

Testimony of James W. Giddens

Trustee for the SIPA Liquidations of Lehman Brothers Inc. and MF Global Inc.
U.S. Senate Committee on Banking, Housing & Urban Affairs
Subcommittee on Securities, Insurance, and Investment
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Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee: Thank you for inviting me to testify. My name is James Giddens, and I chair the Corporate Reorganization and Bankruptcy Group at Hughes Hubbard & Reed LLP. I have worked on issues related to the Securities Investor Protection Act (SIPA) for more than 45 years, most recently as the Trustee for the liquidations of Lehman Brothers Inc. and MF Global Inc. – the two largest liquidations under SIPA and two of the largest bankruptcies of any kind in history.

I welcome the opportunity to bring this experience and perspective to discuss how SIPA and the Securities Investor Protection Corporation (SIPC) have handled the most complex broker-dealer failures, as well as to submit for consideration areas for improvement in the statute and related laws and regulations.

Lehman Brothers Inc. SIPA Liquidation

Two weeks ago marked the seventh anniversary of Lehman's collapse. Thus far, Lehman's broker-dealer customers and creditors have received \$114 billion in distributions. This represents the largest distribution across the worldwide Lehman insolvency proceedings. Importantly, more than 110,000 retail customers, including mom-and-pop investors from all walks of life and from all across the country, received 100 percent of their property within days of the bankruptcy due to the unique account transfer process under SIPA.

This swift return of customer property was critical to restoring stability to the financial system during a time of great doubt and avoiding the potential for further financial collapse. The return of customer property could not have happened without SIPA's account transfer provisions and the ability of the transfers to be backstopped by the SIPC fund. Indeed, it took hundreds of professionals working hand-in-hand with regulators to accomplish this extraordinary task and nearly two years to completely reconcile transferred accounts. A claims process for these accounts – the result in any other kind of bankruptcy proceeding – would have taken years longer.

At a recent court hearing, the Honorable Shelley Chapman, United States Bankruptcy Judge for the Southern District of New York, called the distributions "an incredibly extraordinary accomplishment in this case." I, and, more importantly the customers and creditors who had their funds restored, agree.

MF Global Inc. SIPA Liquidation

When MF Global collapsed on Halloween of 2011 with revelations of more than \$1.6 billion of missing commodity customer property, a near full return of property to customers and creditors was doubtful. My counsel and I testified about the MF Global case before the full Senate

Banking Committee, the Senate Agriculture Committee, the House Agriculture Committee, and the House Financial Services Committee. I am grateful for the support of all of these Committees as we worked under SIPA to recover funds for customers and creditors, and together we achieved a favorable outcome for customers.

The efforts to recover property around the globe required scores of professionals, the invaluable assistance of U.S. regulators, and cooperation from foreign insolvency administrators. In conjunction with the painstaking resolution of complex claims and the approval of innovative motions by the United States Bankruptcy Court, 36,000 securities and commodities customers, many of whom were farmers and ranchers, received 100 percent distributions on their claims.

Secured creditors also received 100 percent distributions on their claims, and a final 95 percent distribution to non-affiliated unsecured creditors is now in the process of being completed – all within less than four years from the commencement of the proceeding.

Distributions to customers in these two liquidations far exceeded initial expectations and demonstrate the flexibility and effectiveness of SIPA in complex, large broker-dealer failures.

Considerations

While SIPA has proven to be a successful mechanism for liquidating broker-dealers and is indeed viewed as a model for the prompt return of customer property in different jurisdictions around the world, there is room for modernization and improvement.

The considerations that follow stem from my and my counsel's experience in Lehman, MF Global and several other liquidations and from my involvement, along with investor advocates, regulatory specialists and academic experts, in a Task Force that issued recommendations for modernizing SIPA.

Specifically, the SIPC Modernization Task Force report included 15 recommendations on how to amend and improve SIPA. In addition, my own investigation reports in the Lehman and MF Global liquidations included eight and six recommendations respectively on improvements to SIPA and related laws and regulations.

I incorporate these three extensive, public documents into my testimony today, and I urge the Subcommittee to consider all 29 of the reform proposals in detail. Among the recommendations in these reports, I would like to highlight the following eight potential reforms for your consideration in particular:

Task Force Recommendations

1) Increase Maximum Coverage to \$1.3 million

Increasing SIPC's maximum coverage from \$500,000 to \$1.3 million, and tying future coverage limits to inflation, would reflect a significant increase in protection for customers and is consistent with the level of protection that is necessary to protect non-professional investors.

2) Eliminate the Distinction in the Levels of Protection for Cash and Securities

Eliminating the distinction between claims for cash and claims for securities resolves potential disparate treatment of customers and increases the amount of protection available to customers of 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. This distinction leads to arbitrary resolution of claims 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.

3) International Cooperation

The collapse of MF Global and Lehman revealed significant gaps between protections afforded customers in U.S. and foreign countries, such as the United Kingdom, arising largely from differences in insolvency laws and the absence of clear legal precedent. Though there may not be a one-size-fits-all solution for these issues, customers would benefit from greater harmonization of rules governing the segregation of customer funds and treatment of omnibus accounts.

Lehman Investigation Report Recommendations

4) Pre-Planning

More pre-liquidation disaster planning, both on an individual broker-dealer and industry-wide basis, including a broker-dealer's "living will" and emergency plan, should alleviate the type of information gap that I and my staff confronted in the Lehman liquidation. Such pre-planning would indicate the categories of customer accounts and associated assets that would need to be protected and set forth how possible scenarios would be dealt with, ranging from complete liquidation of all customer accounts to total or partial account transfer solutions, with details of key operational steps and the core assets that would have to remain to assure effective liquidation of customer accounts.

5) Increase in SIPC Borrowing Authority

In addition to increasing SIPC's maximum coverage as noted above, consideration should also be given to expanding the borrowing and guarantee authority available to SIPC trustees or other liquidators and to permitting more flexibility for use of those funds. While the previously-existing SIPC fund had more than sufficed to meet the demands of all previous SIPA liquidations, the Lehman and Madoff liquidations in particular demonstrate that the failure of a single major SIPC member broker-dealer could require at least the temporary availability of much more substantial sums to support the quick and efficient return of customer property.

6) Earlier Involvement of a Customer Representative

A party with potential responsibility for customers interests – whether SIPC, a putative trustee, a regulator, or a combination of all of these – should be involved in the negotiations related to the sale of a failed broker-dealer. Parties representing customer interests should, with better planning and access to information, bargain against a clear baseline of what needs to be transferred and avoid subsequent uncertainty and surprises.

As experienced in the Lehman case, the seller's immediate focus is likely to be its own post-transaction survival; the purchaser's is with the customers and assets it is taking on, not those it is leaving behind.

MF Global Inc. Investigation Report and Prior Senate Banking Committee Testimony Recommendations

7) Strict Liability for Senior Officers and Directors

Because regulations require futures commission merchants (FCMs) to segregate customer funds at all times, it may be appropriate to impose civil fines in the event of a regulatory shortfall on the officers and directors who are responsible for signing the firm's financial statements. Where there is a shortfall in customer funds, Congress should consider making the officers and directors of the company accountable and personally and civilly liable for their certifications without any requirement of proving intent and without permitting them to defend on the basis that they delegated these essential duties and responsibilities to others.

8) Commodities Customer Protection Fund

The liquidation of MF Global would have played out differently had there been even a modest protection fund for commodities customers – that is, a separate and distinct analog to SIPA in the FCM arena that learns from and builds on SIPA's record of success. A fund limited to protecting these smaller accounts – representing many farmers and ranchers – could be of relatively modest size, but would suffice to make these customers whole very quickly even in a case with a shortfall the size of MF Global's. With such a fund in existence, three-quarters of MF Global's commodities customers could have been made whole within days of the bankruptcy filing.

Conclusion

Since 1970, the SIPA statute has succeeded in protecting customers of SIPC-member brokerage firms, and I believe strongly that the statute has met its policy goals. In particular, the Lehman and MF Global liquidations are an indication that SIPA, SIPC, and the concept of the liquidation trustee work to protect customers and return assets to them as quickly as possible in a manner that is fair and consistent with the law. With consideration given to modernizing elements of the statute and related laws and regulations, I believe the shared goal of continuing and strengthening protection of investors, particularly non-professional investors, can be achieved.

Thank you Chairman Crapo, Ranking Member Warner, and other Members of the Subcommittee for the opportunity to testify before you and to submit this testimony for the full record of the hearing.