

Please do not quote without permission

The Securities Investor Protection Corporation: Problems and Prognosis

A. Rappaport

A.F. Thompson

Department of Finance
University of Northern Iowa
Cedar Falls, IA 50614-0412
Fax: 319-273-2922

Phone: 319-273-2922
Email: allen.rappaport@uni.edu

319-273-2949
frank.thompson@uni.edu

Securities Investor Protection Corporation:

Problems and Prognosis¹

The Securities Investor Protection Corporation is a private non-profit organization chartered by Congress and supervised by the Securities and Exchange Commission. Its purpose is to insulate the economy from disruption that could follow the failure of a major financial institution by providing specific forms of insurance to investors which protects them from financial hardship. The insurance protects investors from some losses when a brokerage firm becomes bankrupt. Recent criticisms of the corporation are discussed. Additions to coverage are suggested.

Introduction and Statement of Purpose

Many recent activities of company executives and members of the securities industry have not been confidence builders for investors. Multiple problems regarding inside information usage, false profits, poor corporate governance, and customer exploitation by brokers have been documented by Levitt (5) and Stoneman, et.al. (11).

Considerable public controversy has also been generated by the Securities Investor Protection Corporation's (SIPC) practices (2,6,7). The SIPC has recently been questioned for the following practices: A historical record of paying more to law firms that serve as bankruptcy trustees who oversee the liquidation of insolvent securities firms than to the customers of those firms (2), A general dissatisfaction with the level of protection provided by narrow objectives, policies, and operating guidelines that do not do enough to protect investors caught in frauds (11, p.6), and failure to adequately communicate the specialized nature of the insurance protection provided including omissions particularly when

compared with the Federal Deposit Insurance Corporation (FDIC) (13, p.6).

Despite the media interest previously cited, SIPC's practices may be of little interest to the average investor. It is more likely that, as one person being interviewed stated, "I don't think the average investor understands what SIPC is and I don't think they care (11, p. 85)." Interest in SIPC may be confined to certain attorneys, the media, and a small group of investors involved in the liquidations of a few securities firms conducted by SIPC's representatives. This paper evaluates the issues and controversy regarding the insurance coverages and policies of SIPC. Recommendations for changes are offered.

Purpose and Operations

Created by the Securities Investor Protection Act (SIPA) of 1970 (9), SIPC is intended to protect the customers of a member brokerage or clearinghouse firm from certain specific losses. SIPC becomes involved when a member firm has problems that require liquidation. There are five failure conditions that are grounds for the initiation of liquidation procedures.² The Act establishing the SIPC followed a number of brokerage firm failures that included securities thefts during a period of national economic uncertainty (4, p.80). With only limited protection offered, SIPC bears only a modest resemblance to the FDIC that it was modeled after. In contrast with the FDIC, SIPC is a private non-profit corporation chartered by Congress. It is not an agency of the federal government (4, p.75). It can, however, by using authority granted to the Securities and Exchange Commission (SEC), borrow up to \$1 billion from the U.S. Treasury. Financing is

also obtained from membership dues currently at \$150 annually per person, an amount not reflecting risk premiums. In addition a \$1 billion credit line is maintained at a group of banks. The net assets of the SIPC as of December 31, 2001, are about \$1.1 billion (9, p.8). The SEC has regulatory authority over SIPC as given by the act establishing SIPC.

The Act establishing SIPC has goals for the U.S. financial markets. Original goals include insulating the economy from the disruption that can follow the failure of major financial institutions and achieving a general upgrading of financial responsibility requirements of brokers and dealers. (4, p.78) The objective of protecting individual investors from financial hardship (4, p.78) has been only narrowly implemented in part due to the limited scope of the loss coverages contained in the statute.

SIPC is a membership organization of about 6791 brokers, dealers, and stock and options exchange members. Current dues are \$150 per member (10, p.8). Criminal action has been initiated in 227 SIPC proceedings since December 1972 (10, p.11). When the various self-regulated securities organizations such as the exchanges, the National Association of Securities Dealers, or the Securities and Exchange Commission or a customer (8, p.9) notify SIPC that customers of a member firm may require the protection of the SIPA Act, SIPC may commence a customer protection proceeding. The proceeding involves applying to a Federal District Court for the appointment of an independent trustee to carry out a liquidation. SIPC will advance funds required to commence the liquidation of the

brokerage firm. In some cases, SIPC may pay claims or transfer customer assets directly to another member firm.

During the liquidation, funds for administrative expenses and payments of cash and securities to the customers of the failed firm may come from a combination of resources held by the debtor firm and payments or advances from SIPC. The priority structure suggested by data in the SIPC annual report involves possible cash advances by SIPC, distribution of customer owned cash and securities from assets held by the debtor, and subsequently from SIPC's assets for claims covered by the SIPA law. Customers whose claims exceed the amounts covered by SIPC become general creditors of the firm being liquidated. Administrative expenses originate from SIPC and the debtor company's assets. Subsequent litigation efforts by SIPC to recover assets as well as by customers to contest claims denied by SIPC's nominated bankruptcy trustees are not uncommon. The rationale behind the degree of administrative cost sharing resulting from liquidating assets held by the debtor and using the resources of SIPC is not clear.

For the period January 1, 1992 through December 31, 2001, the annual average of new cases begun each year was seven for a total of 71. As of December 31, 2001, 30 cases had completed proceedings, 22 had some customer claims being processed, and 19 had pending litigation matters. (10, p.6)

SIPC Investor Protection

For the average investor, SIPC protection is complex and technical. The

investor protection only begins when SIPC member broker - dealers that fail to meet the criteria specified in the SIPA Act are placed in liquidation by the SIPC.² Their customer accounts may be transferred to another SIPC member broker - dealer with full rights and privileges if feasible though this approach appears rare. When a liquidation is commenced, the customers receive cash and securities which can be shown to be registered in their names. Exceptions exist for securities in negotiable form. In addition, customers receive on a pro-rata basis all remaining customer cash and securities where their ownership is supported by available records. It is not clear how administrative expenses are deducted from distributions to customers. Subsequently, SIPC funds are available to satisfy unfilled customer claims up to a maximum of \$100,000 for cash and an additional \$400,000 for securities. Multiple protected accounts are possible for each customer at the same firm with each account having \$100,000 cash and \$400,000 in additional securities coverage in a manner similar to FDIC multiple account coverage.³ If a customer's claims exceed these amounts, the customer becomes a general creditor of the firm. Further payments come from the assets of the banking firm. Officers and creditors of a brokerage firm including creditors with claims on current cash balances are not covered by SIPC (3).

Most types of securities such as notes, stocks, bonds, and certificates of deposit are covered. Investment contracts not registered with the SEC, commodities accounts and various related contracts, declines in market value of securities, and cash balances maintained for the sole purpose of collecting interest

are not covered. (3, p. 1,2) Mutual fund shares are protected if held in a customers account at a SIPC member firm if the firm deals in other securities as well. SIPC does not cover individuals who are sold worthless securities (3, p.4). Transactions that ultimately take place with or are held by a non-member firm such as a separate clearing house may be disallowed by bankruptcy trustees even if a member firm has involvement with the clearing house (6).

When certain types of losses such as security theft are involved, value may be calculated using as a milestone the date on which the bankruptcy court is petitioned to appoint a trustee (4, p. 82). Compensation methods stress efforts to return the original securities owned by the claimant as of the date of petition for appointment of a bankruptcy trustee. Post petition date losses of security value are not considered in decisions to replace or return securities. Even when a SIPC liquidation is involved, fraudulent sales practices, unsuitable investments, failure to execute sell orders (8, p.1), and unpaid arbitration awards not covered by SIPC (13, pp. 1-2, 8, p. 5).

Criticism of SIPC

In the opening section of this paper, multiple criticisms of SIPC were noted. In a previously cited article in the New York Times (7), the argument is made that SIPC paid out only \$233 million in investors claims from 1971 to 1999 while paying \$320 million to lawyers acting as Bankruptcy Trustees to carry out SIPC's mandate by liquidating failed brokerage firms. An officer of SIPC contends, correctly we believe, that these figures fail to consider the costs

associated with approximately \$3.4 billion in cash and securities distributed to customers from their accounts at failed firms by SIPC and the trustees (7).

Principals of SIPC feel that the fees to lawyers are necessary to avoid false claims, locate hidden assets held by people who as owners or officers were liable for claims against failed firms, obtain settlements from insurers, and meet necessary administrative costs (7).

A second critique of the trustees methods of administrating liquidations is the argument that unreasonable standards are imposed to for establishing claims for losses resulting from unauthorized trades. Unauthorized trading accounted for 24 of the 37 liquidations initiated by SIPC from 1996 to 2000 (14, p. 25). SIPC contends that claimants should be able to produce credible (written) evidence of an objection to unauthorized trades originating in the same time period generally within 90 days (13, p.29). The evidence standards have been upheld by the courts while proving harmful to investors for possible reasons of ignorance, inattention, and incompetence. In the Stratton-Oakmont case subsequently discussed, the trustee denied 656 of 728 unauthorized trading claims for failure to meet the standard of objective evidence. A GAO audit sample that tested the administration of the standard supported the trustees actions.⁴ It may be that many investors are unaware of this standard and additional educational efforts are warranted. However, a key problem is that a majority of trades will very likely continue to be made by telephone.

The Stratton-Oakmont case, which involved micro-cap stock fraud, and

the related actions of SIPC's representatives are associated with considerable criticism of SIPC's practices. The criticism results from several key issues. Initially, the bankruptcy trustee directed 1210 of 3400 claimants to obtain their generally worthless securities from the clearinghouse used by the owners of the firm and denied 448 claims for market losses because SIPC makes no provision for protecting against market losses. Three hundred and forty-two claimants indicated they were owed nothing. Approximately 600 claimants were rejected for other reasons. As a result, 76% or 2600 the claimants many of whom may have been caught in a fraud-based manipulation were denied compensation. Broker initiated fraud involving micro cap stocks occurs in a significant number of cases (15) in addition to the Stratton-Oakmont case. The extension of SIPC coverage to customers victimized by this type of fraud needs to be examined.

To qualify for coverage under SIPA, investors must be dealing directly with a member firm and the types of securities specified by SIPA must be involved. These requirements can result in difficult coverage questions. Investors may believe they are dealing with a member firm while engaging in trades through a non-member clearinghouse associated with the member firm. However, SIPC may deny coverage because of the appearance of dealings with the non-member firm. The member firm may control the non-member clearinghouse and use it to aid in perpetrating a fraud. This fraud may involve using funds raised through the non-member affiliate as if they were funds of the member. Some court decisions on these issues have sided with SIPC's narrow interpretation that the claimant is

not covered. Others have found for the complainants. As a result of court decisions, SIPC may be altering its traditional position to some extent. (7, 13, p. 26, footnote 2)

Communication Problems of SIPC

One obvious problem is that the SIPC's coverage is often incorrectly assumed to be similar to that of the FDIC by investors (8, p.6). Investors may think that SIPC covers any loss including fraudulent broker activities (8, p.6). Several contrasts exist in the areas of mission, type of insurance coverage, and requirements imposed on the insured. The FDIC covers money, near money, and capital market instruments of depositors whose characteristics are understood and value is relatively easy to determine. Market value related issues are not a problem. Insurance coverage is straightforward and comparatively easy to understand. Customers of FDIC protected institutions do not have to engage in protective actions such as timely written complaints in reaction to unauthorized securities trades (6,7). Losses from failure to sell securities are not a problem for FDIC customers. Neither are fraud induced losses which receive coverage.

In contrast, the coverage provided by SIPC has significant highly technical omissions that require intensive study of the contents of its customer booklet and web site. A GAO report suggests that SIPC's disclosure practices regarding the need to document timely written complaints about unauthorized trades and the possible lack of coverage when dealing with non-member affiliates even indirectly have been inadequate (12, p.8-9, 8, p.6).

Conclusions

We are unable to find data on the issues raised in this paper that would enable us to set priorities for new areas of coverage by SIPC. Accordingly, our conclusions are based on judgments about the changes that would improve achievement of the SIPA laws objectives. A mandatory prominent display of the SIPC logo would seem obvious, but SIPC claims the lack of legal authority to enforce this requirement. The display would encourage consumer questions and lead to their additional education. Labeling products not eligible for SIPC protection also appears desirable, but this would also have to be voluntary. Requiring all broker dealers and clearing houses to be members of SIPC seems justifiable as well. To meet goals relative to improving investor confidence in the system, a case can be made for making SIPC's coverage more closely resemble that of the FDIC.⁸

While SIPC's insurance fund has the presumption of further financing from the federal government if a large brokerage firm were to fail, the membership dues currently at \$150 per person annually should be shifted to risk adjusted fees based on individual firm risk. It follows that SIPC, as an underwriter, should have a greater role in risk determination and the subsequent risk based rate to be assessed. SIPC has no examination authority at this time. It may be that SIPC needs an examination group that audits brokers. In addition, the early warning capabilities of the examinations currently performed by the SEC and various self-regulatory organizations are not clear.

A number of potential additional coverages appear to meet the conditions for insurability i.e., where losses are definite, subject to calculation, not subject to catastrophe, and rates are determinable. Possible additional coverage issues include the return of all cash balances on hand at the time of failure to rightful owners [1, p.37]. Creditors cash balances currently are accorded a lower priority than those of customers of the firm when cash balances are distributed to owners. Also, customers who are victims of fraud should be reimbursed for their cash losses instead of receiving worthless securities originally created to perpetuate the original fraud.

There are some difficult issues that require further study. These include suitability claims, evidence standards for timely objections to unauthorized trades that generate losses and eventual reimbursement claims, adding coverage for losses from failure to sell decisions, and unpaid arbitration awards. It is not clear how significant the damages from these issues are in firm failures.

The Gramm-Leach-Bliley Act of 1999 eliminated many barriers to affiliations of banks, security firms, and insurance companies. Investors and consumers of financial services will need to comprehend the different coverages provided by the FDIC, SIPC, and various state insurance guarantee funds. This will be a problematic task. Improving SIPC communications and practices will provide a significant degree of relief. This improvement could also aid in the quality of any transition of social security funds to private or personal management if that transfer materializes in the future.

Endnotes

- 1) The Securities Investor Protection Corporation is a relatively obscure private non-profit part of the federal insurance umbrella. A survey of investments texts either suggest that they either do not mention SIPC or give coverage to the basic services available. Technical aspects that may limit coverage are not discussed. Two NASD brokerage exam preparation books were examined. The results were similar to the textbooks.
- 2) There are five conditions specified in Section 5(b) any one of which, if found to exist in a case, is grounds for the initiation of liquidation procedures. They are that the member:
 - a) is insolvent within the meaning of section I (19) of the Bankruptcy Act, or is unable to meet its obligations as they mature, or
 - b) has committed an act of bankruptcy within the meaning of Section 3 of the Bankruptcy Act, or
 - c) is the subject of a proceeding pending in any court or before any agency of the United States or any state in which a receiver, trustee, or liquidator for such member has been appointed, or
 - d) is not in compliance with applicable requirements under the 1934 Act or rules or regulations of the commission or any self-regulatory organization with respect to financial responsibility or

hypothecation of customers' securities, or

- e) is unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules or regulations.

(cited from Krogh, footnote 18)

- 3) Additional coverage may be purchased from private insurers.
- 4) These sections on evidence standards and the Stratton-Oakmont liquidation draw heavily on [14, pp. 25-30].
- 5) The Stratton-Oakmont case led to a 1999 guilty plea to fraud by the two owners. The owners engaged in widespread unauthorized trading of customer accounts in price manipulated micro-cap stocks.
- 6) The British have an organization somewhat similar to SIPC. An examination of their brochure prepared for customers suggests similar difficulties in developing clear explanations of services offered. The reader should examine the Financial Services Compensations Scheme "How We Handle Your Claim For Compensations" www.fscs.org.uk.
- 7) SIPC's involvement begins only with the discovery of an act of bankruptcy committed by a member broker-dealer or other firm. Non-liquidation issues may involve the SEC and self-regulation organizations. The SEC through its office of Compliance Inspections and Examinations inspects and examines operating entities including brokers, dealers, municipal securities dealers, self regulatory

organizations, transfer agents, clearing agencies, investment companies and investment advisors. The total number of SEC inspections was 2,610 in 200. Violations such as suitability issues where a liquidation is not involved are either dealt with by the SEC or by the relevant self regulatory agency such as the National Association of Securities Dealers.

- 8) The authors acknowledge that the FDIC rarely if ever encounters losses requiring reimbursement that result from market declines but a number of FDIC practices appear beneficial.

References

1. Brennan, Bartley A. "The Role of SIPC in Brokerage Failures: A Case Study of the Demise of Bell and Beckwith" *Securities Law Journal*, 13, p.37.
 2. "Group Assails Insurer of Investors", *The Washington Post*, July 21, 1999.
 3. "How the SIPC Protects You", *Securities Investor Protection Corporation*, Washington, D.C., October 1994, pp. 5-16.
 4. Krogh, Harold C. "The Securities Investor Protection Corporation: Financial Stringency in Securities Firms", *Chartered Property and Casualty Underwriters Annual*, Vol. 30, no. 1, March 1977.
 5. Levitt, Arthur, et.al., "Take on the Street," *Pantheon Books*, 2002.
 6. "Many Holes Weaken Safety Net at Failed Brokerages", *New York Times*, October 25, 2000.
 7. "Many Unhappy Returns", *Newsday*, December 20, 1998, F1, 7.
 8. Office of the Inspector General, "Oversight of Securities Investor Protection Corporation", *Audit 301*, March 31, 2000.
 9. *Securities Investor Protection Act of 1970*, 15 U.S.C. S 78 aaa et.seq.(SIPA).
 10. *Securities Investor Protection Corporation*, Annual Report 2001, p. 8,17.
 11. Stoneman, Tracy Pride and Schulz, Douglas J. "Brokerage Fraud", *Dearborn Trade Publishers*, 2002.
 12. *United States General Accounting Office*, *Securities Arbitration*, GAO, GGD-00- 115, June 2000.
 13. *United States General Accounting Office*, *Securities Investor Protection*, GAO- 01-653, May 2001, pp. 4-6, 9, 10, 18-19, 25, 26, 27.
 14. *U.S.Banker*, November 2000, p. 85.
 15. *U.S. Securities and Exchange Commission*, *About Micro Cap Fraud*, www.SEC.gov.
-