

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The top bulb is dark blue, and the bottom bulb is light blue. The hourglass is light gray. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The hourglass is centered on the page.

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Securities Investor Protection Corporation

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CRS Report for Congress

Securities Investor Protection Corporation

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Summary

This report outlines the financial safety net provided for individual investors in stocks, bonds, and mutual funds held at securities firms, which somewhat resembles deposit insurance and insurance guaranty funds. Its implementing body, the Securities Investor Protection Corporation (SIPC), authorized by Congress, is actually a nongovernmental corporation. The Securities and Exchange Commission (SEC) oversees it. In the post-Enron/WorldCom financial climate of distrust of Wall Street, its protection remains important. Although not in the public eye recently, SIPC has paid out or facilitated investor restitutions of large amounts over time. This report will be updated periodically.

Background

The Securities Investor Protection Corporation (SIPC) is a nonprofit, quasi-public, quasi-industry, nongovernmental corporation. When securities firms become incapable of performing their custodial obligations for customers, SIPC is responsible for ensuring that customers recover cash and securities that they had entrusted to the firms. It protects the “position” of registered securities, that is, the number of shares of a specified corporation, etc., rather than any given dollar value of them. SIPC coverage is \$500,000 value per customer, of which cash may be up to \$100,000.¹

The late 1960s saw a marked rise in securities trading volume, exposing major inadequacies in the systems that processed securities trades and provided centralized clearing. Bottlenecks and paralysis plagued the processing of trades, producing significant accounting and reporting abuses. The subsequent stock market decline pushed many securities firms into financial difficulties as many firms merged, failed, or ceased operating. Some firms used customer property for their own trading, while others experienced procedural breakdowns in the management of customer accounts, resulting in customer losses of millions of dollars. In 1970, to avoid a recurrence of these events and the potentially negative consequences for investor confidence in the securities

¹ SIPC’s website, containing much of the following data, is found at [<http://www.sipc.org>].

markets, Congress amended the Securities Exchange Act of 1934 by adding the Securities Investor Protection Act of 1970 (SIPA),² and significantly changed it via the Securities Investor Protection Act Amendments of 1978.³ The Securities and Exchange Commission (SEC) has oversight over the resulting SIPC and its bylaws. SIPA gives the SEC authority to review, disapprove, and even impose SIPC bylaws and rules.

SIPC is not a government agency and it is not a regulatory authority. It is a nonprofit, membership corporation, funded by securities brokerages. SIPC has a seven-member public board of directors. The Secretary of the Treasury and Federal Reserve Board each appoints one, and the President appoints the remaining five, subject to Senate confirmation. Of the President's appointees, three are from the securities industry and two represent the general public. The latter become SIPC's chairman and vice chairman.

Brokerages belonging to stock exchanges and other organized markets automatically become members when they register with the SEC; the statute requires each to pay an annual assessment to SIPC. Part of their assessment, currently a flat \$150 annually, is for administrative costs and part goes into the SIPC fund, which is used to compensate investors. (In many past years, assessments were based on members' revenues.) If the fund should prove inadequate, SIPC may also call upon a standby line of credit of \$1 billion from the U.S. Treasury, which only the SEC can activate, and another \$1 billion line of credit with banks.

Purpose

With a mandate to help maintain investor confidence in the securities markets, SIPC provides protection to customers for securities and cash left with failed securities firms. It insures customer assets (registered securities and cash) against losses of up to \$500,000 at the time of a firm's collapse, of which up to \$100,000 may be covered cash. Covered non-cash assets include registered stocks, bonds, notes, mutual funds, and money market mutual funds as "positions" (number of shares and identified bonds, etc.) rather than fixed-dollar values of them. Congress has designed SIPC to recover a prorated position for customers out of the remaining assets of failed firms, paying remaining covered claims up to the statutory limits if necessary to fill any shortfalls.

Typically, the SEC or a self-regulatory organization like the New York Stock Exchange or the NASDR (the regulatory arm of the National Association of Securities Dealers) alerts SIPC when a securities firm that is a SIPC member is in serious financial difficulty. SIPC normally responds by filing an administrative petition in a federal court to liquidate the firm. The court will usually appoint a SIPC-recommended trustee, although SIPC will sometimes itself be the trustee where liabilities are limited and collapse affects fewer than 500 customers. When the liquidation proceedings are removed to a U.S. bankruptcy court, the trustee notifies the firm's customers and attempts to sell or transfer customer accounts to viable SIPC members. If the firm's customers are unable to recover missing funds or securities from the firm, they may file claims, which

² P.L. 91-598, Dec. 30, 1970, 84 Stat. 1636; codified at 15 U.S.C. §§78ccc — 78lll.

³ P.L. 95-283, May 21, 1978, 92 Stat. 249.

SIPC and the trustee then either accept or reject. To the extent that failed firms are unable to meet accepted customer claims, SIPC advances funds up to statutory amounts noted above. SIPC will not directly compensate for losses in commodities, precious metals, derivatives, investment contracts, limited partnerships, or any other “securities” that are not registered.

The corporation notes that since 1970, 99% of eligible investors have gotten their investments back via SIPC. It has distributed more than \$14 billion, aiding perhaps 625,000 investors. Around \$400 million (less than 3%) came from the SIPC Fund, with the vast majority of disbursements having been recovered from liquidations, etc. SIPC’s fund balance exceeds \$1.2 billion, and it has an additional \$1 billion line of credit with banks, and the same as a draw upon the Treasury noted above, allowing it to resolve cases directly if necessary. It has about 6,500 member firms, yet has had to take on only around six new cases a year for a decade, far less than the large case load in its initial years of operation. In dollar terms, it made its largest distributions to customers in 2001, following stresses in the stock market. The largest number of its proceedings occurred in 1972.

SIPC does not, however, insure against market losses, unlike governmental fixed-dollar protection for depository institutions and insurance companies. Positions delivered to investors may have gone up or down after resolution of collapsed securities firms, and thus, except the cash portion, fluctuate in value. Surveys find many small investors believing that the federal government insures their accounts against market losses, however. The SEC and SIPC have tried to address these misconceptions. In addition, some believe that it covers losses due to securities fraud, etc., which it does not do unless an errant covered firm collapses.⁴

For years, securities firms could purchase excess SIPC coverage, supplementing the governmental coverage up to customer protections of many millions of dollars. The insurance policies varied in coverage, but as “surety bonds,” promised to cover gigantic losses. Carriers generally stopped writing excess SIPC policies in 2003, fearing Enron-like surety bond claims. As the policies expire, their original insurers generally have not renewed them; brokerages typically no longer advertise multi-million-dollar account protection. Looking to remedy this situation, a consortium of 14 large brokerages has formed a captive insurer called the Customer Asset Protection Co. They have designed the new insurer to restore account excess coverage, as a “surety bond” activated when a customer’s claim exceeds the SIPC amount.⁵

Major Issues

SIPC has confronted several major criticisms. Among them are (1) whether it imposes unreasonable requirements on investors for redress from failed brokers who conducted unauthorized trades; (2) whether its overall mission is too restrictive, particularly with respect to stock fraud; and (3) whether SEC oversight is strong enough.

⁴ “Investors Whose Funds Embezzled Had SIPC Claim for Securities, Not Cash,” *BNA’s Securities Regulation and Law Report*, June 28, 2004, p. 1166.

⁵ “CAPCO,” at website [<http://www.capcoexcess.com/USA/index.html>].

Concerns That SIPC Imposes Unreasonable Documentation Requirements for Claims of Unauthorized Trading

SIPC is obligated to pay for losses generated by unauthorized trading by failed firms. Yet some have criticized it for the large number of denied claims in this area. SIPC has historically denied claims for unauthorized trades unless customers complained in writing to the firm within a few days of the trade, and then giving SIPC proof of correspondence. Because most securities orders and associated transactions occur over the phone, some observers have said that expecting unsophisticated investors to make written complaints is unreasonable. Courts have generally upheld SIPC's requirement for hard documentation, which SIPC officials say is necessary to ensure accuracy of claims and to minimize false allegations. Nevertheless, some argue that SIPC could probably document unauthorized trades through other means, such as telephone complaints. Under SEC supervision, SIPC has adopted written guidance for reviewing unauthorized trading claims.⁶

Expanding SIPC's Mission to Cover Fraud

An investor believing to have been victimized by a brokerage firm scam can file a claim with a National Association of Securities Dealers (NASD) arbitration court. (The NASD has primary regulatory jurisdiction over brokerage firms.) If the NASD arbitration panel rules for the investor, its decision then requires the firm to reimburse the losses. Yet if the brokerage firm has filed for bankruptcy protection, SIPC then takes on the claim. SIPC recompenses investor funds stolen or used for unauthorized trading. It does not, however, have jurisdiction over other fraud such as broker refusal to sell a security or making false claims about a security. Entrance of many relatively unsophisticated investors in the securities markets appears to have led to increasing brokerage fraud. Some industry observers, including state securities regulators, have argued that, consequently, SIPC needs to broaden its mandate to include these kinds of securities fraud.

SIPC and industry officials had opposed broadening SIPC's mission, maintaining that investors should be held accountable for their risk taking. They are also concerned that insurance against securities fraud would fuel the misconception that SIPC covers market loss. They question whether the large number of well-behaved brokers should pay the added costs of insuring investors who invest with "bad" brokers. They are also concerned that reconfiguring SIPC's mission to redress securities fraud could imperil SIPC's reserve fund, requiring higher payments from its members (which they would pass on to their customers), and increasing the risk that SIPC might tap into the U.S. Treasury. Proponents of reform, however, counter that a negligible yearly assessment of \$150 finances the SIPC fund, far less than many trading commissions, and thus the Corporation could greatly increase it. SIPC officials have, however, said that they would accept broadening its mandate, conditioned upon congressional amendment of SIPA.

⁶U.S. Government Accountability Office. *Follow-Up on GAO Recommendations Concerning the Securities Investor Protection Corporation*, GAO-04-848R, July 9, 2004, p. 7.

Recent incidents of fraud have led SIPC to issue warnings that con artists are posing as actual SIPC members on the internet, seeking to defraud investors by providing fictitious computer addresses. The result is a kind of brokerage identity theft.

SEC Oversight of SIPC

In 2001, a Government Accountability Office (GAO) report⁷ criticized SEC oversight of SIPC. Among other things, the report stated that the overseeing agency too infrequently conducted on-site examinations of SIPC, that the examinations were too limited in scope, and that the agency had no formal mechanisms for sharing SIPC-generated information (investor complaints, status of liquidations) among the various SEC divisions and offices. GAO also noted that public and private bodies may not have sufficiently mentioned the exact coverage of SIPC protection to investors, especially brokerages.

In 2003, GAO released its first followup report,⁸ finding that the SEC had taken steps to implement its recommendations. GAO's recommended disclosures to investors about SIPC coverage had generally become effective on SEC, SIPC, self-regulatory organization, and brokerage websites. SIPC had added links to other sites in its brochure offering information about investment fraud. GAO found, however, that investors could benefit from more specific links to investor education information including any remaining excess SIPC insurance coverage. Since then, investor education efforts have involved self-regulatory organizations, working with the SEC and SIPC, to give customers better information on SIPC and its limitations.

SEC and SIPC representatives generally agreed with the 2003 report's findings and recommendations. As noted above, GAO issued another followup document in 2004, noting their generally affirmative responses addressing prior concerns over SIPC practices. Concern remains that brokerages are not required to give new customers the SIPC's brochure called *How SIPC Protects You*, however.⁹

⁷ U.S. Government Accountability Office, *Securities Investor Protection: Steps Needed to Better Disclose SIPC Policies to Investors*, GAO-01-653, May 25, 2001, 95 p.

⁸ U.S. Government Accountability Office, *Securities Investor Protection: Update on Matters Related to the Securities Investor Protection Corporation*, GAO-03-811, July 11, 2003, 42 p.

⁹ U.S. Government Accountability Office, *Follow-Up on GAO Recommendations Concerning the Securities Investor Protection Corporation*, GAO-04-848R, July 9, 2004, p. 7.