Statement

Of

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To The

Subcommittee on Securities, Insurance, and Investment,

United States Senate Committee

On

Banking, Housing, and Urban Affairs

September 30, 2015

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee:

Thank you for the opportunity to brief you on the progress the Securities Investor Protection Corporation (SIPC) has made since the beginning of the 2008 financial crisis.

The Subcommittee has asked how SIPC is protecting investors, how SIPC is responding to recent claims and customer protection, and if there are any reforms Congress should consider. The best way to describe how SIPC protects investors, responds to claims, and operates the customer protection regime mandated by statute is to provide you with an overview of SIPC's performance since the beginning of the 2008 financial crisis, which includes the most significant cases in SIPC's history. Potential reforms will be addressed at the end of this statement. The narrative which follows demonstrates that SIPC has protected investors as contemplated by the Securities Investor Protection Act (SIPA). I believe the results achieved to date are impressive, given the scope of the challenges presented.

How is SIPC protecting investors and how has it responded to recent claims and customer protection?

Lehman Brothers Inc.

Lehman Brothers is the largest bankruptcy proceeding of any kind in history. With securities customers' accounts essentially frozen and substantial customer assets at risk, SIPC initiated a customer protection proceeding on September 19, 2008. That same day, in what has been called the most important bankruptcy hearing in history, Bankruptcy Judge James Peck approved the transfer of 110,000 customer accounts containing $92 billion in assets to solvent brokerage firms. Judge Peck noted that he had heard credible evidence that without the ability to transfer those accounts under SIPA, securities markets worldwide could cease to function. SIPC is proud to have been a major actor in restoring investor confidence in the securities markets at that time. The actual transfer of those accounts took place over the next ten days.

The SIPA trustee proceeded to close the complex, worldwide business operations of Lehman. Among the highlights of that work was a victory for investors in the Supreme Court of the United Kingdom that resulted in additional assets being set aside for customers.

Today: All Lehman Brothers customers have received a 100% distribution, and general unsecured creditors in that case have already received 35% of their claims.

In short, the bankruptcy processes imbedded in SIPA have worked well in a severe stress case.

Bernard L. Madoff Investment Securities LLC

Bernard Madoff's Ponzi Scheme collapsed in December 2008. SIPC's intervention resulted in advances to customers and the payment of administrative expenses with results that were unimaginable at the time.

Every customer who left $975,000 or less with Madoff has received all of his, her, or its money back from the trustee. Customers with larger claims have received 48.08% of their initial investment, meaning that a claimant who left $10 million with Madoff has already received $5.3 million from the trustee, including SIPC advances. Further, SIPC took the position that every single asset of the Madoff firm was purchased with stolen money, so all recoveries, of any nature, should go into the "fund of customer property." SIPC thus pays every cent of the administrative expenses in that case.

In addition, based substantially upon painstaking research by the trustee's staff and paid for by SIPC, the United States Attorney for the Southern District of New York has amassed a sizeable sum which comprises a forfeiture fund. Distribution of that fund, which is in excess of $4 billion, has not yet begun.

The SIPA trustee is engaged in extensive litigation which, if successful, will benefit those who have not yet received all of their net funds invested with Madoff.

In summary, the trustee has maximized the returns to victims given the tools available to him. He has worked in cooperation with regulatory and criminal authorities, and will continue to do so. There will be additional distributions as more funds are added to the fund of "customer property."

MF Global Inc.

On October 31, 2011, the SEC notified me at 5:20 in the morning that the customers of MF Global were in need of the protections of the SIPA statute. After receiving authority from SIPC's Chairman within the hour, the SIPC staff mobilized and initiated a liquidation proceeding for that firm that afternoon. This is the eighth largest bankruptcy in history.

The results in the MF Global case are stunning. All securities and commodities customers have been paid in full. Last week, the trustee commenced the final distribution to general creditors, who will receive 95 cents on the dollar. Bankruptcy Judge Martin Glenn recently stated that "At the outset of the case, nobody thought that customers would recover everything they lost."

The trustee and SIPC litigated a number of issues interpreting SIPA, some of which were issues of first impression, and have been uniformly successful.

In short, the process worked, and worked well.

SIPC's Financial Condition

In January 2009 some members of the Committee expressed concern about the financial condition of SIPC. I am pleased to report that SIPC has performed all of its statutory duties during the financial crisis, and that it continues to be in sound financial condition. In December 2008, the SIPC Fund stood at $1.7 billion. Immediately upon the commencement of the Madoff case, the SIPC Board prudently increased the assessments on SIPC member firms to .0025% of net operating revenues. At the close of 2014 SIPC had $2.152 billion. Even including all

expenses of the financial crisis, this demonstrates that SIPC has the ability to raise funds as needed to protect customers and meet its statutory obligations. The SIPC Board has currently set a "target" balance for the SIPC Fund at $2.5 billion, which matches the increased line of credit SIPC has with the United States Treasury.

New Cases

Since December 2012, SIPC has initiated four customer protection proceedings, each of which is very modest in size. SIPC was able to serve as trustee in three of the cases, and use the statutory "direct payment procedure" in the fourth case. This has had the effect of expediting claims determination and satisfaction, in order to return customer assets as promptly as possible. Indeed two of those cases have already been brought to a conclusion. To put these cases in perspective with the cases discussed above, the combined cost to SIPC of protecting customers and administrative expenses in these four proceedings is approximately $7 million.

<u>Are there specific SIPC reforms that SIPC and Congress should consider and why?</u>

Action on SIPC Nominees:

The Committee can assure that SIPC is in a position to be a rapid response team by moving the nomination of SIPC's directors.

I noted above that SIPC was able to initiate a customer protection proceeding for MF Global in a matter of hours. SIPC, by Bylaw, has delegated the authority to initiate a customer protection proceeding to the Chair. For more than a year, SIPC has been without a Chair, or a Vice Chair to serve as Acting Chair. That means that today SIPC might not be as nimble as it was on October 31, 2011 when I contacted SIPC's then Chairman for authority to protect investors in the MF Global case. With no Chair or Vice Chair, should that same urgent situation arise today I would have to call a meeting of the entire Board, on literally no notice.

Thus, I urge the Committee to move the nomination of SIPC's vacant director positions forward.

The SIPC Task Force, Rulemaking, and Legislation

In February 2010, SIPC's Board created a SIPC Modernization Task Force to formulate possible improvements to SIPA. In February 2012, the Task Force made a number of

recommendations, five of which would require legislative change, and one of which required a rule change. (Nine recommendations, which could be implemented as a matter of policy, have been adopted.)

The SEC, working with SIPC, did institute a rule change requiring the independent auditors of SIPC member brokerage firms to file copies of their Audit Reports with SIPC. This program is part of an "early warning system" that gives SIPC the opportunity for informed discussion with regulators and self-regulators, who are responsible for notifying SIPC concerning brokerage firms that may pose a risk to investors.

After extended discussion the Board determined not to propose legislation that would increase the maximum level of protection, and eliminate the distinction in the levels of protection for cash and securities. Among the reasons for the Board's decision was that such legislation would create disparate levels of protection offered by the FDIC and SIPC which could cause disruption and confusion, and also create inappropriate incentives to move funds from banks to brokerage firms. The Board also determined not to expand protection to participants in pension funds on a pass through basis.

The Task Force also suggested legislation setting a minimum assessment on SIPC members of the greater of $1,000 or 0.02% of members' gross revenues from the securities business. Further, the Task Force suggested legislation authorizing the use of the "Direct Payment Procedure" where customer claims aggregate less than $5 million. The Board discussed these proposals but deferred formally recommending a separate bill on these more minor matters until an appropriate opportunity arises.

Restoring Main Street Investor Protection and Confidence Act

While the letter inviting me to this hearing did not ask me to address the Restoring Main Street Investor Protection and Confidence Act, S. 67, that proposed legislation is relevant in the overall context of this hearing. Accordingly, Attachments A and B provide an analysis of that proposal.

I hope this summary has been helpful to the Subcommittee. I would be pleased to answer any questions the Subcommittee may have.

Attachment A

Concerns Respecting The Proposed Restoring Main Street Investor Protection and Confidence Act (S.67)

The "Restoring Main Street Investor Protection and Confidence Act" contains provisions that have a number of what appear to be unintended consequences. Some of the concerns presented by the proposal include:

- The bill requires SIPC to accept as accurate financial statements known to be intentionally fraudulent. Under the bill, SIPC must accept whatever statement a thief issues to his customers.

- The bill legitimizes Ponzi Schemes by guaranteeing that the Scheme's non-existent trades at backdated stock prices giving rise to phony profits are backed by federal taxpayer funds.

- The bill makes Ponzi Schemes a better investment than legitimate securities market trades by, among other things, eliminating market risk.

- The bill's limitations on the Bankruptcy Code's "avoidance powers" in a SIPA case result in demonstrably inequitable distributions of "customer property." For example, had Mr. Madoff's fraud been detected and closed a mere two days later, the $175,000,000 in checks on his desk would have gone to arbitrarily favored clients at the direct expense of other clients to whom the funds actually belonged. This was more than half of the liquid assets the firm had when it failed. Further, as the United States Court of Appeals for the Second Circuit correctly noted, "any dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested."

- The bill provides a complex mechanism for honoring a fraudulent final account statement in the interest of equity. In reality, this is an invitation to extended litigation by various claimants with disparate, conflicting and competing interests in a finite corpus of customer property. This will delay the timely return of customer property to injured victims.

- The bill gives unprecedented and unlimited power to the SEC to compel the expenditure of both private and public funds. That power includes the authority to require SIPC

to initiate the liquidation of any brokerage firm or other institution regardless of whether statutory criteria are met.

- The bill gives the SEC unlimited authority to change the definition of the term "customer."

- The bill renders the SEC's authority unreviewable by the judiciary.

- The bill operates retroactively. It would throw the Madoff case, and the remarkable results achieved to date, into chaos and uncertainty.

- The bill forbids using a trustee on two SIPA cases simultaneously. This eliminates efficiencies and denies customers the benefits of expertise in the most significant cases. SIPC has six ongoing proceedings. Only one individual serves in more than one case. SIPC matches the size and resources of the trustee and the trustee's counsel with the nature and scope of the problem.

- The bill makes it impossible to determine future costs and risk.

The bill would reverse the judicial outcome in the Stanford-Antigua Bank Fraud Case.

SIPC declined to initiate a customer protection proceeding for the Stanford Financial Group in connection with the Stanford-Antigua Bank Fraud. For the first time in SIPC's history, the SEC sued SIPC to compel SIPC to begin a proceeding. The District Court and Court of Appeals examined the circumstances and considered the legal issues in the case and determined that the victims of the Stanford Antigua Bank Fraud were not "customers" that SIPA was designed to protect.

The Restoring Main Street Investor Protection and Confidence Act, S. 67, would require SIPC to underwrite, guarantee, and pay the debt obligations, represented by Certificates of Deposit of the Stanford International Bank, a foreign bank in an offshore tax haven. The Antiguan Bank CD purchasers knowingly sent their money away from a SIPC member to an Antiguan Bank where, in the words of the SEC, the claimants received "high rates of return on CDs that greatly exceeded those offered by commercial banks in the United States."

While SIPC has sympathy for the victims of the Stanford and any other fraud, SIPC was not designed to refund the original purchase price of a bad investment, even where the investment was induced by fraud.

SIPC

EQUITABLE TREATMENT OF INVESTORS

S. 67

An Analysis of the

“Restoring Main Street Investor Protection and Confidence Act”

Stephen P. Harbeck

President and CEO

The Securities Investor Protection Corporation

September 30, 2015

SIPC

This presentation demonstrates that the "avoidance powers" used by a SIPA trustee are essential to a fair and equitable distribution of assets in a Ponzi Scheme such as the Madoff case.

A One Sentence Summary of “Customer” Protection

SIPC protects the custody function that brokerage firms perform for customers

Summary of Customer Protection

1. All “customer name securities” without limitation as to value.
2. A ratable share of the fund of “customer property”.
3. Advances from SIPC of up to $500,000 for each customer, with a maximum of $250,000 for a cash balance. To the maximum extent practicable, and assuming a fair and orderly market, the trustee will use SIPC advances to purchase securities to replace securities which may be missing.

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Summary of Customer Protection

4. To the extent the customer's "net equity" is still unsatisfied, he participates as an unsecured creditor in the general estate of the debtor.

Note: SIPC advances may be, and as a practical matter usually are, made prior to a determination of each customer's ratable share of customer property.

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- Assume three individuals deposit the same amount, on the same day.

- No Actual investments are made for the three customers.

- All three are credited with completely fictitious investment returns.

- Just prior to a discovery of the fraud, one customer makes a substantial withdrawal of his original investment, and some of the fictional profits.

- The other two customers make no withdrawal.

- The fraud is exposed.

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- Under current law: No customer receives more than his original investment.
- Under the proposed legislation:

One customer receives:

- All of his principal investment
- Fictitious profits, in the form of money taken from the other two customers.

The other two customers receive:

- Far less than their original investment.

SiPC

The Facts

DATE	Customer A	Customer B	Customer C
01/01/10	Deposits $2 Million	Deposits $2 Million	Deposits $2 Million
01/01/11	Receives Statement $4 Million	Receives Statement $4 Million	Receives Statement $4 Million
02/01/12	Withdraws $3 Million	Withdraws Nothing	Withdraws Nothing
03/01/12	Receives Statement $1 Million	Receives Statement $4 Million	Receives Statement $4 Million
06/01/12	Ponzi Scheme Exposed Broker's Assets and Other Customer Property Completely Dissipated on Filing Date		

WHAT DOES EACH CUSTOMER RECEIVE?

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<u>Hypothetical 1:</u> Assume total of $6 million deposited and nothing available to distribute.

Results Under Current Law

	Customer A	**Customer B**	**Customer C**
Customer's Net Equity After $1 Million Withdrawal by "A" Is Avoided	$0 (Prior to liquidation, "A" already has received back his $2 million principal. Only $1 million representing fictitious profit is avoided)	$2,000,000	$2,000,000
Customer Property Distributed After Avoidance of $1 Million Transfer to "A"	$0	$500,000	$500,000
Amount Received From SIPC Advances	$0	$500,000	$500,000
Total Amount Received Based on $2 Million Deposit	$0	$1,000,000	$1,000,000

SiPC

Hypothetical 1: Assume total of $6 million deposited and nothing available to distribute.

Results Under the Restoring Main Street Investor Protection and Confidence Act,"

	Customer A	Customer B	Customer C
Amount Withdrawn Pre Liquidation	$3,000,000	-0-	-0-
Amount Received From SIPC Advance	$500,000	$500,000	$500,000
Total Amount Received Based on $2 Million Deposit	$3,500,000	$500,000	$500,000

- Which is More Equitable?

- The Avoidance Powers That the Bill Takes Away Are Exactly What Makes the Distribution More Equitable.

SIPC

Hypothetical 2: Assume Subsequent Recovery From Wrongdoer of $1,000,000

Results Under Current Law

	Customer A	Customer B	Customer C
Customer's Net Equity After "A's" $1 Million Withdrawal is Avoided	$0	$2,000,000	$2,000,000
Customer Property Distributed After Avoidance of Transfer To "A"	$0	$500,000	$500,000
From SIPC	$0	$500,000	$500,000
From Wrongdoer	$0	$500,000	$500,000
TOTAL AMOUNT RECEIVED BASED ON $2 MILLION DEPOSIT	$2,000,000	$1,500,000	$1,500,000

SIPC

Hypothetical 2: Assume Subsequent Recovery From Wrongdoer of $1,000,000

Results Under the "Restoring Main Street Investor Protection and Confidence Act."

	Customer A	Customer B	Customer C
Customer's Net Equity Based on Last Statement	$1,000,000	$4,000,000	$4,000,000
Amount Withdrawn Pre-Liquidation	$3,000,000	-0-	-0-
From SIPC	$500,000	$500,000	$500,000
From Wrongdoer	$111,111	$444,444	$444,444
TOTAL AMOUNT RECEIVED BASED ON $2 MILLION DEPOSIT	$3,611,111	$944,444	$944,444

CONCLUSIONS

- The avoidance powers make a more equitable distribution possible.

- Removing the avoidance powers gives fictional profits to some while depriving others of principal.