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"The Investor's Interest is the Public's Interest"

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REFORMING SIPC

The Securities Investor Protection Corporation: What Are Its Failings and How Could It Better Protect Investors

The Securities Investor Protection Act of 1970 [15 U.S.C.78aaa-111] was enacted by the Congress to protect public investors from monetary losses due to financially-failed brokerage houses. In cases of failed brokerages where the Securities and Exchange Commission or the Securities Investor Protection Corporation (SIPC) have reason to believe that investors' assets need to be protected, SIPC intercedes by appointing attorneys that have responsibility for (1) liquidating the bankrupt firm's assets; (2) determining the legitimacy of investors' claims for financial losses; and (3) making restitution of those losses according to SIPC's charter and by laws. The Securities Investor Protection Corporation is a non-governmental entity, administered by a seven-member Board of Directors appointed by Treasury Department officials and the President.

Investors must meet certain tests to determine if they qualify for restitution under SIPC. If found eligible under SIPC, investors can receive back the value of their portfolio on the date bankruptcy was filed by the brokerage up to certain amounts. Limits are set at $500,000 per customer unless cash claims, which are limited to $100,000 per account.

In order to carry out these duties, SIPC is funded through an annual assessment of member brokerage firms. Its members include all persons registered as brokers or dealers under the Securities Exchange Act of 1934, with certain exceptions. In calendar year 1999, SIPC membership fees are $150 for each member firm, regardless of size and annual securities revenues. According to its 1998 annual earnings report, SIPC has accrued more than $1 billion in cash assets. SIPC also has access to lines of credit up to one billion dollars from the U.S. Treasury and loans from the SEC.

Reforming SIPC

The need to modernize SIPC has much to do with changes in the investment market place -- changes that have been enormous in size and scope since 1970. According to research recently conducted for The Nasdaq Stock Market, only 10.4 percent of American households owned stock either directly or indirectly in 1965 (five years before SIPC was created). That number had doubled to 21.1 percent by 1990, then doubled again to 43 percent over the next seven years.

All in all, it stands to reason that an insurance fund created to protect an elite group of well-heeled investors nearly 30 years ago may not do an adequate job of representing the millions of individuals now in the markets.

Furthermore, with policy makers seriously discussing structural changes to Social Security that could include billions more dollars being invested in the markets by less than sophisticated investors, it is sound public policy to take a look at SIPC's mandate and operations to ensure it is protecting the good of the investing public, as well as serving the intent of the law. The issues surrounding SIPC protection are critical to maintaining the public's trust in the market and those who regulate it.

There is more to the call for SIPC reform, however, than changing times and the continuing growth of the investing public. Recent failures of several notorious micro-cap firms have spotlighted the weakness of SIPC's charter; namely, it is not protecting the exact people it should be -- those who have been intentionally cheated by outlaw brokers and rogue firms that are in the business of regularly and knowingly defrauding investors. Unlike the FDIC, the closest comparable institution to this one, SIPC-appointed attorneys determine the legitimacy of investor claims. In the case of one failed micro-cap brokerage, 96.2 percent of claimants have been denied by SIPC, regardless of how common and well-known were the fraudulent practices of the firm in question. If investors are being denied restitution in these most egregious of cases, how can SIPC claim to be protecting anyone?

Take the case of Stratton Oakmont, a firm accused of swindling investors out of hundreds of millions of dollars. It took five years for the National Association of Securities Dealers (NASD) to finally close down Stratton Oakmont, during which the principals of the firm had enough time to confiscate millions in investor funds and convey them to safe havens. By the time more than 3,000 Stratton Oakmont customers knew they were the victims of fraud, the company's operating capital had been depleted to less than $100,000. In every sense of the word, these investors -- the victims of Stratton Oakmont and firms like it -- deserve the protection intended by the creation of SIPC.

This is not to suggest that SIPC should become an insurance fund for consumers who lose money because of market conditions or just plain bad investment decisions. But once individual brokers and brokerage firms have been found guilty of misconduct and fraud, their victims must be restored or our national trust in the markets -- and those who regulate the markets -- will surely waver. SIPC's primary purpose is to protect the investing public when wrong has been done; without a history of wrongdoing on the part of a failed introducing brokerage firm, SIPC would not be involved in its bankruptcy and liquidation.

Making SIPC More Investor-Friendly

For investors and their representatives who look to SIPC for financial restitution, it often appears the organization's primary goal is to erect barriers to prevent having to pay claims. Whether real or perceived and whether SIPC's statutory language is unintentionally restrictive, it suggests the need for a more consumer-oriented approach for this "safety net for investors" in the form of congressional legislative reform.

SIPC liquidations -- When SIPC liquidation proceedings are initiated, a trustee is appointed to oversee the process. The pool of law firms, however, from which trustees are selected, in fact, represent the elite Wall Street law firms. Since the appointment of trustees for liquidation and attorneys for the trustees is solely discretionary on the part of SIPC, a case could be made for conflict of interest if not merely a bias against investors and toward the industry. Someone other than SIPC should be selecting Trustees.

Other discrepancies in fairness exist with SIPC. For instance, lawyers serving as trustees and attorneys for the trustees get paid first and in full, while claimants may go unrestored for their losses.

In April of 1997, more than 3,000 Stratton investors filed for $130 million in alleged damages. SIPC has paid the attorney they named counsel to the liquidation trustee and his law firm about $3 million in legal fees. At the same time payments to all Stratton claimants have totaled less than $400,000. Furthermore, the final attorney costs (the lawyer named as trustee and his law firm) will be paid from the Stratton estate -- *before any claimants receive their payments.* Legal fees alone could, in fact, deplete the entire debtor's estate. Were this to happen, SIPC is required to pay the lawyers from SIPC funds, but there is no such requirement for any of the claimants.

Determining Customer Net Equity -- For the purpose of distributing securities to customers whose claims are honored, the securities are to be of the same class and series of an issuer, and will be valued as of the close of business on the bankruptcy filing date. This may be fair in some cases, but not in the case of brokers who have stolen the proceeds from legitimate holdings and replaced them with worthless securities. A more equitable way of determining customer net equity should take these circumstances into consideration.

Defining "Conversion" -- SIPC is charged with providing restitution when the customer of a failed brokerage firm suffers losses from conversion. The term "conversion", however, is neither defined in the law nor is a time period specified under which principals must be held accountable for depleting assets that include those of their customers. In fact, SIPC, in decisions supported by courts, has taken the position that the word "conversion" contained in its mandate to restore assets, covers theft and only one type of fraud -- unauthorized trading.

However, in arbitration and court proceedings, there are more instances that constitute conversion than that of unauthorized trading. If this limitation for defrauded investors is truly what was intended in the original law, it lends additional credence to modernizing the statute.

SIPC would not be involved in the bankruptcy proceedings of a failed brokerage unless there was concern by government regulators regarding customer assets. SIPC's involvement in the liquidation of funds for a failed introducing brokerage is <u>strictly limited to those instances where fraud or conversion of funds is suspected</u>.

More Investor Parity on the Board of Directors -- Currently, the Board of Directors of SIPC consists of seven members:

- One director named by the Secretary of the Treasury from that agency's officers and employees;
- One director named by the Federal Reserve Board from its officers and employees;
- Five directors, appointed by the President, by and with consent of the Senate, as follows:
    -- Three directors who represent different aspects of the securities industry;
    -- Two directors who are not associated with a broker or dealer or member of a national securities exchange.

To truly enhance the investor protection mission of SIPC, there should be additional public directors who have a broad understanding of investing, yet have no direct link to the selling of financial or investment products. An investor advocate should be considered.

In summary, the U.S. Congress needs to take a closer look at SIPC -- by statute, by policy and by practice -- to provide a modernized program of protection, along with enhanced government oversight, to serve investors into the next millennium.

This issue paper was prepared by Mark E. Maddox, Esq., President of the Public Investors Arbitration Bar Association (PIABA). PIABA is the trade group for attorneys who represent investors in arbitration cases and other legal proceedings against brokerage firms.