanover Square Sec.*, 55 B.R. 235, 238 (Bankr. S.D.N.Y. 1985) (“Lenders are simply not a class to be specially protected under SIPA and in fact were expressly excluded from the definition of customer upon the enactment of the 1978 amendments to SIPA.”).

<sup>23</sup> See *Securities Investor Protection Act Amendments of 1975: Hearings Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 94th Cong. 171 (1975) (considering, but not enacting, proposed changes to the statutory definition of “customer” to extend protection to persons who had not yet entrusted property but held “executory contracts” for the purchase of securities).

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**Recommendation No. 9:*****Continue to Treat Claims Arising from Repurchase and Reverse Repurchase Agreements as General Creditor Claims***

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***Overview***

In repurchase (“repo”) transactions, a broker-dealer, as ostensible “seller,” transfers to a counterparty, the ostensible “buyer,” certain identified securities (the “Purchased Securities”), against the transfer of funds by the buyer. Simultaneously, the parties agree that the broker-dealer will buy back or repurchase, at a specified future date, the same securities for the same price plus a financing charge or “Pricing Rate,” which is fixed during the life of the repo agreement. As in securities lending transactions, the repo buyer essentially earns interest on the cash that it transferred to the seller for the securities, and has the freedom to use the securities in its business following the initial purchase until the date of repurchase.

Unlike typical customer claims under SIPA, a claim by a repo counterparty is not seeking the return of cash or securities on deposit by the customer for trading purposes. Rather, in a broker-dealer liquidation, a counterparty to an “open” repo or reverse repo transaction often seeks contract damages arising from the broker-dealer’s default on its obligation to resell or repurchase. The amounts claimed generally consist of the difference between the repurchase price of the Purchased Securities (including interest due upon performance) and the Filing Date value of the Purchased Securities, plus any accrued interest. Those counterparties who failed to take possession of their repo collateral may claim the collateral in the liquidation. For example, if the repo participant agreed to lend the broker \$1 million in exchange for securities but left the securities on deposit with the broker, the counterparty might claim the securities if the brokerage fails.

The following factors set these types of claims apart from typical “customer” claims under SIPA:

- Repo transactions are in economic effect secured loan transactions rather than securities investment transactions as contemplated by SIPA;
- The repo contract itself is not a “security” under SIPA;



- Breach of a repo agreement gives rise to a contract claim for damages; and
- The counterparties do not entrust cash or securities to a broker-dealer for trading purposes so as to create the custodial function that is essential to customer status under SIPA.<sup>24</sup>

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### ***Task Force Recommendation***

***The Task Force recommends that claims arising out of repurchase agreements and reverse repurchase agreements not be treated as “customer” claims under SIPA. The Task Force has not addressed hold-in-custody repurchase agreements and takes no position on them.***

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<sup>24</sup> Under Rule 15c3-3, a broker-dealer is generally not obligated to segregate any property in connection with repo transactions. One exception to this rule is where the transaction is a repo transaction where the broker-dealer retains securities it has transferred to the buyer (a “hold-in-custody” or “HIC” repo). See 17 C.F.R. § 240.15c3-3(b)(4)(i)(D). This Rule requires that the broker-dealer obtain the repurchase agreement in writing, and confirm the securities subject to the repurchase agreement in writing. See 17 C.F.R. § 240.15c3-3(b)(4)(i), (iii). In a liquidation of the broker-dealer, the HIC repo counterparty may attempt to claim the securities subject to the repo. (For example, if the counterparty provided \$1 million to the broker-dealer in exchange for \$1.1 million of securities left on deposit with the broker-dealer, the counterparty might attempt to claim the securities if the broker-dealer fails.) Significantly, the broker-dealer also must “[a]dvice the counterparty in the repurchase agreement that the Securities Investor Protection Corporation has taken the position that the provisions of the Securities Investor Protection Act of 1970 do not protect the counterparty with respect to the repurchase agreement.” 17 C.F.R. § 240.15c3-3(b)(4)(i)(A)-(C); see 17 C.F.R. § 240.15c3-3(b)(4)(iii) (specifying additional requirements regarding the right to substitute securities subject to the agreement). The SEC explained that it amended Rule 15c3-3 as a result of “the apparent lack of understanding of hold in custody repo counterparties of their rights and liabilities.” *Customer Protection Rule*, Exchange Act Release No. 24778, 52 Fed. Reg. 30331 (Aug. 14, 1987); see also *Securities; Net Capital, Customer Protection, Recordkeeping and Quarterly Securities Count Rules*, Exchange Act Release No. 23602, 51 Fed. Reg. 32658, 32659-60 (Sept. 15, 1986). See generally *Cohen v. Army Moral Support Fund (Matter of Bevill, Bresler & Schulman Asset)*, 67 B.R. 557 (S.D.N.Y. 1986).

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**Recommendation No. 10:*****Continue to Treat Claims Arising from Open TBA Contracts as General Creditor Claims***

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***Overview***

TBA contracts are forward contracts for the future purchase or sale of “to be announced” U.S. agency debt obligations. In TBA contracts, the parties promise to buy or sell at a future date “to be announced” mortgage-backed obligations of U.S. Agencies,<sup>25</sup> *i.e.*, obligations having defined characteristics (issuing agency, coupon rate, maturity, etc.) but not yet specified (and often not yet in existence) at the time the TBA contract was entered into by the parties. TBA contracts are bilateral agreements between the debtor and the TBA claimants, and are not traded on any securities or commodities exchange or registered with the SEC. The rights of the parties typically are governed by the Master Securities Forward Transaction Agreement (the “MSFTA”), an industry-standard contract designed for transactions of this nature.

This resolution pertains to TBA contracts that are “open” on the “filing date” of the liquidation proceeding because as of that date, the time for performance (the “settlement date”) has not occurred and the obligations of the parties to purchase or sell remain wholly unperformed. Because no securities are specified to the contracts as of the filing date and no securities or cash are transferred to the debtor, the claims in this group are not, like typical customer claims, for the return of cash or securities; instead, they are contract damages claims arising from the debtor’s breach of the TBA contracts. Damages are the breach remedy provided in the MSFTA and established by custom and usage in the industry.

The following factors set these contract damage claims apart from typical “customer” claims under SIPA, and support the argument that they actually are, at best, general creditor claims:<sup>26</sup>

- TBA claimants do not “entrust” cash or securities to the debtor but exchange promises of future performance;

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<sup>25</sup> Such obligations are issued, guaranteed, or issued and guaranteed by the Federal National Mortgage Corporation, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association.

<sup>26</sup> In *In re Lehman Brothers Inc.*, 2011 WL 6098067 (Bankr. S.D.N.Y. Dec. 8, 2011), the court held that claims arising from TBA contracts did not qualify as customer claims under SIPA.

- The TBA contract itself is not a “security” under SIPA;
- The relationship of TBA claimants and a debtor is contractual, typically governed by the industry-standard MSFTA, which disclaims any fiduciary relationship and contains other features that are inconsistent with SIPA customer status; and
- Open TBA contracts are executory contracts, and Congress declined to amend SIPA to consider executory contracts for the purchase of securities as the subject of “customer” claims.

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***Task Force Recommendation***

***The Task Force recommends that because parties to a TBA agreement merely hold contract rights to purchase or sell as yet unidentified securities on a TBA basis, they not be deemed “customers” under SIPA.***

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***Recommendation No. 11:******Continue to Treat Claims Arising From Credits Received Pursuant to Soft Dollar Arrangements as General Creditor Claims***

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***Overview***

The term “soft dollars” refers to arrangements in which “a discretionary money manager receives research or other services from a broker-dealer in addition to transaction execution, and does so in exchange for the brokerage commissions from transactions for discretionary clients’ accounts.” Thomas P. Lemke & Gerald T. Lins, *Soft Dollars and Other Trading Activities* § 1:1 (2010). A typical example of a soft dollar arrangement is where a money manager receives a \$1 credit towards research or brokerage services for every \$1.60 in commissions that the broker receives. *Id.* These credits may be used only to pay for research or brokerage services, and cannot be used as a credit towards the purchase of securities.

SIPA imparts customer status only on investors who deposit cash “for the purpose of purchasing securities.” *See* SIPA § 78lll(2)(B)(i). Because soft dollar credits are only used towards the purchase of research or related services, soft dollars do not qualify as “customer property” under SIPA.

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***Task Force Recommendation***

***The Task Force recommends that credits received pursuant to soft dollar arrangements not be deemed customer property and not give rise to “customer” claims.***

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**Recommendation No. 12:**

***Continue to Treat Claims for Fees Earned in Connection with Underwriting or Other Transactions Effected by a Syndicate as General Creditor Claims***

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**Overview**

Brokers may hold fees earned by syndicate members in connection with underwriting or other transactions effected by a syndicate. These fees, however, are not part of the customary broker/customer relationship, as they are not held for the purpose of investment by customers. Accordingly, the fees do not qualify as “customer property” under SIPA.

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***Task Force Recommendation***

***The Task Force recommends that fees earned in connection with underwriting or other transactions effected by a syndicate not be deemed “customer property” under SIPA.***

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**Recommendation No. 13:*****Study Discrepancies Between SEC Rule 15c3-3 and “Customer Property” Under SIPA***

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***Overview***

The Task Force has identified, examined, and discussed various discrepancies that exist between SIPA and the “Customer Protection Rule” Rule 15c3-3, promulgated by the SEC under the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* Whether and to what extent the discrepancies should be reconciled, and in what respect, will require substantial study and consultation between SIPC and the SEC, taking into account the stated concerns of interested parties. Because a thorough analysis of the reasons for, and the policies that underscore, the differences, and of whether and to what extent the differences should be reconciled, if at all, is best done by SIPC in concert with the SEC, the Task Force makes the following recommendation:

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***Task Force Recommendation***

*Although there are discrepancies between SEC Rule 15c3-3 and provisions of SIPA, the discrepancies may be necessary. Both the Securities Exchange Act of 1934 and SIPA share the goal of customer protection, but in some cases, the regulatory functions of the SEC may compel one approach while the limited protection afforded under SIPA may require a different approach. The Task Force recommends that SIPC, in consultation with the SEC, taking into account the stated concerns of interested parties, study the discrepancies between SEC Rule 15c3-3 and SIPA, and determine whether resolution of these discrepancies is appropriate, and if so, to what extent and in what manner.*

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**Recommendation No. 14:*****International Relations:******SIPC to Assist in the Creation of an International Association***

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***Overview***

Broker-dealers increasingly have overseas affiliates or subsidiaries and do business across the globe. As such, the failure of a multi-national brokerage can have cross-border implications affecting domestic and foreign customers. In light of the realities of modern day broker-dealer operations, the Task Force is considering how customers of a multinational broker-dealer may be better protected by SIPC and whether membership in an international association of investor protection entities (“International Association”) would further SIPC’s mission.

The Task Force has examined SIPC’s past international activity and the cross-border issues that have arisen in the liquidation of Lehman Brothers Inc. and its related entities (“Lehman”). The Task Force believes that membership in an International Association could assist in the resolution of these issues in future multi-national firm liquidations. An International Association would create a forum for discourse among its members and could promote cooperation among securities investor protection organizations.

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***Task Force Recommendation***

***The Task Force recommends that SIPC, in cooperation with the international investor protection community, take a leading role in the creation of an International Association, provide suggestions for the primary goals of the Association, and study whether the Association should be independent or affiliated with an established organization.***

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***A Brief History of SIPC’s International Efforts***

SIPC’s history of international outreach began in the 1990s with a series of seminars regarding the capital markets to former Soviet republics, and the examination by an internal SIPC committee of the effect of globalization of the securities markets on SIPC. Since 1999, SIPC has made presentations to representatives from countries in the European Union, China, Egypt, and Jordan, as they were in the process of forming their respective national investor protection schemes. SIPC also has made presentations to, and joined, the International Organization of Securities Commissions (“IOSCO”) as an affiliate member.

### ***The Memorandum of Understanding Program***

Recognizing the importance of international cooperation, SIPC has negotiated and signed Memoranda of Understanding (“MoU”) with a number of its foreign counterparts. Although they are non-binding at law, these cooperation agreements provide for annual information exchanges and a platform to deal with the failure of a financial intermediary that has a footprint in both jurisdictions.

The following is a list of SIPC’s MoU partners, and the years the agreements were signed:

- Financial Services Compensation Scheme, United Kingdom, 2004
- Canadian Investor Protection Fund, 2005
- Securities and Futures Investor Protection Center, Taiwan, 2006
- Korea Deposit Insurance Corporation, 2007
- China Securities Investor Protection Fund Co., Ltd., 2009
- Egyptian Investor Protection Fund, 2009

### ***A New International Association of Investor Protection Entities***

The China Securities Investor Protection Fund (“CSIPF”) has taken a leadership role in international cooperation between and among similar entities, and has moved to solidify the ties between them. In 2009, the CSIPF urged SIPC and the Canadian Investor Protection Fund to join with it to create a new entity to deal exclusively with investor protection in the context of financial intermediary failure. Chairman Chen Gongyan, former head of the CSIPF and now Chairman of the Securities Association of China, recommended the idea of an International Association to the Task Force at its initial meeting.

### ***The Need for an International Association***

The liquidation of large, multinational brokers has required substantial cross-border cooperation. An International Association could help to forge relationships between and among the securities investor protection entities. An International Association could also facilitate the exchange of information between and among members and provide an established channel for communication. This would allow closer collaboration among the affiliated debtors and investor protection schemes. Other existing international associations, such as IOSCO and the International Insolvency Institute (the “III”), have created mechanisms for cross-border cooperation. For example, in 2001, the III adopted the Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases, which were created in conjunction with the American Law Institute. A more targeted set of guidelines for investor protection entities could prove helpful in cross-border liquidations.



### ***The Goals of an International Association of Securities Investor Protection Entities***

An international securities investor protection forum could work towards the following specific goals:

1. Facilitate the communication, coordination and cooperation among all securities investor protection entities and tribunals, when appropriate;
2. Promote cooperation among securities investor protection entities with respect to cross-border compensations for securities investors;
3. Provide for the sharing of relevant information and data among members when appropriate;
4. Explore potential mechanisms for the preservation of the value of a debtor's worldwide assets and the maximization of recovery for all securities investors;
5. Promote methods for coordination of an efficient and transparent claims process;
6. Promote discussion of comity among independent jurisdictions;
7. Promote the development of securities investor protection internationally; and
8. Explore methods for international dispute resolution in cases involving cross-border issues.

### ***An International Association May be Independent or Affiliated***

An International Association may be affiliated with an existing international securities or insolvency association or be a completely stand-alone entity. Having an affiliation with an existing international association, such as IOSCO or the *III*, could be advantageous because each of these organizations has an infrastructure in place, including annual meetings, a mechanism for leadership and decision making, and established channels for communication. In addition, the relationships forged between investor protection entities and other members of the existing organizations could prove beneficial. On the other hand, an International Association as a stand-alone entity allows complete independence, autonomy, and authority, although it may place a greater burden on the members to create an infrastructure and increase administrative duties.

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**Recommendation No. 15:*****SIPC to Continue Investor Education Efforts***

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***Overview***

Since 2000, SIPC investor education efforts have included (i) literature and a web site in investor friendly terminology; (ii) five separate public service announcement (PSA) campaigns; and (iii) a paid million-dollar advertising campaign.

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***Task Force Recommendation***

***Subject to SIPC's consultation with FINRA and the SEC, the Task Force recommends that:***

- (1) The Board should consider the feasibility of including plain-English information about SIPC on brokerage statements and whether its benefits would outweigh its costs;***
- (2) SIPC recommend an increase in the amount of information that brokers are required to learn about SIPC as part of their continuing education;***
- (3) SIPC hire a dedicated investor education employee; and***
- (4) SIPC ask state regulators to include information about SIPC as part of their outreach efforts.***

***The Task Force also recommends that SIPC conduct a study, including through the use of focus groups, both before and after implementing these changes to determine investors' level of knowledge of SIPC and the effectiveness of these changes.***

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***(1) The Board Should Consider the Feasibility of Including Plain-English Information about SIPC on Brokerage Statements and Whether Its Benefits Would Outweigh Its Costs***

The Task Force recognizes the importance of educating the investing public through the information provided by broker-dealers. Thus, certain members of the Task Force suggested including information on SIPC protection on the initial brokerage statement, whether provided in paper or electronic form, and periodically thereafter. They emphasized that the information included on the brokerage statement should be simple, easy to understand, and eye-catching. In

addition, the information should provide the scope and limits of protection, including what is not protected by SIPC.

Certain other members of the Task Force expressed concerns at the cost and effectiveness of including information on the brokerage statement. The Task Force is therefore presenting this issue to the Board to consider in conjunction with the below recommendation to hire a dedicated investor education employee.

***(2) SIPC Should Recommend an Increase in the Amount of Information that Brokers Are Required to Learn about SIPC as Part of Their Continuing Education***

Pursuant to FINRA Rule 1250, securities professionals have a continuing education requirement. See FINRA Rule 1250, available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=10204](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10204). In addition, firms are required to establish a formal training program for their registered representatives. See *id.*; Continuing Education, FINRA, available at <http://www.finra.org/Industry/Compliance/ContinuingEducation/>. As a way to ensure that registered individuals are relaying accurate information about SIPC to their customers, the Task Force recommends that registered individuals be required to learn about SIPC as part of FINRA's continuing education requirements. SIPC staff can work in conjunction with FINRA to develop this information, which should include an explanation to investors of SIPC protection.

***(3) SIPC Should Hire a Dedicated Investor Education Employee***

A dedicated investor education employee may enhance SIPC's investor education efforts. He or she could work with the SEC, FINRA and state securities regulators to coordinate investor education and ensure that accurate information about SIPC is reaching investors. The Task Force recommends that SIPC hire a dedicated investor education employee.

***(4) SIPC Should Ask State Securities Regulators to Include Information about SIPC as Part of Their Outreach Efforts***

State securities regulators regularly engage in outreach to investors. SIPC should request each state securities regulator to include information on SIPC and SIPA as part of its regular outreach. This recommendation would be a cost-effective way to achieve the investor education goals of both the state regulators and SIPC.

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**Comment:**

***SIPA's Mandate of Customer Protection Generally Means that Committees Representing Unsecured Creditors of the Debtor's General Estate Serve Little Purpose in a SIPA Case***

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SIPA does not provide for the appointment of a committee to represent the interests of unsecured creditors. Historically, creditors' committees have not played any role in proceedings under SIPA in part because the emphasis of these proceedings has been on protecting customers through maximization and distribution of the "Fund of Customer Property."

The creation of a creditors' committee, as a result of several fundamental aspects of SIPA, would be of limited or no benefit in most cases, and would potentially even require SIPC to advance additional funds for expenses without any material benefit to the estate. For example, the supervisory functions that otherwise typically would be performed by a creditors' committee in a bankruptcy case are, in a SIPA case, performed by SIPC, which is closely involved in the oversight of every SIPA proceeding. In addition, as SIPA provides only for liquidation, not reorganization, there is no plan of reorganization for a creditors' committee to participate in formulating, and most importantly, there rarely is a materially significant unsecured general estate in a SIPA proceeding to be reorganized. Moreover, Congress intended the SIPA proceeding to resemble most closely a Chapter 7 liquidation under the Bankruptcy Code and not a bankruptcy reorganization. While used in reorganization cases, unsecured creditors' committees rarely occur in Chapter 7 cases because unlike the situation in reorganization cases, the Bankruptcy Code does not provide for compensation to professionals assisting the committee in Chapter 7 cases.

The creation of such a committee could be detrimental to the goals of the efficient administration of the assets and prompt resolution and payment of the claims of securities customers who are the intended beneficiaries of a SIPA proceeding and potentially impose needless additional administrative costs on SIPC.<sup>27</sup>

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***Task Force Comment***

***The Task Force has concluded that SIPA's mandate of customer protection generally means that an Unsecured Creditors' Committee serves little purpose in a SIPA liquidation.***

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<sup>27</sup> See *In re MF Global, Inc.*, 2011 WL 5884247 (Bankr. S.D.N.Y. Nov. 23, 2011).

## **ACKNOWLEDGMENTS**

The Task Force extends its appreciation to those persons who met with the Task Force and shared their time, experience and valued insight on issues of concern to the Task Force. This includes representatives of the Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Depository Trust & Clearing Corporation, the Investment Company Institute, and the Government Directors of the Securities Investor Protection Corporation from the Department of the Treasury and the Federal Reserve Board.

The Task Force also wishes to thank those members of the public who took the time to share their views, opinions, and concerns on matters relating to SIPA and SIPC.

Finally, the Task Force expresses special gratitude for the assistance rendered by our colleagues and associates in the firms or organizations that we represent, and by staff members of the Securities Investor Protection Corporation.



## **APPENDIX A**

### **CORPORATE GOVERNANCE REVIEW**

by

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# **REPORT FOR SIPC MODERNIZATION TASK FORCE: SIPC CORPORATE GOVERNANCE REVIEW**

*By Lawrence A. Cunningham*

August 13, 2010

Thank you for the opportunity to provide this report of my independent corporate governance review of some of the operations of the Securities Investor Protection Corporation. I understand that, in light of the insolvencies of the brokerage firm Lehman Brothers Inc. and the revelation of a Ponzi scheme at Bernard L. Madoff Investment Securities LLC, SIPC's Board of Directors formed the SIPC Modernization Task Force to examine SIPC's mandate under the Securities Investor Protection Act and operations and make related recommendations. As part of that effort, you engaged me to conduct a governance review and provide this report. I was delighted to conduct the review and am pleased to provide this report.

## **I. My Review and this Report**

In my review, I communicated with nearly half the members of SIPC's staff, many in-person, several by telephone, and several by electronic mail, and made similarly varied inquiries of outside lawyers who have been involved in SIPC customer protection proceedings. My review included reading the Securities Investor Protection Act (including as amended by the Dodd-Frank Act of 2010); related rules appearing in the Code of Federal Regulations (known as the Series 100 through Series 500 Rules); SIPC's By-Laws (Nov. 2009 rev. ed.); SIPC's Annual Reports for 2009 and 2008; SIPC's statement of Organization and Responsibilities (May 12, 2010); SIPC's Operations Manual (August 2004); SIPC's Trustee's Guide (undated), including exhibits containing scholarly commentary; SIPC's Personnel Guide (Sept. 2006 rev. ed.); SIPC's brochure (in the form accompanying its 2009 Annual Report, apparently dated as of 2007); and parts of SIPC's internet Web site.

I also read a letter from Representative Paul E. Kanjorski (March 3, 2010) and related press release concerning the SIPC Modernization Task Force; reports about SIPC prepared by the U.S. General Accounting Office (May 2001 and July 2003) (concerning customer information and excess insurance), Ernst & Young (February 2002) (concerning internal audit), and Corporate Review Services (April 30, 2004) (concerning selection and supervision of external consultants); and an internal SIPC memorandum addressing recommendations of the Securities and Exchange Commission (June 2003) (concerning review of fee applications of external SIPC trustees and counsel).

The purpose of my review was to evaluate aspects of SIPC's corporate governance. This refers to internal organization, structure, staffing, policies, and procedures concerning operations and execution by SIPC's staff of its assigned mission. Outside the scope of this review are broader matters concerning SIPC's mission and this Task Force's undertakings. Except in passing, therefore, this report does not evaluate SIPC's statutory mandate or specific policy or other matters raised by the statute, such as what securities are covered, what asset distribution methods are used, or maximum customer protection limits set; relations with member firms, or



assessments on them or financial resources; investor knowledge or education about investments or SIPC; or the selection, structure, composition, compensation or activities of SIPC's board of directors or relations between it and the rest of the corporation; or other similar broad policy matters.

Within those parameters, on the basis of my review, it is my opinion that SIPC's corporate governance is excellent. Its organizational structure is coherent; its supporting documentation outstanding; its technological capabilities becoming state of the art; its staff of optimal size, enabling a nimbleness necessary to respond quickly to execute its mission; its professional team exceptionally well-qualified, dedicated and collegial; and its network of external consultants and experts rich to enable leveraging internal swiftness and expertise with external manpower as needed. No organization or its governance is perfect, of course, and my review enables me to make a few recommendations.

My recommendations, detailed in what follows, may generally be classified as objects of modernization but I have not limited suggestions to that classification. The recommendations I suggest considering, in substantially the order of importance, are as follows:

A. Technical Document Updates: make technical updates to existing documentary support, including (1) the statement of Organization and Responsibilities to increase detail and uniformity, (2) the Trustee's Guide to reflect technological and other developments and actual practices, and (3) the Operations Manual for the same purposes, and to adopt a plan to update these using annual supplements followed by regular periodic (five year) revised editions.

B. Expand Document Wealth: sustain the accumulation of written experience for transmission to incoming staff, including by (1) developing additional corporate manuals concerning matters like prevailing brokerage firm practices and securities product innovations, and (2) make existing data bases of consultants and trustees accessible to staff rather than within the province of senior SIPC officials and consider expanding content.

C. Human Resources Investment: (1) assure adequate future staffing in SIPC's Operations Division by recruiting examiners across generations and be prepared to give them the training that the existing team has provided to other relatively recent recruits on a systematic basis, (2) compare the organizational structure contemplated by the list of authorized officers in SIPC's By-Laws to the existing officer corps, and (3) increase support of professional development for staff, including for completing unfinished college degrees and advanced specialized degrees relevant to the field, and for promoting the production of written materials for external publication.

D. Substantive Document Updates and Highlights: (1) make substantive updates to existing documentary support, in the Trustee's Guide and Operations Manual, to better reflect SIPC's prevailing practice on compensation policies for outside consultants and trustees, and (2) highlight in distinctive repositories SIPC's mission (by abstracting it from the statute) and ethical commitment (by reformatting existing By-Law and Personnel Guide provisions). SIPC may also wish to consider whether to have its internal controls audited, though I refrain from recommending that.

None of these suggestions requires changes to SIPA; most can readily be implemented by SIPC's staff; some may warrant or require SIPC Board review or approval; and suggestions concerning reformatting some By-Law provisions would require SEC involvement. In making these suggestions, I emphasize that my review indicated a highly effective corporate governance environment at SIPC and yielded confidence in its existing governance regime. Accordingly, as the level of detail provided in the recommendations may also signal, these suggestions should not be seen as criticizing SIPC's leadership or staff but to represent expectable ideas that an independent outside review might crystallize.

## II. SIPC in Review

### A. Design and Execution

1. Mission. The Securities Investor Protection Corporation was created by the Securities Investor Protection Act of 1970 to provide stated protection to customers of troubled U.S. securities brokers and dealers. SIPC is a nonprofit private corporation whose members are securities brokers and dealers registered under the Securities Exchange Act of 1934. Though not part of the federal government, its seven-member board consists of five presidential appointees and two government officials, and it is overseen by the Securities and Exchange Commission. Its primary purpose is to take charge of and liquidate failing brokerages and promptly arrange to return customer assets and pay customer claims within statutory limits.

SIPC administers a fund supported by member assessments available when a failing firm's general estate is insufficient to cover customer claims and also has access to credit through the SEC from the U.S. Treasury. Specific statutory language in SIPA defines the class of "customers" covered and provides a term of art to define the "securities" that are covered. Other technical legal and business terms arise in SIPC's day-to-day operations, including concepts such as customer name securities, customer property, and customer net equity, many elaborated in the Series 100 to 500 CFR rules. SIPA prescribes in clear terms rules governing the commencement of customer protection proceedings. These include appointment of a trustee and applicable judicial procedures and other aspects of the liquidation process. Despite lucidity, litigation and practical judgment over the meaning of some of these terms and rules recurs.

2. Performance. From its inception in 1971 through 2009, SIPC commenced 322 customer protection proceedings. Over the past decade, it commenced an average of four cases annually. In its history, SIPC has returned to more than 700,000 customers some \$108 billion in assets, most from failed firms' estates, along with about \$1 billion from the SIPC fund. Only a small minority of claims have exceeded the statutory limits. Eight cases are currently open, due to litigation or ongoing claims processing. Internal work flow at SIPC therefore varies over time in ways not always predictable but that require the staff and its team of outside consultants and trustees to act swiftly whenever new failed firms appear.

Among current cases are two unprecedented in magnitude that began in 2008: Lehman Brothers Inc. (involving some \$92 billion in securities of some 135,000 customers) and Bernard L. Madoff Investment Securities LLC (involving an entirely fraudulent mirage costing SIPC an

estimated \$1.6 billion to protect customers, based on assumptions explained in SIPC's 2009 financial statements, Annual Report, p. 18 n.4). It's unlikely that multiple calamities of that magnitude will recur within such short order; recent statutory changes in the Dodd-Frank Act of 2010 appear to repose considerable responsibility for dealing with systemically important firm failure, including broker/dealers, in federal agencies; and SIPC operated effectively in the face of this pair of unprecedented failures, following longstanding practice of retaining experts with large staffs and resources and participating alongside them throughout related customer protection proceedings.

3. Proceedings. SIPC does not regulate brokers or dealers or supervise them. It relies on referrals from regulatory authorities, such as the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission, of pending firm financial difficulties. When a referral is received, SIPC's Vice President - Operations and Finance reviews it, preparing a worksheet (called Form 26) to evaluate whether to recommend commencing a proceeding, in consultation with SIPC's General Counsel. The two report recommendations to SIPC's President who submits ultimate recommendations to SIPC's Board Chair. The Chair is authorized by SIPC's By-Laws to direct the staff to initiate proceedings and that approval on recommendation is virtually automatic. This streamlined but collaborative process is well-designed to enable acting quickly and decisively on referrals.

Once authorized, the President and General Counsel confer to assign a SIPC staff attorney to head up the legal aspects of the proceeding and the Vice President – Operations and Finance assigns an examiner. SIPC staff members then proceed to their assigned tasks, its lawyers obtaining requisite judicial orders and legal staffing and its examiners closing down the firm and marshaling its assets in preparation for its liquidation and distributions to customers. Throughout, SIPC's and its staff's primary goal is expeditious movement to return and pay customer funds. To do that usually involves SIPC making advances to customers, through trustees, that it thereafter seeks to recover in later stages of a proceeding. The process is efficient and swift, even in large cases.

## B. Approach and Implementation

1. Structure. SIPC's organizational structure is simple and coherent and its internal staffing both sophisticated and lean. Under its Board of Directors, SIPC's President is charged with overall corporate responsibility. That includes interacting with Congress and supervising SIPC's staff, of about 32 people, consisting of lawyers, examiners, other professionals, and support personnel. The staff assumes sole responsibility for the vast majority of customer protection proceedings SIPC initiates, with the team of lawyers and examiners managing all aspects of the case and claims.

A network of skilled professionals with expertise in brokerage operations and liquidations is available to it nationwide to assist in the process. For larger or unusually complex cases, SIPC retains an outside trustee and counsel to carry much of the day-to-day burden of managing a liquidation, though its lawyers and examiners remain primarily responsible for the case and claims and supervise retained experts closely. This model, invented at SIPC's founding by SIPC's initial leadership who helped draft SIPA and implement it, has served SIPC and

securities customers well and continues to do so. As an example, the outside trustee and trustee's counsel in the Lehman case deploy more than 100 lawyers on the case, half of whom devote substantially their entire practice to that one case for nearly two years already. It would be foolish to expand SIPC itself to be so equipped.

SIPC is organized into two primary divisions, whose heads are officers of the corporation who report directly to the President: the Legal Division and the Operations & Finance Division, with the latter sub-divided into three further units, Operations, Finance, and Information Technology. The Legal Division is headed by SIPC's General Counsel and Secretary, and staffed by a total of six full-time attorneys, including her. They hold various titles designating seniority: General Counsel and Secretary (both officer positions); Senior Associate General Counsel; Senior Associate General Counsel for Dispute Resolution; Associate General Counsel; Assistant General Counsel; and Staff Attorney. There is also a Law Librarian/Paralegal, who provides vital assistance with document maintenance, and two legal secretaries. There is another legal secretary slot that is currently vacant.

SIPC's Operations and Finance Division is headed by a Vice President, an officer of the corporation, and each sub-division by an Assistant Vice President (of Operations, Finance, and Information Technology). Within Operations, there are three Senior Examiners and one Examiner. All are supported, adequately, by two secretaries. Within Finance, there is a Cash Manager, Manager – Accounting (supported by an Accounting Supervisor reporting to Manager – Accounting, and a staff accountant below that) and a single person wearing three hats (Manager-Member Assessments/Human Resources/Plant and Facilities), all supported by three clerks. Within Information Technology, there are two staff workers, imaging coordinator and computer support specialist. About a dozen additional support staff round out the operation.

2. Documentary Support. SIPC maintains exceptional written materials succinctly reflecting the accumulated wisdom of its personnel over four decades. Primary governance documents are a comprehensive Trustee's Guide, of particular value to the lawyers in the Legal Division, and a detailed Operations Manual, of particular value to the examiners in the Operations Division. In addition, SIPC has recently updated its statement of internal Organizations and Responsibilities, identifying functions of the Divisions, containing an organizational chart, and listing all current staff members. The Securities Investor Protection Act provides specific guidance for SIPC operations and staff responsibilities. SIPC's By-Laws and Personnel Guide contain codes of conduct and statements of business ethics. The By-Laws also contain governance provisions at the levels of directors, officers and members. The Personnel Guide also contains provisions about employee duties and benefits. The Finance Division maintains assorted guides and materials concerning accounting procedures and policies.

SIPC's annual reports mirror the leanness and simplicity of the corporation's operations. Its 2009 edition consists of a transmittal letter to the SEC, a succinct Chairman's message, an overview of SIPC, list of directors (with photographs) and officers, summary of customer protection proceedings, discussion of membership and the SIPC fund, a summary of pending litigation and other actions, an auditor's report and accompanying financial statements, followed by a table depicting the historical size of the SIPC fund since inception and a series of appendices capturing full historical distributions to customers, five-years of revenue-expense

analysis, and data on pending and recently completed customer protection proceedings. This gives a useful and comprehensive picture of SIPC, all in 35 pages of clear presentation. It also offers a CD in its back cover, containing extensive additional information, including a copy of SIPC's brochure and applicable member rules.

3. Technological Support. SIPC's general computer system provides office-wide access to all case materials, including legal documentation in pending and past cases and related forms. Virtually all archival materials are preserved using modern imaging techniques. SIPC maintains computer operations in its Washington office backed up by separate facilities off-site in Virginia, further backed up using a third-party service provider at a site in another nearby state. These practices, initially prompted by anticipated national challenges ahead of the turn of the millennium (the so-called Y2K bug) and enhanced by the terrorist destruction of computer capabilities on September 11, 2001, follow prevailing business practice.

SIPC is in the midst of a computer enhancement project that will enable customers to prepare and file claims on-line and examiners to review them electronically. That's important because, until now, as the SIPC Web site acknowledges, speaking to customers: "You can't file your SIPC claim form electronically, but you can use this Web site feature to fill out your form and print it out. You must still copy the completed form, all attachments, and then mail the original to the designated address."

In response to recommendations GAO made in 2001 and 2003, SIPC updated its Web site and brochure to clarify that investors should register brokerage firm complaints with those firms; expanded statements discussing market risk and SIPC coverage; and amended its By-Laws (Article 11, 4§ (a)(6)), concerning member advertising, to require firms displaying a statement about SIPC coverage to include links to SIPC's Web site. SIPC also added to its brochure links to its Web site offering information concerning investment fraud.

### C. Human Resources

1. Expertise. SIPC's staff commands rich and varied experience and boasts extensive reservoirs of knowledge. The staff seems to treat SIPC as a destination career site, with seven of its current personnel originally employed by SIPC in the 1970s, shortly after its creation, and another one-third of the staff each beginning employment in the 1980s and 1990s. Average current employee tenure is approximately 18 years, down slightly in the past two years due to retirements of two veteran employees and hiring of six new staff members. SIPC's President has been employed by SIPC since 1975 and is a former SIPC General Counsel; its current General Counsel has been employed by SIPC since 1983; its current Vice President – Operations and Finance started in 1998; and its Assistant Vice Presidents for both Operations and Finance both began working at SIPC in 1973.

All SIPC's lawyers were hired laterally (not just out of law school), have distinguished academic records, and collectively a ladder degree of experience (being out of law school, 37, 32, 26, 18, 11, and 3 years, respectively, and varying in age accordingly). All the examiners were also hired laterally, usually with extensive (multi-decades long) experience in back office brokerage operations. They are individually and as a group older than the lawyers. The Finance

Division likewise boasts seasoned experts and, like the Legal Division, staff varies widely in age. The Information Technology Division is small, consisting of a Vice President and two staffers.

2. Recruiting and Training. All professional staff hiring is done laterally. The Legal Division emphasizes academic achievement; the Operations Division emphasizes back office brokerage experience. As a result, and given that SIPC's overall staff is small, SIPC does not maintain any formal in-house professional training programs. Lawyers and examiners, with experience in other organizations, bring skills with them. Even so, lawyers may have experience and skills in securities and litigation generally, but that may not include brokerage firm liquidations or even bankruptcy; examiners are assumed to have extensive experience in back office brokerage operations and that may include brokerage liquidations but not necessarily. Training of new recruits consists primarily of assigned reading of internal documents, especially the Trustee's Guide for lawyers and Operations Manual for examiners, along with ad hoc direction and supervision in early cases by senior staff in the respective Divisions. Aside from professional training, SIPC technology experts offer training in computer and software applications.

3. Culture. SIPC's small personnel size makes for a lean and nimble organization. SIPC's statement of Organization and Responsibilities succinctly delineates the functions and responsibilities of each Division. Some functions require involvement of more than one Division, particularly between its Legal Division and Operations Division concerning presenting financial information in court documents and relations with external trustees, but clearly divides responsibility and calls for cooperation.

In response to my questions of people in both Divisions, there's evidence of full adherence to that cooperation requirement. Those interviewed, in all Divisions, expressed enthusiasm for colleagues, within and across Divisions. Examiners and lawyers alike emphasized that work tends to be done in groups, with ongoing consultation among examiners and among lawyers. People often described SIPC as akin to a family, where people all get along and work for the common good, acknowledging the occasional disagreement or pique. Reports indicate that staff gathers annually for regular outings and that more informal socializing occurs; many employees regularly exercise in the gym within SIPC's building that's free to employees of the building's tenants. That building and SIPC's offices are first class modern professional facilities in downtown Washington DC, offering a comfortable work environment.

The long length of service of many SIPC employees demonstrates employee satisfaction, institutional loyalty, and the opportunity for internal advancement. The continuing recruitment of others over recent years shows SIPC's appeal as an employer. SIPC's statement of Organization and Responsibilities lists the entire SIPC staff, starting with the Chairman and President, and including the receptionist, mailroom and other clerks, and secretaries. That reflects a healthy and inclusive organizational identity. There is no mandatory retirement age (though the SIPC retirement plan contains provisions keyed to age) and many staff members have worked and do work well into their seventies.

4. Compensation and Benefits. Just as SIPC is not part of the federal government, its salary system is independent of the federal government and its compensation scale. Nevertheless,

SIPC monitors government pay scales and levels of private industry compensation. SIPC's scale probably falls somewhere in between the two. Compensation and employee performance are reviewed annually by an employee's direct supervisor; compensation of officers is set by the Board. SIPC's benefits package includes a retirement plan, savings plan, flexible spending account, and health, life and long-term disability insurance coverage. SIPC also pays the cost of continuing education, such as for CPE and CLE credits, and absorbs the cost of professional fees including state registration fees for attorneys and accountants. The corporation also pays for work-related seminars for all employees. SIPC does not pay for tuition to cover finishing a college degree or earning an advanced degree.

No components of SIPC employee compensation involve any form of incentives to achieve particular results. In fact, the entire operating framework—from the SIPA statute throughout internal operations—is designed with essentially neutral incentives, focused on expeditious customer protection. The staff members get no more or less whether they open and close a particular case or any given number of cases or recover any particular form or amount of customer property. There's no sense of conflict between paying brokerage customers and preserving the SIPC fund, given that most customer distributions are recovered from firm assets and how supplemental resources in the fund and available lines of credit are ample. Staff members acknowledge psychic satisfaction when they are able to call customers to inform them they are protected and covered under valid claims.

5. Leveraging by Outsourcing. Though SIPC prefers to rely upon its internal staff whenever possible to handle legal and operational aspects of all customer protection proceedings, it also regularly relies upon outside consultants to assist examiners when serving as trustee and engages trustees and trustee's counsel in other cases. SIPC staff remains primarily responsible for all aspects of any proceeding and work alongside of and supervise closely those outside experts. Consultants and trustees tend to be selected on an ad hoc basis in light of particular needs of a case, geographic location, and the need to choose professionals immediately. Several prominent New York law firms have partners who have developed a specialty in SIPC proceedings. Outside trustees SIPC selects are usually partners at such firms who in turn retain their law firm as trustee's counsel. That approach is highly efficient and minimizes conflicts; to resolve conflicts that may arise, the trustee may also retain a separate boutique law firm.

SIPC maintains careful policies governing retention of external consultants and their compensation. Retention policies include maintaining data bases of approved consultants and associated oversight as recommended in a 2004 report made by Corporate Review Services after an isolated case of a SIPC examiner charged with receiving kickbacks from third-party vendor assignments. On cost containment, policies include seeking discounts, commitments that quoted rates remain in effect for at least one year, and assurances that work will be performed by the least-costly competent personnel. Pricing appears to be competitive, with plenty of consulting and law firms available who prize working with SIPC. For complex litigation assignments, budgets are requested, and invoices mandated quarterly (or monthly for large cases during busy periods), in accordance with SEC recommendations made in 2003. (See Trustee's Guide, page 11-3.) Likewise in accord with those recommendations, all fee discussions and negotiations are documented, usually by exchanges of emails. Legal fees are subjected to numerous rounds of

review, first within the outside firm, then between the SIPC lawyer assigned to the case, followed by SIPC's general counsel, and ultimately subject to court approval.

#### D. Oversight

SIPC's entire substantive operation is dictated by the Securities Investor Protection Act and SIPC is subject to extensive and periodic review and oversight by numerous organizations. These include Congress, the SEC, the GAO, various judges overseeing its customer protection proceedings, and its regular outside auditor, of recent years, Grant Thornton. Reviews of input from those and other organizations in the past decade indicate that SIPC is responsive. SIPC also faces de facto oversight from securities brokerage customers nationwide and the outside attorneys serving from time to time as external trustees and trustees' counsel. Occasionally, as in the aftermath of the Madoff fraud revelation, SIPC faces the scrutiny of media and even of advocates in private civil litigation. The Task Force in June 2010 opened a separate Web site to solicit input into its process from members of the general public.

### III. Report and Recommendations

Before offering a series of recommendations for consideration, I note two modernization projects underway or recently completed that should be sustained. The first is enhancing SIPC's customer liquidation processing computer system to enable claimants to prepare and submit claims over the internet. This will also enable SIPC examiners to review submitted claims and support documentation through SIPC's in house computer system and to evaluate and determine claims through that system. This process should be completed by year end and any resources the Information Technology Division requires to complete and sustain it should be provided.

The other is the revised statement of Organization and Responsibilities, dated as of May 2010, prepared for the Modernization Task Force and updating the previous version dating to 2000. This version adds a SIPC organizational chart. Though some are not enamored of the utility of such a chart, it represents prevailing best practice and is useful in thinking about an operation and its people, even for a small group like SIPC.

#### A. Technical Document Updates

1. Statement of Organization and Responsibilities (May 12, 2010). SIPC's new statement of Organization and Responsibilities is substantively excellent, particularly its delineation of the functions and responsibilities, especially of the relation between the Legal Division and Operation Division concerning matters where issues overlap and require inter-Divisional cooperation. Producing this statement obviously required input from various Divisions and personnel. The input appeared to vary. That may reflect differing outlooks of the respective Division heads. Even so, some harmonization may be warranted, in part because of how the variation may suggest underlying points warranting improvement.

All employees are listed. Biographical highlights are abstract and limited, suggesting what's seen as most important. The singular detail is the starting employment date at SIPC. That seems a matter of pride worth highlighting. Other details vary, some noting prior



experience and some not. Some people have college or advanced degrees and some do not, at least one has an advanced degree that isn't listed; those who do not are listed as having attended a given college or as having attended or completed high school. Closer attention to presentation and uniformity in this document may be warranted.

Policy information concerning the Legal Division is incrementally more detailed than that for the other Divisions. It explains (p. 5) that the Legal Division "functions as much like a law firm as a corporate environment permits." That means performing most SIPC legal services internally, except in rare cases, and explains why SIPC puts "emphasis on high academic standards and litigation experience" in recruiting. (This is suggested by but not detailed in the abstract biographical data appearing beneath each lawyer's name, with the staff having earned law degrees from Georgetown University, New York Law School, St. John's University, University of Pittsburgh, Columbia University, and Fordham University. Undergraduate degrees are not listed. I understand that one of the lawyers also holds an advanced law degree, the LL.M., though this is not listed.)

The Operations Division's parallel page does not describe what it emphasizes in recruiting or why. My review indicates that it emphasizes practical and comprehensive back office brokerage experience. It may be worth stating that. Accompanying biographical notes state that experience for two senior members of this Division (24 years for the Vice President and 23 years for a senior examiner) but not for the others (I found out that one has more than 20 years and another has nearly 30 years of experience). The four employees designated as examiners are all shown to have attended identified colleges, without earning degrees. Listing their brokerage experience seems desirable.

The Finance Division's parallel page also does not describe what it emphasizes in recruiting or why. All personnel but two (a secretary and a member status clerk) earned college degrees (the phrase High School appears under the names of those two). The description of its functions and responsibilities emphasizes handling mostly SIPC's administrative affairs, including internal accounting, retirement plan, member assessments, and SIPC's credit agreement, along with administration of debtor estates. In practice, although the Finance Division occasionally handles administration of debtor estates, and easily has the capacity and expertise to do so, most of that work is handled by external trustees or other consultants. The Information Technology Division is also silent on recruiting criteria, though it's small, consisting of an AVP and two others (one with the phrase High School appearing).

2. Trustee's Guide (undated). The Trustee's Guide appears to be a generally reliable guide to the law and practice of customer protection proceedings under SIPA that SIPC carries out. Newer lawyers in the Legal Division and lawyers working for trustees or counsel attested to the value of this Guide. My own impression is that it provides a comprehensive and detailed reference for trustees, whether within SIPC or external. It seems to be a vital tool of SIPC's corporate governance. It is written clearly, contains copious statutory and other references, and includes extensive exhibits of repeatedly used legal forms and other materials central to a trustee's duties. It appears to have been prepared by senior or former lawyers in the Legal Division and shows a considerable exertion of effort to consolidate relevant and useful information in one place.

That said, the Trustee's Guide is undated but looks dated, other than a few pages that have obviously been updated recently. The first recommendation is to date it and consider preparing annual updates with complete incorporating revisions every five or so years. It shows its age in several ways, many trivial but some important and all worth updating now. I have not compared the Trustee's Guide to relevant statutory requirements as these may have been amended since the last publication, and a legal review of that may be warranted. I also understand that some advanced complexities in the Lehman case require addressing matters beyond the Guide's scope. To the extent those issues may recur, lessons from that proceeding should be incorporated into the Guide and its exhibits.

A cursory review shows that the Trustee's Guide appears to have been written before the proliferation of voice-mail, e-mail and the dawn of the internet. Examples that should be updated include the following. Add electronic passwords to the list of things the trustee should secure (p. 2-2: "get keys, burglar alarm codes, combinations, or anything else which will facilitate entry into the premises and files or offices") and to change (p. 2-2, referring to changing locks on doors and safes). When directing trustees to post a sign on the brokerage's office listing name, address and telephone number (p. 2-2), add the trustee's e-mail address and any Web page. When advising trustees to assume control of mail (p. 2-3), add e-mail. Add computers and internet access to the list of necessary services that trustees must maintain that now lists telephone, electricity, and water (p. 2-7). In the references to various kinds of leases (p. 2-7), add a reference to computers. When telling trustees to respond to answering machine messages and letters (pp. 3-1 and 3-2), change the reference to answering machines to voice-mail and add e-mail and advise updating any internet Web sites.

All these examples prompt suggesting creating a separate section to the Trustee's Guide on updating or creating an internet Web site for the failing firm and its liquidation. That would also be a logical place to discuss SIPC's new technological capabilities relating to submitting and reviewing customer claim forms on line. That page or other sections of the Trustee's Guide might discuss other examples of technological modernization the current version addresses but that are less obviously outmoded. These include the reference to making publication in newspapers (p. 5-2) and a suggestion to consider updating that to include publication on a firm's Web site or for trustees to create a Web site. Another example concerns references to getting stock price quotes from *The Wall Street Journal* (p. 5-2), which does not publish the comprehensive list it once did, and suggesting updating that to reference reputable online sources like Yahoo Finance or E-Trade.

A few other minor questions or suggestions concerning technology arise. The Trustee's Guide references (p. 5-1) short retention periods by clearing brokers for computer tapes. I wonder whether that is still true. Page 11-4 refers to a SIPC spreadsheet formatted in Quattro Pro; it says that will be sent to the trustee on diskette, but now that's probably sent by e-mail attachment. There are references to the NASD that should be updated to FINRA (examples appear on pages 5-2 and 18-1). Also showing signs of age is the reference on page 8-1: "If there will be a distribution of a large block of securities, review Exhibit 26 and consult with SIPC's legal staff." Exhibit 26 is a 1972 document and I wonder whether it is still current. For the

avoidance of doubt, I suggest updating the 1972 document by rewriting it in the form of a currently dated memorandum.

Statements on page 17-1 should also be updated. These refer to R.M. Smythe & Co., Inc., at 170 Broadway, New York, New York, as in the business of appraising non-marketable securities. Smythe was acquired in 2008 by Spink and is now called Spink Smythe, and its current address is 145 West 57<sup>th</sup> Street (18<sup>th</sup> floor), New York, New York 10019, telephone 800-622-1880, and its internet address is [www.spinksmythe.com](http://www.spinksmythe.com). The Guide adds that Smythe publishes a reference book called “*Robert D. Fisher Manuals of Valuable and Worthless Securities 1926 to 1971*.” It appears that the suffix (referring to years) has been dropped from that volume’s title. The Trustee’s Guide also says that Smythe will research whether seemingly worthless securities actually have value and, if so, will sell them through Herzog and Company, taking a fee. It’s worth verifying whether Spink Smythe still does that through Herzog. The Guide says that Smythe is the “only firm in America which performs this type of research.” An SEC web site page suggests there may be others, including Financial Information, Inc., publisher of *Financial Stock Guide Service*.

As a question of style, this edition of the Trustee’s Guide invariably uses masculine pronouns, which is no longer the norm for corporate documents in America. (An exception appears on page 11-4 where reference is made to “his or her.” Related pages, discussing reviewing fee applications of trustees and counsel, were obviously updated around 2003 after the SEC made related policy suggestions on that subject.) Of minor importance, but worth doing if updating the Trustee’s Guide: the Guide’s dozens of exhibits are referenced out of order, with Exhibits 27, 28, and 29 referenced on page 1-4, and references to other exhibits, beginning with exhibit 1, appearing on page 2-1 and later pages. Similarly, the Guide’s index of exhibits as they appear in the accompanying CD presents them in a random order; the list should be revised to appear in alpha-numeric order. It would also be helpful to include in the list of exhibits a cross-reference to pages in the Guide where exhibits are referenced or discussed.

3. Operations Manual (August 2004). The Operations Manual offers a clear and comprehensive guide of great utility to examiners within SIPC and to consultants they may retain from time to time. It is clearly written and makes the process easy to understand. The Operations Manual manifests a valuable repository of accumulated practical wisdom essential to the liquidation process. I understand that it was last updated in August 2004, in a project led by an examiner recently recruited at that time. It could now use some updating, though its content and style makes it appear less outdated than the Trustee’s Guide (including its routine use of both masculine and feminine or neutral pronouns). For example, the Operations Manual should be updated to reference the internet as a resource in several places (an example appears on page 16 when discussing dealing with a debtor’s office space) and to change occasional references from the NASD to FINRA (e.g., p. 27).

Concerning the Operating Manual’s style, there is some duplication of text in the Trustee’s Guide. (Examples appear on p. 12, Public Relations; p. 15, Immediate Actions of Liquidation Proceedings; and p. 23, Bank Loans.) This duplication may be intentional and desirable, to the extent that the two resources are of primary value to different professional groups, lawyers and examiners, who may not be assumed to read both documents. But that may

be doubtful and in any event worth noting. In addition, the paragraphs on page 40 (concerning allocation in connection with an account transfer) and page 41 (on final housekeeping matters) span nearly a full page each. They should be broken up into multiple paragraphs. Once broken up, the discussion of final housekeeping may warrant unpacking and expansion, as it seems to condense important steps into dense prose unlike the clarity in the rest of the Manual. It compresses topics I would expect to see spelled out in an operations manual.

As with the Trustee's Guide, of like minor importance but worth doing if updating the Operations Manual, the exhibits are referenced out of order. (For example, exhibit 3 is first referenced on page 11 while exhibit 2 is first referenced on page 15; and on page 32 a series of exhibits appears in this confusing order: 4, 5, 8, 9, 11, 7, 10, 6). Also as with the Trustee's Guide, it would help to include in the list of exhibits (p. 42) a cross-reference to pages in the Manual where they are referenced or discussed.

Page 25 of the Operations Manual says: "The Trustee should bring any Repo transactions to the attention of the SIPC attorney assigned to the case." This reads as if it was inserted as a one-off addition when a more comprehensive approach may be warranted. I can see why this is not delineated, given the potentially uncertain classification of such transactions as securities or not. But there are likely other instruments that defy easy classification that may warrant similar direction too—as discussed next.

## B. Expand Document Wealth

1. Current Practices. The Trustee's Guide and Operations Manual cover substantial territory and may have been comprehensive when originally published and most recently updated. Since then, however, developments may have occurred that warrant considering additional documentary support, either as parts of those documents, as exhibits, or as stand-alone resources. In the spirit of the modernization motif, it's clear that many of today's brokerage firms and securities products differ substantially from those that existed during the first several decades of SIPC's existence. That is certainly true of larger firms, like Lehman, and is also likely true of many other SIPC members.

The sheer volume of brokerage and securities activity has led to firms that are more decentralized and have staffs with more specialized tasks and assignments. The pace of innovation in securities products has accelerated rapidly and results in a variety of securities well beyond stocks, bonds, shorts, options, and even repurchase agreements, to include a bewildering array of structured products, derivatives, advanced forms of options, like long-term equity appreciation securities (LEAPS), and other instruments, held in additional kinds of accounts, like portfolio margin accounts. These developments and how examiners and trustees may be expected to handle them—when, whether and how to close them out, under the Series 300 rules of the CFR, for example—may warrant capturing in documentary form, as a repository of collective and accumulated wisdom and experience among SIPC's staff, both in the Legal and Operations Divisions.

In some ways, the two groups have different needs and may have different interests. Examiners are interested in clarity concerning such matters as whether particular financial

instruments are securities within the meaning of that term of art or not, and how to handle them; some lawyers may desire like clarity, though others may be more willing to leave contestable classification issues like that to particular contexts when they arise. Even so, some effort to synthesize the variety of firms and products could be fruitful. That may be particularly useful to enable staff with more recent maturation points to share cutting edge knowledge with veterans for whom the pace of innovation and change may seem overwhelming. It's a way to consolidate knowledge that likely would prove useful to new recruits to both Divisions, whatever wealth of experience they may bring with them to SIPC.

That can also provide an organizational road map for dealing with problems that can be foreseen though faintly. A comparative historical example may illuminate. SIPA was amended in 1978 to require trustees to replace customer securities with open market purchases. That change was made without any advance planning and there was no written reflection or guidance about what that would involve or how a trustee should proceed. Within SIPC, a consensus emerged merely to muddle through the process without formally stating policy in a manual or otherwise.

As it happened, that approach worked reasonably well and trustees developed procedures and practices informally and case by case over time to implement that statutory requirement. But it remained true that advance written guidance would have been helpful in many cases. In today's world, with greater complexity, and a more conscious tendency for organizations to adopt formal written manuals on various subjects concerning operations, attempting to articulate aspects, issues, and resolution procedures concerning brokerage firms and securities products may be warranted, all in the spirit of modernization.

2. Consultants/Trustees Data Base. Despite considerable internal expertise, it's common for SIPC staff to engage outside experts on various matters, including when examiners engage accountants, consultants and others for discrete tasks, and when lawyers retain external trustees and trustee's counsel. The Vice President – Operations maintains a data base of consultants and this is reportedly available to examiners. That list includes information they supply about themselves and capabilities. There are as many as eight to ten based in New York and others of smaller size scattered nationwide. For trustees (and counsel), a dozen easily-recognized large New York based firms are available for most cases (with about four tapped regularly throughout SIPC's history); for smaller cases elsewhere in the country, the legal team finds local counsel in local areas when needed using customary techniques for identifying legal professionals.

But it was not obvious in my review that all examiners or lawyers are aware of such data bases, access them regularly, or can readily identify required expertise quickly. I understand that this may be due to how retention of external professionals is determined at SIPC's officer level and in accordance with other policies recommended in the 2004 Corporate Review Services report. Even so, given the varying complexities and needs of different liquidation cases and the value of consultants having just the right expertise for a job, and familiarity with SIPC (see Operations Manual, p. 14), it may be desirable to provide staff-wide access to data bases of consultants and trustees on whom examiners and lawyers can call as needed. Ideally, the data base would include not only information the external professionals supply but notes on previous SIPC assignments completed, and brief notes on its value and cost. This could simply involve

incorporating into the data base evaluations of external consultants made at the conclusion of cases. That may be helpful to relatively newer SIPC staff and may also formalize a pool of potential future employees SIPC may from time to time wish to recruit.

### C. Human Resources Investment

1. Recruiting and Training. It's vital to SIPC's continued success that it be able to recruit capable professionals in all its Divisions. Among staff in the Legal Division and Operations, it's essential that professionals be familiar with ongoing securities brokerage business developments and practices, able to work toe-to-toe with trustees and their counsel and outside accountants and other consultants. Ideally, the professional staff would consist of persons across the career ladder, to enable the team as a whole to possess the range of value that comes from a combination of veteran experience along with energetic new perspectives. That facilitates the transmission of senior knowledge down the career ladder and mutual education about evolving trends and practices.

The Legal Division's current composition approximates that ideal, with its members each separated roughly by a decade of seniority and representing all cohorts. The Operations Division, in contrast, tends to be congregated among more senior personnel, making it, as one noted, "a bit long in the tooth." It could be desirable to plan a recruitment program to address that imbalance. One reason for the difference in the Divisions may be due to the required skill set or recruiting philosophy. Recruiting of lawyers at SIPC emphasizes academic achievement along with some securities litigation experience. Lawyers younger and older will qualify and find the job offer strongly appealing.

The Operations Division emphasizes back office brokerage experience, with less emphasis on formal education. And in today's brokerage environment, with highly specialized tasks, there are simply fewer people towards the earlier career stages who have seen the broader range of back office operations. The result may be a natural and rational propensity to recruit in the more senior ranks. That's may be optimal, so long as a continuing supply of talent is available. But it does reduce the particular and overall length of service examiners have with SIPC. One solution is continuing to recruit examiners for SIPC from among the group of outside consultants used in other customer protection proceedings. Another would be a combination of accepting less experienced applicants with beefed up training may be useful. That said, it's notable that kindred recruiting challenges seem to appear at cousin organizations in Washington, such as the FDIC and SEC.

2. Officers. SIPC's existing organizational structure is coherent, essentially dividing the corporation into two Divisions, Legal and Operations/Finance, with one officer overseeing each and each of them reporting to the President, the only other officer. The Operations/Finance half of the corporation is further segmented into those two components, each overseen by an Assistant Vice President, plus a technology sub-division. SIPC's By-Laws don't exactly map onto that reality, though. They contemplate as officers a Senior Vice President – Finance, a position that's not presently occupied, along with a Vice President for each of Finance and Operations, positions currently combined and held by a single individual (as the By-Laws authorize). Given existing governance realities, however, it seems that if SIPC wished, for

promotion, retention, or recruitment, to name a Senior Vice President, the role would be at least as desirable overseeing Operations as Finance. Adding such an authorized officer to the By-Laws, a Senior Vice President – Operations, may thus be desirable.

It's also notable that two other officer positions authorized in the By-Laws, Controller and Treasurer, are not presently occupied. Instead, the current Vice President – Operations and Finance oversees the non-officer Assistant Vice President – Finance, who discharges related functions. This comparison of the By-Laws to existing entitlement indicates that there is room within the organizational structure to recognize achievement and provide advancement, should that be desirable. It's not possible to make any particular recommendations in this regard, as nothing has come to my attention that would justify any, but the built-in flexibility and other points warrant noting.

3. Professional Development. The Trustee's Guide contains as exhibits two law review articles published by SIPC lawyers, one by its current President and former General Counsel when he was Assistant General Counsel (1982) and one co-authored by its current General Counsel when she was Associate General Counsel (1990) (her co-author was then SIPC's Deputy General Counsel and later its President). These are excellent, and oft-cited, overviews of much of what SIPC does and its statutory mandate. They were undoubtedly valuable exercises for those authors and useful contributions to the field when published two and three decades ago. It may be desirable to encourage current SIPC lawyers to consider undertaking similar contemporary endeavors, as suggested by a more recent (2006) shorter piece by its President (and former General Counsel) and Associate General Counsel appearing in the American Bankruptcy Institute Journal. It could be particularly interesting and valuable to provide case studies of the customer protection proceedings arising out of the Lehman insolvency and Madoff fraud.

More broadly, it could be desirable to increase support for external training of the professional staff. That certainly includes maintaining existing support for periodic professional development events. More important, it would include tuition support to complete unfinished college degrees and for advanced specialized degrees relevant to the field. Four of SIPC's six examiners (not the Vice President or Assistant Vice President) attended college but did not complete it or earn the degree. For any of those who may find it desirable, and have the time, it would be a wonderful employer outreach to support that, as many other modern corporations do. That may be an especially appealing tool to help address the recruiting challenge discussed earlier. Likewise, all SIPC lawyers obviously earned their J.D. degrees, and one holds an advanced law degree, the LL.M. (in tax law). If any of those should wish to pursue an LL.M., especially one focused on securities law or other related specialty, it would be an appealing show of professional support for SIPC to back that, again as many other modern corporations do.<sup>1</sup>

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<sup>1</sup> Corporate examples include large corporations like JC Penney and Northrop Grumman; quasi-public agencies like the Port Authority of New York and New Jersey; and smaller enterprises like WaWa Corp. Human resource management firms like Cerdian can help. See [www.cerdian.com/employee\\_benefits\\_nav/1,6267,15689,00.html](http://www.cerdian.com/employee_benefits_nav/1,6267,15689,00.html). There are tax-advantaged and tax-limited ones. See [www.finaid.org/otheraid/employertuitionassistance.phtml](http://www.finaid.org/otheraid/employertuitionassistance.phtml).

## D. Substantive Document Updates and Highlights

1. Compensation Policy for Outside Consultants. Aside from employee salaries and benefits, SIPC's largest category of operating expenses, important expense line items reflect legal, accounting, and other professional fees. Though obtaining excellent professional services is the paramount concern, SIPC maintains policies designed to contain those costs and SIPA addresses this by requiring court approval of certain fees. Policies include those emphasized in the 2004 Corporate Review Services report addressing controls to prevent improprieties in retaining and paying external consultants. They include policies such as the Legal Division has of asking for litigation budgets from retained outside counsel. They include suggestions the SEC made in 2003 concerning requesting invoices at least quarterly and, for large cases during great activity periods, monthly. SIPC policies also speak to requesting discounts for services and assurance that quoted rates will remain in effect for at least one year.

They also routinely reference language such as the following. Concerning fees of trustees and trustee's counsel, the Trustee's Guide states: "Tasks which can be competently performed by an associate should not be performed by others whose time commands higher rates." Trustee's Guide, pages 1-3 and 11-1. The Trustee's Guide and the Operations Manual amplify that point for compensation of all external consultants, whether trustees, counsel, accountants, or others, seeking an "understanding that the firm will use persons with the lowest grade who are qualified to perform the tasks required." Trustee's Guide, page 12-1; Operations Manual, page 13. These expressions and others reflect a commitment to compensation based on hourly rates. The SEC's intervention clearly contemplated fees for legal services based on hourly rates, suggesting that hours be classified in designated categories, and the Trustee's Guide requires fee statements to provide detailed record of time expended, including the number of hours and the hourly rate. Trustee's Guide, pages 1-2 and 12-1.

Though hourly rates, performed at lowest-priced competent levels, may contribute to ideal cost containment policies, it's important to appreciate that SIPC's practices do not adhere rigidly to this model. They are more congruent with current developments in professional fee practices that increasingly depart from both the hourly rate and the formulation about least-cost competent providers. This is especially so in the legal profession, though extends to other professional service providers too.

Law firms traditionally grew through associate leverage for profitability. The business model admitted large numbers of young associates, paying \$80 per hour (say \$160,000 for a 2000 hour year) and billing them at \$180 to \$250. Firm partners made money and enticed some associates to make partner. Today, corporate clients have become stronger, with in-house counsel wielding more power. Many don't accept the leverage pyramid structure anymore or fund it. They say something like: "I'll pay \$750 per hour to get advice and representation from a true expert, but won't pay \$250 per hour for an associate learning what they're doing." Examples abound. The "Value Challenge" issued by the Association of Corporate Counsel calls for corporate clients to move away from hourly billing altogether.<sup>2</sup> Some ACC members are refusing to pay anything for work done by anyone without at least two years practice experience.

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<sup>2</sup> See [www.acc.com](http://www.acc.com).



SIPC's own practices reflect these developments and, of course, even its written policies about external compensation are not inconsistent with it. Significant discounting occurs, including a considerable discount for the trustee and its counsel in the Lehman case. The law firm has reduced its monthly billings for hourly rates significantly and isn't charging, as other firms do, for the cost of meals and transportation. SIPC pursues such flexibility in other ways, including negotiating to adjust for the value of services rendered without slavish adherence to hourly billings or rates. When feasible, contingency fees are used, especially for collection cases, though that's only feasible for matters with discrete outcomes. Accordingly, it may be desirable to update SIPC's written policies to reflect its flexibility in practice as a way to assure that this knowledge is communicated to newer SIPC staff and to external consultants, trustees, and trustees' counsel.

Modest adjustments to the existing language may be all that's warranted. Examples may include: "Though SIPC is accustomed to accepting proposals and fee applications based on hourly rates using the least-cost competent personnel, overall cost for outstanding professional value is what's sought. SIPC is interested in discussing alternative billing arrangements, which may include fixed pricing for discrete assignments and/or involving higher-cost personnel to perform assignments in less time so that, on balance, least cost is achieved with greatest professional skill."

2. Highlighting Vital Statements. Modern corporations, including those of SIPC's size, tend to have adopted several specific manuals or statements. Standard examples are mission statements; codes of corporate ethics; and policies concerning internal control. SIPC already has versions of materials like these scattered in various governing documents but it could be beneficial to highlight these vital statements differently. Doing so should not result in complex documents or foster bureaucracy within SIPC or diminish its nimbleness and family spirit. They should embrace a positive sense of mission, ethics, and compliance.

A mission statement may seem like a redundancy within SIPC, given the clear and often repeated directive derived from SIPA to promote investor confidence by providing protection to customers of securities brokers and dealers. Yet that would also render the task of producing a mission statement easy, and the statute doesn't exactly use those phrases. There is a widespread view among SIPC personnel, and among outsiders, that SIPC's mission and their jobs are particularly noble. They are to protect customers by returning cash or securities in failed brokerages, and "within statutory limits, to replace such cash or securities when they are missing. That's an easy mission statement to write and would both cement and build morale. It can certainly help get through difficult days or cases and can have other salutary effects.

SIPC has a code of conduct set out in its By-Laws and restated verbatim in its Personnel Guide, along with additional statements concerning seeking employment elsewhere and whistleblower procedures and protections. These are provided to all employees, who are also asked to attest to receiving and understanding them. In the past, that attestation exercise was repeated for all employees whenever the documents were amended; in the future, this will be done annually whether amendments were made during the year or not. These policies reflect prevailing best practices among corporate employers, a norm reflected in the Sarbanes-Oxley Act of 2002, which requires public companies either to adopt a code of ethics or explain why they don't.

SIPC's By-Law and Guide provisions are important statements of core values and warrant just a few suggestions. The code of conduct appears in the By-Laws in a penultimate Article labeled "Miscellaneous" (pp. 17-20). While substantively unobjectionable, that classification may wrongly signal a triviality to the provisions that should not be sent. Accordingly, it may be desirable to revise the By-Laws to add a separate newly named article containing the code of ethics. In turn, the Personnel Guide reiterates those provisions and adds material, including whistleblower policy.

It's not obvious why the additional material appears in the Guide but not in the By-Laws. Perhaps this is because the Board adopts the By-Laws, subject to SEC approval, and SIPC's officers adopt the Guide. Yet that procedural point doesn't diminish the substantive value of the full combined code of conduct and other statements of ethics. Consideration should be given to giving both sets of standards equal prominence in both the By-Laws and the Guide. (As with the Trustee's Guide, these materials also invariably use solely the masculine pronoun, something to edit when updating them.) I understand that even such reformatting of the By-Laws would require SEC involvement and approval. It still may be worth doing.

A parallel example, may help. SIPC's By-Laws also contain vital provisions concerning member advertising. This is seen as so vital that SIPC has separately created a stand-alone document presenting it, republishing it on its CD-ROM accompanying its 2009 Annual Report. A similar separate presentation of the By-Law concerning the code of ethics, combined with the additional material from its Personnel Guide, could be prepared. (As with the code of conduct, this advertising By-Law appears in the Article called "Miscellaneous." (pp. 13-17). That heading isn't proportional to the topic's vitality, which would be reflected by giving the topic its own Article.<sup>3</sup>)

Sarbanes-Oxley imposes specific requirements for internal control over financial reporting, and most corporations maintain extensive systems for that and to assure compliance with law. SIPC maintains internal control over financial reporting on substantially, though not exactly, the same basis as prescribed by Sarbanes-Oxley and related standards promulgated by COSO and adopted by the PCAOB. Those are reviewed annually by SIPC's outside independent auditor, Grant Thornton in recent years, though only for the purpose of auditing SIPC's financial statements—not as a separate audit of internal controls as Sarbanes-Oxley requires. Such audits are costly and there is no obvious justification for SIPC to follow that practice. Indeed, SIPC occasionally has requested its outside auditor to conduct particular tests of certain controls, including whether employees received and understand SIPC's Personnel Guide, especially its whistleblower provisions. That may be sufficient. Accordingly, I do not necessarily recommend expanding the annual audit to include internal controls, but this report wouldn't seem complete without mentioning it.

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<sup>3</sup> If revising the By-Laws, it may also be good housekeeping to relocate another item classified as miscellaneous, limiting corporate capital expenditures, to Article 8, which likewise limits corporate borrowing, making assessments, and pledging security.



