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SECURITIES INVESTOR PROTECTION

The Regulatory Framework Has Minimized SIPC's Losses

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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

This report responds to your requests that we review the operations and solvency of the Securities Investor Protection Corporation (SIPC). It discusses how the regulators' success in protecting customers depends upon the quality of regulatory oversight of the securities industry. We also provide recommendations to improve Securities and Exchange Commission (SEC) and SIPC disclosures to customers and SEC's oversight of SIPC's operations.

We will send copies of this report to the Chairman, SIPC; the Chairman, SEC; appropriate congressional committees and subcommittees; and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues, who may be reached on (202) 275-8678 if there are any questions concerning the contents of this report. Other major contributors to this report are listed in appendix IV.

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Executive Summary

Purpose

Congress created the Securities Investor Protection Corporation (SIPC) in 1970 after a large number of customers lost money when they were unable to obtain possession of their cash and securities from failed broker-dealers. SIPC was established to promote public confidence in the nation's securities markets by guaranteeing the return of property to small investors if securities firms fail or go out of business. SIPC is a member-financed, private nonprofit corporation with statutory authority to borrow up to $1 billion from the U.S. Treasury.

This report responds to requests by the Senate Banking Committee and the House Energy and Commerce Subcommittee on Oversight and Investigations that GAO report on several issues, including (1) the exposure and adequacy of the SIPC fund, (2) the effectiveness of SIPC's liquidation oversight efforts, and (3) the disclosure of SIPC protections to customers.

Background

The law that created SIPC also required the Securities and Exchange Commission (SEC) to strengthen customer protection and increase investor confidence in the securities markets by increasing the financial responsibility of broker-dealers. Pursuant to this mandate, SEC developed a framework for customer protection based on two key rules: (1) the customer protection rule and (2) the net capital rule. These rules respectively require broker-dealers that carry customer accounts to (1) keep customer cash and securities separate from those of the company itself and (2) maintain sufficient liquid assets to protect customer interests if the firm ceases doing business. In essence, SIPC is a back-up line of protection to be called upon generally in the event of fraud or breakdown of the other regulatory protections.

Except for certain specialized broker-dealers, all securities broker-dealers registered with SEC are required to be members of SIPC. Other types of financial firms that are involved in the purchase or sale of securities products, such as open-end investment companies and certain types of investment advisory firms, are not permitted to be SIPC members. As of December 31, 1991, SIPC had 8,153 members. Of this number, only 954 are authorized to receive and hold customer property. The rest either trade exclusively for their own accounts or act as agents in the purchase or sale of securities to the public. SEC and SIPC officials estimate that over $1 trillion of customer property is held by SIPC members.

SIPC is not designed to keep securities firms from failing or, as in the case of deposit insurance for banks, to shield customers from changes in the market value of their investment. Rather, SIPC has the limited purpose of ensuring that when securities firms fail or otherwise go out of business, customers will receive the cash and securities they own up to the SIPC limits of $500,000 per customer, of which $100,000 may be used to satisfy claims for cash. Thus, the risks to the taxpayer inherent in SIPC are less than those associated with the deposit insurance system.

SEC and self-regulatory organizations, such as the New York Stock Exchange, are responsible for enforcing the net capital and customer protection rules. However, if a firm is in danger of failing and customer accounts are at risk, SIPC may initiate liquidation proceedings. SEC and industry participants do not expect that SIPC's back-up role in liquidating firms should be needed very often, which both reduces SIPC's exposure to loss and minimizes potential adverse market impacts. SIPC liquidation proceedings can be quite complex, and it can take weeks or longer before customers receive the bulk of their property.

In the 20 years since its inception, SIPC has been called on to liquidate 228 firms, most of which have involved fewer than 1,000 customers. The revenues available to the SIPC fund have been sufficient to meet all liquidation and administrative expenses, which totaled $236 million. As of December 31, 1991, the accrued balance of the fund stood at $653 million, the highest level ever. After conducting a review of its funding needs, SIPC adopted a policy to increase its reserves to $1 billion by 1997. SIPC and SEC officials believe that reserves of this level, augmented by bank lines of credit of $1 billion and also by a $1 billion line of credit at the U.S. Treasury, will be more than sufficient to fulfill its back-up role in protecting against the loss of customer property.

Results in Brief

The regulatory framework within which SIPC operates has thus far been successful in protecting customers while at the same time limiting SIPC's losses. However, complacency regarding SIPC's continuing ability to be successful is not warranted because securities markets have grown more complex and the SIPC liquidation of a large firm could be very disruptive to the financial system. The central conclusion of this report—that SIPC's funding requirements and market stability depend on the quality of regulatory oversight of the industry—underscores the need for SEC and self-regulatory organizations to be diligent in their oversight of the industry and their enforcement of the net capital and customer protection rules.

No objective basis exists for setting the right level for SIPC reserves, but GAO believes that efforts to plan for the SIPC fund's future needs by increasing SIPC's reserves represent a responsible approach to dealing with the fund's potential exposure. However, in view of the industry's dynamic nature, SIPC and SEC must make periodic assessments of the fund to adjust funding plans to changing SIPC needs. In particular, measures to strengthen the fund must be taken immediately if there is evidence that the customer protection and net capital rules are losing effectiveness.

While SIPC generally has received favorable comments from securities regulators and industry officials on its handling of past liquidations, it could do more to prepare for the potential liquidation of a large firm. SIPC's readiness to respond quickly by having the information and automated systems necessary to carry out a liquidation is important for the timely settlement of customer claims. The impact upon public confidence in the securities markets may be important in the liquidation of a large firm with thousands of customers.

SIPC and SEC could provide the public with more complete information about the nature of SIPC coverage. Certain SEC-registered firms that are not SIPC members, including some investment advisers, may act as intermediaries in the purchase and sale of securities to the public and have temporary access to customer funds. These firms are not required to disclose the fact that they are not SIPC members, even though their customers are subject to the risks of loss and misappropriation of their funds and securities. Better disclosure is needed so that customers can make informed investment decisions.

GAO's Analysis

Strong Enforcement Is the Key to Continued Success in Protecting Customers

To date, SIPC's role in providing back-up protection for customers' cash and securities has worked well. The securities industry has faced many difficult challenges since SIPC's inception, such as major volatility in the stock markets and numerous broker-dealer failures (including two of the largest securities firms within the past 3 years). Since 1971, more than 20,000 broker-dealers have failed or ceased operations, but SIPC has initiated liquidation proceedings for only 228—about 1 percent—of these firms. (See p. 22.)

Most firms involved in SIPC liquidations failed due to fraudulent activities. Within the last 5 years, 26 of 39 SIPC liquidations have involved failures due to fraud by firms that were acting as intermediaries between customers and firms authorized to hold customer accounts. Most firms that cease operations do not require a SIPC liquidation because they do not carry customer accounts, customer accounts are fully protected, or they and/or the regulators have made alternative arrangements to protect the customer accounts. (See pp. 29-31.)

In the future, SIPC losses can remain modest if SEC and self-regulatory organizations continue to successfully oversee the securities industry. But complacency is not warranted, and securities markets could be significantly disrupted if the enforcement of the net capital and customer protection rules proved insufficient to prevent a SIPC liquidation of a large securities firm. In that instance, customers of the firm could experience delays in obtaining access to their funds. In addition, the development of new products and the increasing risks associated with the activities of many of the larger securities firms pose special challenges to the regulators. (See pp. 36-39.)

SIPC Has Addressed Its Funding Needs

There is no scientific basis for determining what SIPC's level of funding should be because the greatest risk the fund faces—a breakdown of the effectiveness of the net capital and customer protection rules—cannot be foreseen. However, given the growing complexity and riskiness of securities markets, GAO believes that SIPC officials have acted responsibly in adopting a financial plan that would increase fund reserves to $1 billion by 1997. While GAO cannot conclude that this level of funding will be adequate, $1 billion should be more than sufficient to deal with cases of fraud at smaller firms, and it probably can finance the liquidation of one of the largest securities firms. The $1 billion fund may not, however, be sufficient to finance worst-case situations such as massive fraud at a major firm or the unlikely simultaneous failures of several of the largest broker-dealers. Periodic SIPC and SEC assessments must account for factors such as the size of the largest broker-dealer and any signs that regulatory enforcement of the net capital or customer protection rules has deteriorated. (See pp. 40-46.)

Improve SIPC Preparation for Liquidating a Large Firm

SIPC liquidations may involve delays and can expose customers to declines in the market value of their securities. To minimize delays, in the early 1980s a SIPC task force and SEC recommended that SIPC prepare for potential liquidations of large firms. However, SIPC continues to make only limited preparations for the potential liquidations of large troubled firms. SIPC believes it is unlikely it will ever be called on to liquidate a large firm and cites its record of success as demonstrating its ability to liquidate any firm. (See pp. 54-57.)

GAO has no reason to question the way SIPC has conducted liquidations. However, those liquidations have all been of relatively small firms. GAO is concerned that lack of preparation and planning may limit SIPC's ability to ensure the prompt return of customer property in the event it was called on to liquidate a large, complex firm. SIPC could have been better prepared to conduct the liquidation of a large firm that could have become a liquidation in 1989. In addition, SIPC has not analyzed automation options and may be limited in its ability to ensure that the trustee of a major liquidation would be able to acquire a timely and cost-effective automation system. Working with SEC, SIPC should improve its capabilities in these areas. (See pp. 57-61.)

Improve Disclosure to Customers

SIPC-member broker-dealers are required to display a SIPC symbol to notify their customers that they are SIPC members. They are also encouraged to provide customers with a brochure that explains SIPC protection. GAO believes that this brochure could be modified to clarify areas of confusion that have been raised by customers—for example, that customers of firms that fail or go out of business have only 6 months to file a claim. (See pp. 65-67.)

However, the greatest opportunity for customer confusion arises from SEC-registered firms that act as intermediaries in the purchase and sale of securities products to customers. These firms include some SIPC-exempt broker-dealers and certain types of investment advisory firms. These firms may have temporary access to customer property but are not required to disclose that they are not SIPC members. Some customers have purchased securities from nonmember intermediaries that were affiliated or associated with SIPC firms and were not protected by SIPC when the intermediary firm failed. Customers of these intermediary firms risk loss of their property by fraud and mismanagement. GAO believes that customers should receive information on the SIPC status of SEC-registered intermediary firms that have access to customer funds and securities so that they can make informed investment decisions. (See pp. 67-72.)

Recommendations

The chairmen of SIPC and SEC should periodically review the adequacy of SIPC's funding arrangements (see p. 53). The chairmen should also work with self-regulatory organizations to improve SIPC's access to the information and automated systems necessary to carry out a liquidation of a large firm on as timely a basis as possible. In addition, the SEC Chairman should periodically review SIPC operations to ensure that SIPC liquidations are timely and cost effective (see p. 62).

Finally, the chairmen of SIPC and SEC, within their respective jurisdictions, should review and, as necessary, improve disclosure information and regulations to ensure that customers are adequately informed about the SIPC status of SEC-registered financial firms that serve as intermediaries in customer purchases of securities and have access to customer property (see p. 72).

Agency Comments

SEC and SIPC provided written comments on a draft of this report (see apps. II and III). SEC and SIPC agreed with GAO's assessment of the condition of the SIPC fund and with GAO's recommendation for periodic evaluation of the fund's adequacy. SEC also agreed with GAO's recommendations to improve its oversight of SIPC's operations and to consider some expansion of SEC disclosure regulations. SIPC agreed with GAO's recommendation to improve SIPC disclosures to customers. SEC and SIPC did not believe that problems exist in obtaining information or acquiring automated liquidation systems, but they agreed to review their policies and consider GAO's recommendations in these areas.

Contents

Abbreviations

DTC	Depository Trust Corporation
FDIC	Federal Deposit Insurance Corporation
FDR	Fitzgerald, DeArman, and Roberts, Inc.
FOCUS	Financial and Operational Combined Uniformed Single report
NASD	National Association of Securities Dealers, Inc.
NYSE	New York Stock Exchange
OCC	Options Clearing Corporation
SEC	Securities and Exchange Commission
SIPA	Securities Investor Protection Act
SIPC	Securities Investor Protection Corporation
SRO	self-regulatory organization
WBP	Waddell Benefit Plans, Inc.

Introduction

This report was prepared in response to requests from the chairmen of the Senate Banking Committee and the House Energy and Commerce Subcommittee on Oversight and Investigations that we review the effectiveness of the Securities Investor Protection Corporation (SIPC). SIPC, a private, nonprofit membership corporation established by Congress in 1970, provides certain financial protections to the customers of failed broker-dealers. As requested, this report assesses several issues, including the exposure and adequacy of the member-financed SIPC fund, the effectiveness of SIPC's liquidation efforts, and the disclosure of SIPC protections to customers.

Background

The Securities Investor Protection Act of 1970 (SIPA), which created SIPC, was passed to address a specific issue within the securities industry: how to ensure that customers recover cash and securities from broker-dealers that fail or cease operations and cannot meet their obligations to customers. To address this issue, SIPA authorized the Securities and Exchange Commission (SEC) to promulgate financial responsibility rules designed to strengthen broker-dealer operations and minimize SIPC's exposure. The rules require broker-dealers to (1) maintain sufficient liquid assets to satisfy customer and creditor claims and (2) safeguard customer cash and securities. SIPC serves a back-up role and is generally called upon to compensate the customers of firms that fail due to fraud and cannot meet their obligations to customers.[1]

When a troubled firm cannot fulfill its obligations to customers, SIPC initiates liquidation proceedings in federal district court. The court appoints an independent trustee or, in certain small cases, SIPC itself to liquidate the firm if the court agrees that customers face losses. After the case is moved to federal bankruptcy court, SIPC oversees the liquidation proceedings, advises the trustee, and advances payments from its fund if needed to protect customers. Customers of a firm in liquidation receive all securities registered in their name and a pro rata share of the firm's remaining customer cash and securities. Customers with remaining claims for securities and cash may each receive up to $500,000 from the SIPC fund, of which no more than $100,000 can be used to protect claims for cash. SIPC coverage applies to most securities—notes, stocks, bonds, debentures, certificates of deposit, and options on securities—and cash deposited to purchase securities. However, SIPC coverage does not include,

[1]The regulators require operating firms to maintain blanket fidelity bonds to protect customers against the fraudulent misappropriation of their property.

among other things, any unregistered investment contracts, currency, commodity or related contracts, or futures contracts.

Congress enacted SIPA in response to what is often referred to as the securities industry's "back-office crisis" of the late 1960s, which was brought on by unexpectedly high trading volume. This crisis was followed by a sharp decline in stock prices, which resulted in hundreds of broker-dealers merging, failing, or going out of business. During that period, some firms used customer property for proprietary activities, and procedures broke down for the possession, custody, location, and delivery of securities belonging to customers. The breakdown resulted in customer losses exceeding $100 million because failed firms did not have their customers' property on hand. The industry attempted to compensate customers through voluntary trust funds financed by assessments on broker-dealers. However, industry officials, SEC, and Congress subsequently agreed that the trust funds were inadequate,[2] and that an alternative—SIPC—was needed to better protect customers and maintain public confidence.

SIPC's Structure and Membership

SIPA defines SIPC's structure and identifies the types of broker-dealers that are required to be SIPC members. Under SIPA, SIPC has a board of seven directors that includes government and industry representatives and determines policies and oversees operations.[3] Among other duties, the board has the obligation to examine the condition of the SIPC fund and ensure that it has sufficient money to meet anticipated liquidation expenses. SIPC has one office located in Washington, D.C., and employs 32 staff members. SIPC spent about $5.1 million in 1991 to pay salaries, travel, and other operating expenses.

SIPA authorizes SEC to oversee SIPC and ensure that SIPC fulfills its responsibilities under the act. For example, SIPC must submit all proposed rules to SEC for review and approval. SEC's oversight responsibilities for SIPC are generally similar to SEC's oversight responsibilities for the self-regulatory organizations (SRO)—the national exchanges such as the New York Stock Exchange (NYSE) and the National Association of

[2]The trust funds failed for the following reasons: (1) the size of the funds was inadequate, (2) the exchanges disbursed money from the funds on a voluntary basis, and (3) the funds did not protect customers of firms that were not members of the exchanges.

[3]The president of the United States appoints five of the directors, subject to Senate approval. Two of these appointees—the chairman and the vice-chairman—must be from the general public; the other three represent the securities industry. The secretary of the Treasury and the Federal Reserve Board appoint officers of their respective organizations to serve as the sixth and seventh directors.

Securities Dealers, Inc. (NASD). SROS, whose boards are elected by their members, are private corporations that examine broker-dealers, monitor their compliance with the securities laws and regulations, and, along with SEC, notify SIPC when a broker-dealer experiences financial problems.

With certain exceptions discussed below, all firms registered as broker-dealers under section 15(b) of the Securities Exchange Act of 1934 are required to become SIPC members regardless of whether they hold customer accounts or property. As of December 31, 1991, SIPC had 8,153 members. Of this total, only 954 (12 percent) were carrying firms that had met the SEC requirements for holding customer property or accounts.[4] The other 7,199 SIPC members (88 percent) were either (1) introducing firms, which serve as agents between the customers and the carrying firms and handle customer property for limited periods,[5] or (2) firms that trade solely for their own accounts on the national securities exchanges.

Data were not available to determine the total amount of customer property that is protected by SIPC. SEC does not routinely collect data on the amount of fully paid customer securities held by broker-dealers that would make up the bulk of SIPC's potential exposure. However, SEC and SIPC officials estimated that broker-dealers hold over $1 trillion of SIPC-protected customer property based on data from the 20 largest broker-dealers.[6]

SIPA excludes broker-dealers whose principal business, as determined by SIPC subject to SEC review, is conducted outside the United States, its possessions, and territories. A SIPC official said that SIPC reviews applications for exclusion on a case-by-case basis. Moreover, SIPA excludes broker-dealers whose business consists exclusively of (1) distributing shares of registered open-end investment companies (mutual funds) or unit investment trusts, (2) selling variable annuities, (3) providing insurance, or (4) rendering investment advisory services to registered investment companies or insurance company separate accounts.

[4]These carrying firms also include clearing firms that hold customer property for a limited period solely to settle trades.

[5]For example, the introducing firm may send a customer's check to the clearing firm as payment for executing a trade.

[6]SEC officials stated that information on the amount of SIPC-protected customer property is not collected for several reasons: (1) the value of customer securities is marked-to-market and changes continuously; (2) gathering this information would be expensive and require significant computer capability, which would be especially difficult for small firms; and (3) SEC has not needed the data for regulatory purposes.

SIPC Has Back-Up Customer Protection Role

Congress established SIPC as one part of a broader regulatory framework to protect the customers of U.S. broker-dealers. Congress also required SEC to issue financial responsibility rules designed to improve the operations of broker-dealers and prevent the types of abuses that occurred during the 1960s back-office crisis. The two key financial responsibility rules are the customer protection rule and the net capital rule.

In 1972, SEC issued a customer protection rule (rule 15c3-3) that requires firms to safeguard customer cash and securities and forbids their use in proprietary activities. In 1975, SEC strengthened its net capital rule (rule 15c3-1). The net capital rule requires firms to have sufficient liquid assets on hand to satisfy liabilities, including customer and creditor claims.

SROs and SEC are responsible for monitoring broker-dealer compliance with the customer protection and net capital rules and for closely monitoring the activities of financially troubled firms. Generally, the regulators are able to arrange the transfer of all customer accounts at troubled firms to other firms or to return customer property directly to customers if the troubled firms are in compliance with the SEC rules. A SIPC liquidation becomes necessary if customer cash and securities are missing or if the SRO feels that there is not enough money to self-liquidate.

SIPC Protections Differ From Deposit Insurance Protections

SIPC's protections differ fundamentally from federal deposit insurance protections for bank and thrift depositors, which are administered by the Federal Deposit Insurance Corporation (FDIC).[7] SIPC does not protect investors from declines in the market value of their securities. The major risk that SIPC faces, therefore, is that broker-dealers will lose or steal customer cash and securities and violate the customer protection or net capital rules. By contrast, FDIC protects the par value of deposits and accrued interest payments up to $100,000.[8]

Suppose that a customer purchased one share of XYZ Corporation for $100 through a broker-dealer, and the firm held the security. The market value of the share then declined to $50. If the broker-dealer failed and the share was missing, SIPC would advance $50 so that the trustee could purchase one share of XYZ Corporation. SIPC would not protect the customer against the share's $50 market loss. By contrast, FDIC would pay an individual with

[7]The other deposit insurer is the National Credit Union Administration, which protects the customers of credit unions.

[8]Customers receive similar protection from both FDIC and SIPC for cash claims of up to $100,000.

a $100 deposit the full $100 if the bank failed, even if the assets of the bank were worth 50 percent of their book value.

Another difference is that SEC's customer protection rule prevents broker-dealers from using customers' securities and funds for proprietary purposes. By contrast, the essence of banking is that banks use insured deposits to make loans and other investments. Consequently, by guaranteeing the par value of deposits, FDIC protects depositors not only against the disappearance of deposits due to bookkeeping errors or fraud but also against bad investment decisions by such banks. It is much riskier for the government to protect depositors against the consequences of bad investments, as FDIC does, than only against missing property, as SIPC does.

There is also a difference in the amount of customer property that is protected. SIPC protects customer losses of up to $500,000 after all customer funds and securities have been distributed on a pro rata basis from the failed firm's separate account that includes all customer property. This means that a customer with a claim for $5 million of stock who received $4.5 million of their stock from the pro rata distribution would then receive an additional $500,000 worth of securities from SIPC. Creditors of the failed securities firm cannot claim assets from the firm's customer property account. By contrast, bank depositors are assured of recovering their deposits only up to the $100,000 limit; if they had any deposits exceeding $100,000, in many cases they are required to join all other creditors for a pro rata share of the remaining failed bank assets.

Finally, SIPC and FDIC protections differ in that the customers of broker-dealers liquidated by SIPC trustees are likely to wait longer to receive compensation than are insured bank depositors. Under SIPA, customers frequently must file claims with the trustee before receiving their property. Although trustees and SIPC have the authority to arrange bulk transfers of customer accounts to acquiring firms to speed up the process, such transfers are not always possible if the firm failed due to fraud, if it kept inaccurate books and records, or if its accounts were of poor quality. Moreover, a bulk transfer can take weeks or longer to arrange. In contrast, FDIC frequently transfers the insured deposits of failed banks to other banks over a weekend.

SIPC Reserves Are Increasing

Between 1971 and 1991, SIPC initiated liquidation proceedings against 228 failed firms. As of December 31, 1991, SIPC trustees had completed 183 of the 228 liquidation proceedings. The 183 completed liquidations had an average of about 930 customer accounts and cost SIPC about $500,000 per liquidation in customer protection and administrative expenses. At year-end 1991, the other 45 liquidation proceedings remained open because trustees were still processing claims or litigating matters, such as civil actions against former firm officials.[9]

As of December 31, 1991, SIPC's cumulative operational expenses totaled $63 million and liquidation expenses for closed cases and open proceedings totaled $236 million. Of the $236 million, SIPC used $175 million to satisfy customer claims for missing cash and securities and $61 million to pay administrative costs, such as trustees fees and litigation expenses. (See table 1.1.)

Table 1.1: SIPC's Cumulative Expenses for the Years 1971-1991

Type of expense	Total expense
SIPC operations	$62,575,788
Liquidation expenses	
Administrative costs	61,032,655
Customer claims	174,834,104
Total	**$298,442,547**

Source: SIPC.

To acquire the cash necessary to pay liquidation expenses and maintain a reserve fund, SIPC levies assessments on the revenues of member firms and also earns interest on the invested fund balance. When SIPC was first established, the assessment was 0.5 percent of a firm's gross revenues from the securities business of each member.[10] Rates fluctuated from that time depending on the level of expenses, and for several years the assessment was nominal. Following the stock market crash of 1987, the SIPC board decided to increase the assessment rate to 0.019 percent of gross revenues. In 1990, SIPC assessments amounted to $73 million, based upon industry gross revenues of $39 billion.

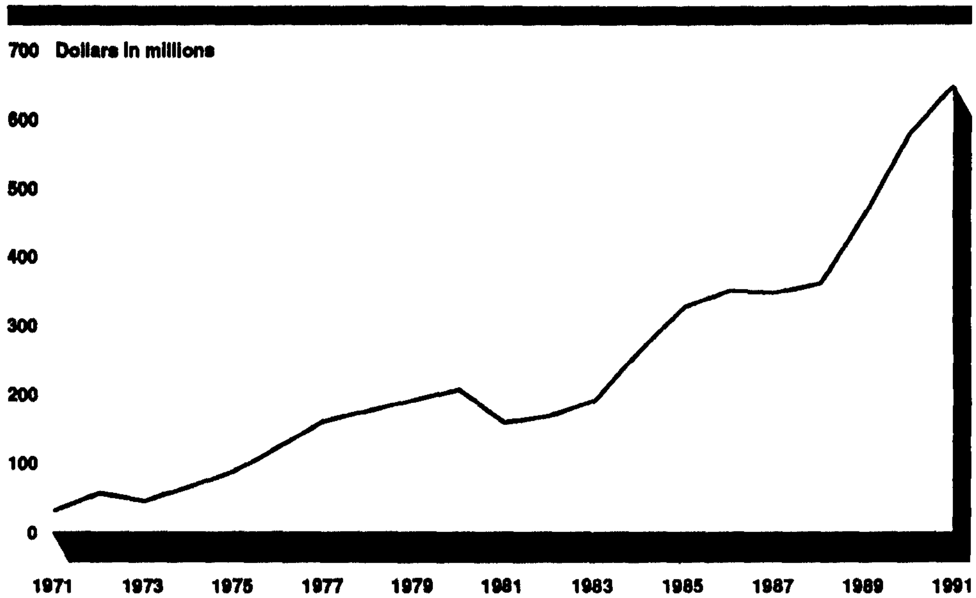
Because of the assessment increases, interest income, and low liquidation expenses, SIPC's accrued fund balance has increased significantly in recent

[9]Litigation matters were still pending in 37 of the 45 cases. In those 37 cases, the trustees had already satisfied all customer claims.

[10]Gross revenues, as specified in SIPA, include fees and other income from various categories of the securities business but do not include revenues received by a broker-dealer in connection with the distribution of shares of a registered open-end investment company or unit investment trust, from the sale of variable annuities, or from insurance business. In 1990, gross revenues were about 54 percent of total industry revenues.

years (see fig. 1.1).[11] As of December 31, 1991, the accrued balance of SIPC's fund was $653 million, its highest level since SIPC's inception and an 87-percent increase over the fund balance at year-end 1987. SIPC also maintained a $500 million line of credit with a consortium of U.S. banks at year-end 1991. In addition, SIPC has the authority to borrow—through SEC—up to $1 billion from the U.S. Treasury.

Figure 1.1: SIPC Accrued Fund Balance, 1971-1991



Source: SIPC.

In 1991, the SIPC board reviewed the adequacy of the fund size and bank borrowing authority in light of potential liquidation expenses. Based on the review, the board decided to build the fund at a 10-percent annual rate with a goal of $1 billion by 1997. To accomplish this goal, the board set the assessment rate at 0.065 percent of each firm's net operating revenues; this action resulted in assessment revenue in 1991 of $39 million—a $34 million

[11]The SIPC fund, as defined by SIPA, consists of cash and amounts invested in U.S. government or agency securities while the accrued fund balance represents SIPC's assets minus funds needed to complete ongoing liquidations.

reduction from the amount collected in the previous year.[12] In 1991, the fund increased by $47 million due to interest revenue. The board also decided to raise SIPC's bank line of credit to $1 billion beginning in 1992. Over the next 4 years, $250 million of credit will come due annually and may be renewed. The line of credit was arranged with a consortium of banks and cannot be canceled by the banks, but the banks could decline to renew as each portion of the line comes up for renewal.

Objectives, Scope, and Methodology

We received separate requests from the chairmen of the Senate Banking Committee and the House Energy and Commerce Subcommittee on Oversight and Investigations to assess several issues, including (1) the exposure and adequacy of the SIPC fund, (2) the feasibility of supplemental funding mechanisms such as private insurance, (3) the effectiveness of SIPC's liquidation efforts, and (4) the disclosure of SIPC protections to customers. We were also asked to determine whether SIPC needs the authority to examine the books and records of its members and to take enforcement actions.

To gain a basic understanding about how SIPC and the securities regulatory framework protects customers, we reviewed SIPA and its legislative history, SEC's net capital and customer protection rules, and SIPC bylaws and internal documents. We also reviewed our previous reports on the securities industry.

During our review, we determined that no quantifiable measure exists to assess the exposure of the SIPC fund and the adequacy of its reserves (such as the ratio of reserves to insured deposits, which FDIC uses to assess the exposure of the Bank Insurance Fund). As a result, we based our conclusions about the SIPC fund's ability to protect customers and maintain public confidence in the markets on such factors as SIPC's past expenses, current trends in the securities industry, the regulators' enforcement of the net capital and customer protection rules, and SIPC's policies and procedures.

We reviewed the principal studies used by the SIPC board in making its judgments: a report prepared by the Deloitte and Touche accounting firm and a report on SIPC's assessment policies prepared for SIPC by a task force

[12]Net operating revenue-based assessments allow broker-dealers to deduct all interest expense from securities business revenue. Broker-dealers also have the option of continuing to deduct 40 percent of interest revenue from margin accounts.

of regulatory and industry officials.[13] We did not independently duplicate the methodology of these studies, but we assessed the reasonableness of the studies and the board's decisions in light of the risk characteristics of the industry, the history of SIPC liquidations, the effectiveness of the regulatory structure, and recent developments within the industry. We discussed the reports and SIPC fund issues with senior SIPC officials, SEC officials in the Division of Market Regulation and the New York Regional Office, officials at NYSE and the NASD, officials at the Federal Reserve Board and the Federal Reserve Bank of New York, and an official at the Department of the Treasury. We also interviewed the individuals who wrote the Deloitte and Touche report and industry representatives to ascertain their views on the adequacy of the SIPC fund.

We did not conduct a comprehensive review of the efficiency of SIPC's liquidations proceedings; rather, we focused on SIPC's preparations for liquidations that could affect the timeliness of customers' ability to access their accounts. We also looked at the SEC's oversight efforts and reviewed a 1985 SEC letter to the SIPC chairman reporting on SEC's review of SIPC's operations, which is the only written evaluation SEC has issued on SIPC's operations. We discussed SIPC's annual financial audits with its independent auditor, Ernst and Young. We also contacted the trustees of four large SIPC liquidations (as measured by SIPC expenditures and number of customer claims paid). We interviewed the trustees of the two most expensive liquidations to date—Bell and Beckwith, and Bevill, Bresler & Schulman, Inc. In addition, we interviewed the trustee who liquidated the largest firm, Blinder Robinson and Co., Inc. (as measured by the number —61,000—of customer claims paid) and contacted the trustee who liquidated Fitzgerald, DeArman, and Roberts, Inc. (FDR) in the largest bulk transfer to date (30,000 accounts). Moreover, we discussed with senior SIPC officials their efforts to prepare for the liquidations of two large firms that could have become SIPC liquidations—Thomson McKinnon Securities Inc. and Drexel Burnham Lambert Incorporated.

We reviewed SIPC bylaws and SEC regulations to determine the requirements for SEC-registered firms to disclose their SIPC status. We also reviewed SIPC and SEC customer correspondence and litigation relating to customer protection issues to assess customer concerns in this area.

We did our work between May 1991 and May 1992 in accordance with generally accepted government auditing standards.

[13]See The Securities Investor Protection Corporation: Special Study of the SIPC Fund and Funding Requirements, Deloitte and Touche, October 8, 1990. Also see Report and Recommendations of the SIPC Task Force on Assessments, presented to the SIPC Board of Directors September 26, 1991.

Agency Comments

SIPC and SEC provided written comments on a draft of this report. Relevant portions of their comments are presented and evaluated at the end of chapters 3 through 5. The comments are reprinted in their entirety as appendixes II and III. They also provided technical comments on the draft, which were incorporated as appropriate.

The Regulatory Framework Is Critical to Minimizing SIPC's Exposure

As we pointed out in chapter 1, the regulatory framework—including the net capital and customer protection rules—serves as the primary means of customer protection while SIPC serves in a back-up role. Since Congress passed SIPA in 1970, the regulatory framework has successfully limited the number of firms that have become SIPC liquidations. The firms that SIPC has liquidated failed primarily because their owners committed fraud and misappropriated customer cash and securities. Given the relative success of the regulatory framework, which relies largely on SEC and the SROs to prevent SIPC liquidations, we do not believe that SIPC needs the authority to examine its members. However, SEC and the SROs must continue to enforce existing rules to ensure that SIPC can fulfill its back-up role and maintain public confidence in the securities industry. The regulators' ability to protect SIPC in the future could prove challenging due to the continued consolidation of the industry and increased risk-taking by major firms.

Few SIPC Liquidations Needed to Protect Customers

The U.S. securities industry consists of thousands of broker-dealers, many of which are small and not allowed to hold customer property. The regulatory framework and the restrictions on the holding of customer property ensure that hundreds of broker-dealers can fail or cease doing business each year without becoming SIPC liquidations. As table 2.1 indicates, 20,344 SIPC members went out of business or failed between 1971 and 1991, but only 228 (about 1 percent) became SIPC liquidations. Moreover, the number of SIPC liquidations begun annually has declined since the early 1970s. Between 1971 and 1973, SIPC initiated an average of 31 liquidations a year. Since 1975, SIPC has initiated an average of seven liquidations a year.

Table 2.1: SIPC Membership and Liquidations, 1971-1991

Year	SIPC members	Non-SIPC terminations[a]	SIPC liquidations
1971	3,994	[b]	24
1972	3,756	669	40
1973	3,974	622	30
1974	4,238	551	15
1975	4,372	631	8
1976	5,168	219	4
1977	5,412	637	7
1978	5,670	663	4
1979	5,985	637	6
1980	6,469	635	5
1981	7,176	741	10
1982	8,082	706	8
1983	9,260	666	7
1984	10,338	1,176	9
1985	11,004	1,059	12
1986	11,305	1,354	8
1987	12,076	1,033	4
1988	12,022	1,430	5
1989	11,284	1,791	6
1990	9,958	2,279	8
1991	8,153	2,845	8
Total		**20,344**	**228**

[a]Number of terminations listed in SIPC's annual reports minus the number of SIPC liquidations.

[b]SIPC did not report on membership terminations in 1971.

Source: SIPC annual reports, 1971-1991.

Many of the 20,344 firms that went out of business without SIPC involvement were introducing firms or firms that trade solely for their own accounts on national securities exchanges and do not hold customer property. In the absence of fraud, introducing firms can fail, disband, or cease doing business without becoming SIPC liquidations. However, SIPC protection is extended to these firms because fraudulent activities—such as theft of money or securities—could result in customer losses. The partners of a small firm who trade solely for their own account may decide to sell the firm's proprietary securities and cease doing business. A SIPC official also said that SIPC's membership may fluctuate because individuals tend to form broker-dealer firms during market upturns, as in the early to mid-1980s. Many firms may later cease doing business or fail when market downturns occur, as happened after 1987.

According to a SIPC official, the SIPC liquidation caseload peaked in the early 1970s because many firms still suffered operational and financial problems associated with the "back-office crisis" discussed earlier. The number of SIPC liquidations has declined since 1975 as a result of the introduction of the customer protection rule, the strengthening of the net capital rule, and improved supervision by the regulators. Moreover, before financially troubled firms actually fail, the regulators frequently arrange for the transfer of their customer accounts to acquiring firms. For example, between 1980 and 1990, NYSE and SEC arranged account transfers for 21 of the 25 NYSE members that went out of business under financial duress and protected about 2.7 million customer accounts. SIPC liquidated the other four firms, which, combined, had about 112,500 customer accounts.[1] In its 20-year history, SIPC has paid about 329,000 customer claims.

How the Regulators Have Protected Customers While Minimizing SIPC's Exposure to Losses

The customers of broker-dealers that fail or go out of business without becoming SIPC liquidations generally can continue trading in their accounts without any delays or disruptions if their accounts are transferred to other firms or if their property is returned. The regulatory foundations of this customer protection are the net capital and customer protection rules. The regulators routinely monitor broker-dealer compliance with the rules and place financially troubled firms under intensive supervisory scrutiny. The regulators may also arrange for the transfer of the accounts of troubled firms to acquiring firms via computer.

Net Capital Rule

The net capital rule requires each broker-dealer to maintain a minimum level of liquid capital sufficient to satisfy its liabilities—the claims of customers, creditors, and counterparties. Net capital is similar to equity capital in that it is based on an analysis of each broker-dealer's balance sheet assets and liabilities. Unlike equity capital, however, only liquid assets—such as cash, proprietary securities that are readily marketable, and receivables collateralized by readily marketable securities—can be counted in the net capital calculation. Assets that are not considered liquid include furniture, the value of exchange seats, and unsecured receivables.

[1]The four firms were John Muir & Co., Bell and Beckwith, Hanover Square Securities Group, and H.B. Shaine & Co., Inc.

The proprietary securities that qualify for inclusion in the net capital calculation must be carried at their current market value. Even after securities positions are marked to reflect market value, the net capital rule offers further protection by requiring broker-dealers to deduct a certain percentage of the market value of all proprietary security positions from the capital of the firm. These deductions—or "haircuts"—are intended to reflect the actual liquidity of the broker-dealers' proprietary securities by providing a cushion for possible future losses in liquidating the positions. For example, debt obligations of the U.S. government receive a haircut depending on their time to maturity: from a 0-percent haircut for obligations with less than 3 months to maturity to a 6-percent haircut for obligations with 25 years or more to maturity. Haircuts for more risky assets can be much higher.

SEC also allows broker-dealers to include subordinated liabilities that meet the rule's requirements in the net capital calculation. In order to count toward net capital, these subordinated liabilities must be subordinated to the claims of all present and future creditors, including customers, and must be approved for inclusion as net capital by the broker-dealer's SRO. The subordinated liabilities may not be repaid if the repayment would reduce the broker-dealer's net capital level below a level specified by the rule, and the liabilities must have an initial term of 1 year or more.

The minimum amount of net capital required varies from broker-dealer to broker-dealer, depending upon the activities in which the firm engages. Because they hold customer property, carrying firms have higher minimum capital requirements than introducing firms. In addition, the regulators have established "early-warning" levels of net capital that exceed the minimum requirement. As discussed below, the SROs notify SEC and place restrictions on firms whose capital falls to the early warning levels. They also begin consultations with the ailing broker-dealer to formulate a recovery plan. Should the plan fail, the regulators may try to arrange a transfer of the customer accounts to one or more healthy broker-dealers.

As soon as the net capital falls below the minimum level, the firm is closed. Closing a broker-dealer before insolvency either makes the firm a viable merger candidate (because there is residual value left in the firm) or allows the broker-dealer's customers to be fully compensated when the firm is liquidated.

Customer Protection Rule

The customer protection rule (rule 15c3-3) applies to carrying firms because they hold customer securities and cash. The rule requires the firms to have possession or control of customers' securities. As a result, the rule minimizes the need for SIPC liquidations because financially troubled firms can return customer property or send it to acquiring firms under the supervision of the regulators.

The customer protection rule has two provisions. The first provision requires broker-dealers to maintain possession or control[2] of customers' fully paid and excess-margin securities.[3] This requirement prevents broker-dealers from using customer property to finance proprietary activities because fully paid and excess-margin securities must be in possession or control locations. The rule also forces the broker-dealer to maintain a system capable of tracking fully paid and excess-margin securities daily.

The second provision of the customer protection rule involves customer cash kept at broker-dealers for the purchase of securities. When customer cash—the amount the firm owes customers—exceeds the amount customers owe the firm, the broker-dealer must keep the difference in a special reserve bank account. The amount of the difference is calculated weekly using the reserve account formula specified in the customer protection rule.[4] The rule assumes that all margin loans will be collected because they are collateralized by the securities in customer margin accounts. A sharp and sudden decline in the market value of this collateral would render the loans unsecured; hence, these loans are required to be overcollateralized.

[2]The customer protection rule specifies the locations in which a security will be considered in possession or control of the broker-dealer. This includes those securities that are held at a clearing corporation or depository, free of any lien; carried in a Special Omnibus Account under Federal Reserve Board regulation T with instructions for segregation; a bona fide item of transfer of up to 40 days; in the custody of foreign banks or depositories approved by SEC; in a custodian bank; in transit between offices of the broker-dealer; or held by certain subsidiaries of the broker-dealer.

[3]Excess-margin securities in a customer account are margin securities with a market value in excess of 140 percent of the account debit balance (the amount the customer owes the firm). For example, assume that a firm has a customer account with 100,000 shares of stock and that each share has a $10 market value, for a total account value of $1,000,000. The customer pays for $900,000 worth of stock and purchases the remaining $100,000 worth on margin from the broker-dealer. Applying the 140 percent to the $100,000 owed by the customer results in $140,000 worth of margin securities that the broker-dealer can use as collateral on the original $100,000 loan. To calculate the excess-margin securities in the account, subtract $140,000 from the market value of $1,000,000. The broker-dealer must have $860,000 worth of excess-margin securities in its possession or control.

[4]See appendix I for a more detailed explanation of the reserve formula and the customer protection rule.

Broker-dealers are subject to initial margin account requirements set by Federal Reserve Regulation T and SRO regulations that must be met before a customer may effect new securities transactions and commitments. In addition, maintenance margin requirements are set by the SROs and broker-dealers. The requirements specify how much equity each customer must have in an account when securities are purchased and how much equity must be maintained in that account. For example, the NYSE requirement for securities held long (owned by a customer but held by a brokerage firm) in a margin account is currently set at 25 percent of the current market value of the securities in the account.

With these customer protection rules in place and properly enforced, customers are assured that their cash—up to the $100,000 SIPA limit—is readily available and can be quickly returned. These rules also facilitate the unwinding of a failed firm through a self-liquidation, with oversight by the regulators, without the need for SIPC's involvement.

While the customer protection rule significantly limits SIPC's exposure, it does not completely eliminate the exposure. The rule includes provisions that are intended to minimize the compliance burden yet could potentially result in SIPC losses. For example, broker-dealers are required to make the cash reserve deposit calculation only once a week, on Friday, and to make the actual bank deposit the following Tuesday. Therefore, if a firm received large customer cash deposits on a Wednesday and became a SIPC liquidation on Thursday, it might not have sufficient cash in the reserve bank account to pay customer claims. SIPC might have to reimburse the customers for the cash deposits if the deposits could not be recovered from the firm's estate. Also, a broker-dealer is considered to be in compliance with the rule and in control of customer securities when the securities are in transfer between branch offices. A liquidation expert told us that this provision has been used by small, financially troubled broker-dealers to fraudulently disguise the fact that they do not have the required control over their customers' property.

Regulators Monitor Compliance With Rules on Routine Basis

SEC and SROs have established inspection schedules and procedures to routinely monitor broker-dealer compliance with the net capital and customer protection rules:

- The two largest SROs—NYSE and NASD—inspect their carrying members annually. During each exam, the examiners calculate the firm's net capital and assess the quality and accuracy of the automated systems it uses to maintain possession and control of customer fully paid and excess-margin securities.[5]

- SEC annually examines about 6 percent of the broker-dealers that the SROs have previously examined to ensure broker-dealer compliance with the securities laws and to evaluate and provide feedback to the SROs on the quality of their examination programs. Once every 2 years, SEC also examines the 20 largest broker-dealers that carry customer accounts.
- SEC requires broker-dealers to notify the regulators when their capital falls to certain levels above the minimum requirement and again if it falls below the minimum requirement.
- SEC requires carrying firms to submit financial and operational data monthly and requires introducing firms to report quarterly. The financial data include a computation of each firm's net capital and the amount in its reserve bank deposit account.
- SEC requires each broker-dealer to have its financial statements audited each year and to file the audited statements with the regulators.

The regulators' policy is to place firms with financial or operational problems under more intensive supervisory scrutiny than that outlined above. Evidence of such financial or operational problems include net capital levels that (1) decline to early warning levels that exceed the parameters or (2) lead to consecutive monthly losses. When such problems are detected, the regulators may require the firm to provide daily financial statements and restrict its activities, such as its ability to increase its asset size. The regulators may also begin to solicit other firms to acquire the troubled firm's customer accounts. If the troubled firm continues to deteriorate, the regulators may arrange for the transfer of its customer accounts to an acquiring firm or firms.

The regulators' ongoing monitoring and supervisory efforts are critical to minimizing SIPC's potential exposure. Regulators told us that they pay especially close attention to financially troubled broker-dealers. In an attempt to stay in business, financially troubled broker-dealers may be forced to alter their behavior in such a way as to increase SIPC's exposure if the firm fails and becomes a SIPC liquidation. For example, NYSE officials said that a financially troubled broker-dealer may be tempted to violate the customer protection rule by using fully paid customer securities as collateral in order to increase its short-term borrowings. This situation may arise if creditors have cut off their unsecured loans needed for liquidity purposes. If this broker-dealer does not recover and becomes a

[5]See Securities Regulation: Customer Protection Rule Oversight Procedures Appear Adequate (GAO/GGD-92-17, Nov. 21, 1991).

SIPC liquidation, SIPC may need to make advances to recover the customer property serving as collateral for these additional loans. To keep track of this sort of activity, SEC and the SROs frequently require troubled broker-dealers to report their daily bank and stock loan activity.

Most SIPC-Liquidated Firms Failed Due to Fraud

Although the regulatory framework has successfully protected millions of customers without the need for SIPC liquidations, SIPC has had to liquidate 228 firms. SIPC officials estimate that fraud—which can prove difficult for the regulators to detect—was involved in more than half of the 228 liquidations and accounted for about 81 percent of SIPC's $236 million in liquidation expenditures as of December 31, 1991. The fraudulent schemes have included not only the officials of carrying firms who illegally violated the customer protection and net capital rules but also officials at introducing firms who stole customer property that should have been sent to the carrying firms for the customers. Between 1986 and 1991, introducing firm failures accounted for 26 of SIPC's 39 liquidations. Other factors that have caused SIPC liquidations include poor management and market conditions.

Ordinarily, the regulators have time to transfer out a troubled firm's accounts because broker-dealer financial positions tend to deteriorate over a period of months or years. However, the regulators may not discover fraud until the principals of the firm have already depleted its capital or misappropriated customer assets. For example, in the most expensive liquidation —Bell and Beckwith (see table 2.2)—a senior firm official managed to "borrow" $32 million from the firm's margin accounts over a 5-year period without being detected by the regulators. As collateral for the loan, the official pledged stock in a Japanese corporation, which he valued at nearly $280 million; its real worth was approximately $5,000. When the fraud was discovered, SIPC initiated liquidation proceedings to protect customers.[6]

[6]The official spent time in federal prison, and the SIPC trustee, in conjunction with the Bevill, Bresler & Schulman, Inc., trustee, agreed to a $10 million settlement with the firm's auditors.

Table 2.2: Most Expensive SIPC Liquidations as of December 31, 1991

Firm	SIPC expenses	Cause of failure
Bell & Beckwith	$31,722,352	Firm official stole about $32 million from the firm by grossly inflating the value of collateral for the margin loan.
Bevill, Bresler & Schulman, Inc. (BBS)	26,395,628	BBS officials funded the losses of its affiliates. The losses continued to mount and resulted in failures of BBS and several affiliates.
Stix & Co., Inc.	16,990,497	Firm officials wrongfully diverted about $14 million from the firm by creating fictitious margin accounts. Officials used the funds to purchase real estate.
Joseph Sebag, Incorporated	11,351,787	Firm officials allegedly purchased shares without customers' permission and caused share prices to artificially increase. When share prices collapsed, Sebag failed because it had a substantial ownership position in the shares.
Government Securities Corp.	8,109,953	Firm officials allegedly set up fraudulent "managed accounts" for certain customers. Rather than executing trades, firm officials used customer funds for their own benefit.
Total	**$94,570,217**	

Source: SIPC.

Fraudulent sales practices may also increase financial and regulatory pressures on a firm and force it into a SIPC liquidation. For example, Blinder Robinson—the largest liquidation as measured by customer claims paid (61,000)—became a SIPC liquidation in July 1990 when its owner tried to put the penny stock firm[7] into a federal bankruptcy proceeding without the knowledge of SEC and SIPC. At the time, Blinder Robinson was under serious regulatory and financial pressure because SEC had been investigating the firm's sales practices for almost a decade and a Denver businessman had won a substantial legal judgment against the firm.[8] According to the SIPC trustee, Blinder Robinson's owner filed for bankruptcy so the firm could avoid its legal obligations. However, SIPC

[7]Penny stock firms specialize in selling the low-priced securities of highly speculative companies.

[8]NASD had first informed SIPC about Blinder Robinson's deteriorating position in August 1988.

filed liquidation proceedings against the firm because its customers were at risk, and the courts have agreed with SIPC.

To date, fraud at a major broker-dealer involving the possession or control requirement or the cash reserve calculation has not adversely affected SIPC. While fraud and questionable management practices have contributed to the demise of major broker-dealers, such as E.F. Hutton and Drexel, the regulators have had time to arrange the transfer of customer accounts without the need for SIPC liquidations.[9]

Other Factors That Have Caused SIPC Liquidations

Poor management and market conditions may also cause firms to fail with minimal warning and become a SIPC liquidation. For example, H.B. Shaine and Company, Inc., failed during the October 1987 market crash because management did not properly oversee the firm's options department. Certain customers engaged in risky options trading, which proved profitable while the market increased during the mid-1980s. However, when the market plunged on October 19, 1987, the Options Clearing Corporation (OCC) issued very high margin calls to the firm. Shaine officials could not collect sufficient margin payments from their options customers, and the firm had insufficient capital to pay the margin calls, so it was closed and turned over to SIPC. The trustee anticipates that the Shaine liquidation ultimately will impose minimal costs on SIPC because the firm had most customer property on hand and the administrative expenses will be recovered from the firm's estate. Of the approximately 30 broker-dealer firms that failed as a result of the October 1987 stock market break, only Shaine required a SIPC liquidation.

A SIPC official also said that SIPC has initiated liquidation proceedings to protect the customers of firms no longer in business. When a SIPC member broker-dealer chooses to cease operations, it should file a form with SEC and its withdrawal from registration becomes effective 60 days after the filing. SEC checks the form to see whether the firm owes any property to customers. If any amounts are owed, SEC asks the SROs to ensure that all customer property is returned. SEC should then notify SIPC of the firm's withdrawal date, which starts a 180-day countdown. During the next 180 days, SIPC must protect any customers who come forward with valid claims for cash or securities. Under SIPA, SIPC cannot initiate liquidation proceedings after the 180-day period has passed. SIPC correspondence files

[9]In E.F. Hutton's case, the firm merged with Shearson Lehman Brothers in 1988. In Drexel's case, the failure of the holding company due to fraud, the resulting settlement, and the concentration in high-yield securities impaired the broker-dealer's ability to trade and ultimately forced the broker-dealer into bankruptcy.

indicated that several customers have lost cash and securities because they filed claims after the 180-day deadline.

SIPA Liquidation Procedures Involve Delays

Customers benefit if the regulators can arrange to protect customer accounts without the need for SIPC liquidations because the customers generally do not lose access to their investments. However, if a SIPC liquidation becomes necessary, SIPC and the trustees must comply with SIPA procedures (see table 2.3), such as freezing all customer accounts. The period of time during which customers are denied access to their accounts depends upon whether the trustee pays claims account by account via the mail or arranges a bulk transfer of customer accounts to acquiring firms. According to SIPC officials, bulk transfers often permit customers to trade in their accounts within days or weeks of the liquidation's commencement, although the process can take longer. Payment of claims account by account can take months. For example, when FDR failed in 1988, the trustee used the bulk transfer authority to satisfy about 25,000 (80 percent) of 30,000 claims within 3 months of the liquidation's commencement. By contrast, the trustee of Blinder Robinson had to pay about 61,000 customer claims on an account-by-account basis. The trustee had paid out about half of the claims 6 months after the start of the liquidation, and the entire process took about a year.

When the liquidation process denies customers access to their accounts for extended periods, they can be exposed to declines in the market value of their securities. The market risks facing customers were exemplified by the failure of John Muir & Co. in August 1981. An NYSE member, Muir had approximately 16,000 customer accounts. While the SIPC trustee arranged the transfer of about 8,000 accounts within 10 days of the liquidation's commencement and another 4,700 accounts within 3 months, it took 7 months or more to satisfy the remaining accounts, primarily because of disputes over how much the customers owed Muir. The delay adversely affected many of the Muir customers, who were denied access to their accounts. For example, one customer who owned $500,000 worth of stock at the start of the Muir liquidation received shares worth about $350,000 from the trustee 14 months later.

Table 2.3: SIPA Liquidation Proceedings

Step	Overview
Regulators notify SIPC about troubled firm.	SEC and the SROs have the responsibility to examine SIPC members. Under SIPA 5(a), regulators must notify SIPC when a firm is in or approaching financial difficulty, such as substantially declining net capital levels.
SIPC initiates liquidation proceedings.	SIPC may initiate liquidation proceedings in federal district court if customers are at risk.
Court appoints trustee to liquidate firm.	If the court agrees with SIPC, it may appoint an independent trustee and counsel to liquidate the firm. Trustee may hire legal staff, and then the case is removed to federal bankruptcy court.
Accounts are frozen and trustee completes "housekeeping" tasks.	Trustee secures firm offices and customer and creditor accounts, hires liquidation staff, locates customer property, and begins notification process.
Customers file claim with trustee.	Customers have 6 months to file a claim. Trustee's staff and SIPC officials review claims to ensure accuracy. Customers can appeal trustee's decision on claims to bankruptcy judge.
Trustee distributes customer property up to SIPA limits.	Trustee distributes customers' name securities and approves claims up to SIPA limits of $500,000 ($100,000 cash) per customer. SIPC makes advances to cover missing cash and securities.

Source: SIPC.

Payment of claims account by account can be time consuming because it is a labor-intensive process, particularly for large firms. For example, a SIPC official said the bulk transfer of a major firm's accounts may involve several employees, and an official involved in the Blinder Robinson liquidation said that paying claims account by account required 26 employees during the initial stages of the liquidation. After the staff and SIPC officials had reviewed and approved each customer claim, the staff had to send instructions to the Depository Trust Corporation (DTC) in New York, where Blinder kept most securities, to deliver the appropriate securities via the mail to the liquidation site in Englewood, CO. The staff opened the package from DTC to ensure that it contained the appropriate number of securities and that the securities were registered to their proper owners. Only then did the staff send the securities to the customers via registered mail.

Bulk transfers can expedite the payment process because customer accounts are transferred via computer to acquiring firms before the trustee reviews customer claim forms. However, trustees and SIPC arranged bulk transfers for only 18 of the 99 liquidations commenced between 1978 and

1991. (See table 2.4.) A SIPC official said the high incidence of fraud—more than 50 percent—among SIPC liquidations accounts for the low number of bulk transfers. In such cases, the trustee and SIPC staff cannot rely on the books and records of the firm, so they review each customer claim to ensure accuracy. Another reason for the low number of bulk transfers is that some failed broker-dealers specialized in securities (such as penny stocks) that qualified acquiring firms found unattractive. The Blinder Robinson trustee said he did not attempt a bulk transfer because (1) firms experienced in handling numerous customer accounts expressed no interest in Blinder's customer accounts, which primarily contained penny stocks, and (2) firms that did express interest lacked adequate financial and operational controls to accept the accounts without endangering their own survival.

Table 2.4: SIPC Bulk Transfers, 1978-1991

Firm	Filing date	Number of claims paid
Mr. Discount Stockbrokers, Inc.	6/30/80	541
Gallagher, Boylan, & Cook, Inc.	3/17/81	1,363
John Muir & Co.	8/16/81	16,000
Stix & Co., Inc.	11/5/81	4,205
Bell & Beckwith	2/5/83	6,523
Gibralco, Inc.	6/21/83	713
California Municipal Investors	1/31/84	1,500
Southeast Securities of Florida, Inc.	1/31/84	11,658
M.V. Securities, Inc.	3/14/84	1,338
June Jones Co.	6/4/84	1,079
First Interwest Securities Corp.	6/7/84	6,140
Coastal Securities	5/3/85	331
Bevill, Bresler & Schulman, Inc.	4/8/85	3,601
Donald Sheldon & Co.	7/30/85	2,362
Cusack, Light & Co., Inc.	6/25/86	256
Norbay Securities Inc.	10/14/86	9,103
H.B. Shaine & Co., Inc.	10/20/87	4,372
Fitzgerald, DeArman, & Roberts, Inc.	6/28/88	30,376
Total		**101,461**

Source: SIPC.

A Major SIPC Liquidation Could Damage Public Confidence

Because SIPC liquidations can involve delays, the liquidation of a major broker-dealer could damage public confidence in the securities industry. Under such a worst-case scenario, hundreds of thousands of customers could be temporarily denied access to their property and exposed to market risks. Although the regulatory framework discussed earlier has been successful in preventing such an occurrence, the regulators and SIPC cannot afford to become complacent. This is all the more true because large firms are continuing to engage in riskier activities than in the past. To prevent large broker-dealers from becoming SIPC liquidations in the future, the regulators must continue to vigorously enforce the net capital and customer protection rules and other applicable securities laws and regulations.

Potential Impacts on Market Stability

The SIPC liquidation of a major broker-dealer may only affect the customers of the failed firm. However, it is possible that the impact of a large SIPC liquidation could adversely affect the stability of securities firms and markets more generally. This spillover effect could occur if customers of other broker-dealers became worried about what would happen if their broker-dealer got into financial difficulty. In such an event, large numbers of customers could be motivated to move their accounts from one broker-dealer to another to avoid the possibility of having their funds tied up for some indefinite period of time. Or customers might get out of securities investments altogether, for example, by selling investments and depositing money in a bank. Both types of adjustments could be destabilizing to the normal operation of the securities markets, but the latter situation of actually selling securities could be highly disruptive because it could result in rapid declines in the prices of many types of securities.

SEC and SIPC officials told us that the destabilizing effects associated with a large broker-dealer liquidation could be contained. The regulators and SIPC believe they could arrange to transfer the customer accounts of a large failed firm to acquiring firms within weeks. Unlike penny stock brokers such as Blinder Robinson, the officials said that the customers of large broker-dealers tend to hold highly liquid assets such as government bonds and blue chip stocks in their accounts. Other large broker-dealers find such customer accounts attractive and could generally be expected to bid on and acquire the accounts within a relatively short time.

Incentives Foster Efforts to Avoid Major SIPC Liquidations

Given the potentially adverse consequences of a major broker-dealer liquidation, incentives exist to avoid such an event. Regulators, creditors, and customers of failed securities firms all have incentives to avoid the unpleasant aspects of SIPC liquidations—their length, their cost, and the provisions in SIPA regarding creditor and counterparty relationships with the failed broker-dealer:

- Regulators (SEC, SROs, and the Federal Reserve) want to avoid very large SIPC liquidations because such liquidations can cause significant delays for counterparties of the failed firms and can disrupt the smooth functioning of the financial markets.
- Creditors want to prevent a SIPC liquidation because their share of the failed broker-dealer's assets would decrease in the event of a SIPC liquidation, where SIPC has a priority claim on the assets of the firm to pay the administrative costs of the liquidation.
- Customers prefer that their firm not go into a SIPC liquidation because they could lose access to their property for an extended period of time and, consequently, be exposed to market risk.
- Banks having loans and other arrangements with a failed broker-dealer want to avoid SIPC liquidation because they lose the ability to call their loans or unwind transactions for a period of time determined by the court. This exposes them to market risk and reduces their flexibility.
- Other securities firms with noncustomer claims against troubled firms would like to avoid SIPC liquidations because they, like creditors, could only settle claims from the general estate, which would be diminished by administrative expenses, and the completion of any other nonopen financial arrangements, like those involving banks, would be delayed.

The strength of these incentives, in tandem with the regulatory framework, can be very important. As we pointed out earlier, most firms that have slipped through the regulatory framework and become SIPC liquidations were small and failed as a result of fraud. As table 2.5 indicates, the five largest SIPC liquidations in terms of customers are dwarfed by the five largest broker-dealers. At year-end 1990, the Securities Industry Association, an industry trade group, reported that it had 50 members with 100,000 or more customer accounts.

Table 2.5: Major Securities Firms and Largest SIPC Liquidations

Major securities firms by number of customer accounts	Customer accounts
Merrill Lynch, & Co.	7,900,000
Shearson Lehman Brothers, Inc.	4,000,000
Prudential Securities, Inc.	2,700,000
Dean Witter Reynolds, Inc.	2,500,000
Paine Webber Group, Inc.	1,700,000
Largest SIPC liquidations by number of customer accounts	**Customer claims paid**
Blinder Robinson, Inc.	61,334
Weis Securities, Inc.	32,000
Fitzgerald, DeArman, and Roberts, Inc.	30,376
John Muir & Co.	16,000
OTC Net, Inc.	14,107

Sources: 1991-1992 Securities Industry Yearbook and SIPC.

Regulators and SIPC Must Avoid Complacency

While the incentives and the regulatory framework have been successful in preventing major SIPC liquidations to date, SEC officials and SIPC cannot afford to become complacent. During our review, SEC officials told us that two large firms—Thomson McKinnon and Drexel—could have become SIPC liquidations. In fact, in July 1989 SIPC's general counsel flew to New York to prepare to initiate liquidation proceedings against Thomson McKinnon, which had about 500,000 customer accounts.[10] Fortunately, SIPC did not have to liquidate Thomson McKinnon because NYSE and SEC officials arranged the transfer of the firm's customer accounts to Prudential-Bache Securities Inc. Moreover, in 1990 four major broker-dealers received capital contributions from their parent firms: the First Boston Corporation; Shearson Lehman Hutton Inc.; Prudential-Bache Securities Inc.; and Kidder, Peabody & Co. Incorporated.

Looking forward, there is no cause for complacency because changes in the securities industry are making the regulators' job of monitoring broker-dealer net capital and protecting customers more difficult. Continuing a trend that began about 10 years ago, broker-dealers are relying on riskier activities for more of their revenue than in previous decades. Moreover, many of these activities are new and technically sophisticated, and the risks involved may not be well understood. The

[10]Thomson McKinnon had been experiencing financial problems since the 1987 stock market crash. In 1989, the firm entered into merger negotiations with Prudential-Bache. On July 14, 1989, the merger negotiations broke down temporarily in a dispute over Thomson's financial exposure. The negotiations later resumed and Prudential-Bache acquired Thomson's customer accounts and retail branch network.

sophisticated, and the risks involved may not be well understood. The structures of broker-dealers and broker-dealer holding companies are also changing and becoming more complicated. Increasingly, broker-dealer holding companies are moving very risky activities out of the registered and regulated broker-dealers and into unregulated affiliates. Although these affiliates are separate, their activities, and financial difficulties, could affect the financial health of the broker-dealer (a SIPC member).[11] These changes may reduce the amount of time the regulators have to protect customers of a financially troubled broker-dealer, making it more difficult to protect customers without SIPC involvement.

While the riskiness of broker-dealers and their affiliates has continued to increase, SEC's ability to oversee the securities industry and thereby protect SIPC was enhanced by the passage of the Market Reform Act of 1990 (P.L. 101-432, 104 Stat. 963). This act, passed in the wake of the Drexel bankruptcy, authorized SEC to collect information from registered broker-dealers and government securities dealers about the activities and financial condition of their holding companies and unregulated affiliates. SEC has issued proposed rules under the act that would require firms to maintain and preserve records on financial activities that might affect the broker-dealer. SEC officials plan to use this information to assess the risks presented to these regulated broker-dealers by the activities and financial condition of their affiliated organizations.

No Expansion of SIPC's Role Warranted

We were asked to look into whether SIPC should have the authority to examine the books and records of its members to fulfill its customer protection role. Given the relative success of the regulatory framework to date in preventing SIPC liquidations, we do not believe there is any evidence to warrant such an expansion of SIPC's authority.

Several practical problems also are associated with such proposals. SIPC, with 32 staff members, does not have the resources to ensure that its members comply with securities laws and regulations. Giving SIPC regulatory authority to monitor its 8,153 members would, therefore, require a large increase in SIPC's staff and impose additional costs on the securities industry. The benefits of such an expansion are questionable because it would (1) duplicate the work of SEC and SROs and (2) prove counterproductive if it weakened the accountability SEC and the SROs now have for monitoring securities firms and enforcing the net capital and

[11]See our report Securities Markets: Assessing the Need to Regulate Additional Financial Activities of U.S. Securities Firms (GAO/GGD-92-70, Apr. 21, 1992).

customer protection rules. SEC and the SROs should continue to serve as the first line of defense for customers. SIPC should also maintain its back-up role within the regulatory framework. However, although SIPC does not need expanded regulatory authority, it can better prepare for potential liquidations (see ch. 4).

Conclusions

The regulatory framework has successfully limited the number and size of SIPC liquidations. Most of the firms that slipped through the regulatory framework and became SIPC liquidations failed because of fraud. When a SIPC liquidation becomes necessary, customers may be denied access to their accounts for extended periods. The delays expose customers to market risk, and if a major broker-dealer becomes a SIPC liquidation, public confidence in the securities industry could be damaged. In recent years, several large broker-dealers have experienced financial difficulties that could have resulted in SIPC liquidations. As a result, the regulators and SIPC cannot afford to become complacent about the possibility of a major firm becoming a SIPC liquidation. They must work to avoid such an outcome and be prepared to respond effectively if it should occur.

SIPC's Responsible Approach for Meeting Future Financial Demands

In 1991, the SIPC board implemented a new strategy for building the SIPC customer protection fund. The board set a goal of $1 billion for fund resources (cash and investments in government securities) to be met by 1997. The board also changed its assessment strategy. The new strategy calls for consistent fund growth of 10 percent annually, with assessment rates varying as needed to achieve the target. If SIPC expenses remain in line with past experience, assessments will be lower than they have been for the last 2 years. In November 1991, SEC approved the board's proposed changes to the SIPC bylaws, and SIPC implemented the plan.

Given SIPC's back-up role in securities industry customer protection, we believe that the board's strategy represents a responsible approach to anticipating funding demands that may be placed on SIPC in the future. The plan provides resources well above what SIPC would need if its future demands are similar to those of its past. Furthermore, SIPC's resources should enhance the credibility of protection afforded to customers from the failure of a very large firm—something SIPC has never experienced—if such a firm should end up in a SIPC liquidation. However, the reasonableness of this strategy depends entirely on the continued success of the securities industry's regulatory framework in shielding SIPC from losses. Given the changing nature of the securities industry, the SIPC board and SEC will have to continue to assess the adequacy of the fund.

SIPC Funding Needs Are Tied to the Risk of a Breakdown in the Regulatory System

One characteristic of the SIPC Fund that makes assessing its adequacy very difficult is that fund liquidation expense is not correlated with any traditional measure of financial exposure for financial institutions, such as credit risk or the amount of insured property. Instead, its adequacy is most dependent on the industry's compliance with SEC and SRO rules, particularly the SEC customer protection and net capital rules. The probability of such compliance, or noncompliance, is not quantifiable.

If the risk of broker-dealer activities was a good predictor of SIPC expenses, we would expect to find either that SIPC liquidations increased sharply during economic downturns in the securities industry[1] or that most of the broker-dealers ending up in a SIPC liquidation were engaged in very risky activities. However, we found that neither case represents reality.

[1] The riskier a broker-dealer's activities, the more sensitive that broker-dealer is to economic downturns, poor decisions, or even bad luck and the more likely the broker-dealer is to fail.

SIPC endured a period of securities industry recession from 1987 through 1990 without an appreciable increase in the number of SIPC liquidations.[2] Moreover, a significant percentage of broker-dealers that have been turned over to SIPC did not engage in particularly risky activities. As we explained in chapter 2, 26 of the 39 broker-dealers turned over to SIPC since 1986 (67 percent) were introducing firms engaged in very low risk lines of business.

If the amount of SIPC-protected property was correlated to SIPC losses, we would expect that the largest liquidations would be the most costly. However, this has not been the case. Tables 3.1 and 3.2 show that the size of a broker-dealer (as measured by the amount of customer property or the number of customers) is not correlated with the cost to SIPC. Returning $190 million worth of property to customers of John Muir, Inc., resulted in no cost to SIPC while returning about $106 million to Bell and Beckwith customers cost SIPC nearly $32 million. Blinder Robinson, listed in table 3.2, had more customers than all five firms listed in table 3.1, yet this liquidation was much less expensive than that of Bell and Beckwith.

Table 3.1: Most Expensive SIPC Liquidations as of December 31, 1991

Dollars in millions

Firm	SIPC advances	Customer claims paid	Customer property returned
Bell & Beckwith	$31.7	6,523	$105.7
Bevill, Bresler & Schulman, Inc.	26.4	3,601	417.5
Stix & Co., Inc.	17.0	4,205	51.2
Joseph Sebag, Inc.	11.4	3,640	33.9
Government Securities Corp.	8.1	2,403	40.8
Total	**$94.6**	**20,372**	**$649.1**

Source: SIPC.

[2] See table 2.1, where SEC turned four broker-dealers over to SIPC for liquidation in 1987, five in 1988, six in 1989, and eight in 1990.

Table 3.2: Largest SIPC Liquidations as Measured by Customer Claims Paid as of December 31, 1991

Dollars in millions

Firm	SIPC advances	Customer claims paid	Customer property returned
Blinder Robinson, Inc.	$6.2	61,334	$25.8
Weis Securities, Inc.	3.4	32,000	187.2
Fitzgerald, DeArman, and Roberts, Inc.	5.6	30,376	137.0
John Muir & Co.	0.0	16,000	190.4
OTC Net, Inc.	-.4	14,107	17.4
Total	**$14.8**	**153,817**	**$557.8**

Source: SIPC.

As has been discussed, the regulatory framework established in the last 20 years to protect customers of broker-dealers has helped to limit SIPC liquidations to a little over 1 percent of all broker-dealer closures. With the SIPC fund currently equaling more than twice SIPC's cumulative liquidation expenses from 1971 through 1991, it appears that SIPC is in a good position to continue its past performance with these small broker-dealers. Thus, based on the historical record alone, SIPC resources would seem to be adequate. There is, however, no reason to assume that the future will be like the past. Therefore, SIPC must consider its funding needs in relation to the possibility of a breakdown in security industry compliance with the net capital and customer protection rules.

SIPC's Plan Seems Reasonable to Fulfill Back-Up Role

In 1989, the board initiated a substantial reevaluation of its funding and assessment strategies. While the board believed that the regulatory framework—backed up by the SIPC fund—was adequate to protect customers, it recognized that the securities industry had changed dramatically since SIPC's inception. The industry had consolidated, with fewer firms doing a greater share of the business. The primary source of industry revenue had also changed from commissions to more risky lines of business such as trading, mergers and acquisitions, and merchant banking. Moreover, the stock market crash in 1987 and the recent demise of several of the largest broker-dealers in the industry (including Thomson McKinnon and Drexel) as well as the savings and loan and banking crises, attracted a great deal of attention and caused a significant decrease in public confidence in financial institutions.

The board first approached the question of how to adapt to changes in the securities industry and how to confront sagging customer confidence by evaluating the adequacy of the fund. To help in this process, the board commissioned a study of the fund's size as well as alternatives to supplement the existing fund, which comprises cash and government securities and is supplemented by commercial bank lines of credit.[3] The study considered SIPC's responsibilities, its resources, and the effect of changes in the risks taken by broker-dealers on SIPC's future funding requirements, given the current regulatory framework.

The study also explored plausible scenarios that might place the SIPC fund under considerable strain, such as the failure of the largest broker-dealer in the industry, and whether or not SIPC resources were sufficient to withstand this sort of stress. Finally, the study considered alternative forms of customer protection that could be used to supplement the current cash fund.

The board decided that building a cash fund to an amount sufficient to liquidate the largest broker-dealer[4] in the industry would be an effective way to demonstrate SIPC's capacity to protect customers. According to the fund adequacy study, $1.24 billion was the largest amount likely to be needed to liquidate the largest broker-dealer. Of this amount, roughly 60 percent would represent temporary liquidity requirements and would be recovered by SIPC in the course of the liquidation.

The largest cost component of such a liquidation was assumed to be temporary advances required to retrieve customer property pledged as collateral for bank loans or involved in stock loans.[5] If such an event were to occur, SIPC, with a $1 billion fund together with a $1 billion commercial bank line of credit and the $1 billion Treasury line of credit, would provide the resources necessary to meet this responsibility.

[3]See Deloitte & Touche's Special Study of the SIPC Fund.

[4]Deloitte & Touche estimated how much it would cost SIPC to liquidate the largest broker-dealer in the industry, at the time of the study. The study based this estimate only partially on SIPC liquidation experience because SIPC has never liquidated a broker-dealer that had more than 61,000 customers. By comparison, the largest broker-dealer in the industry had more than 6 million customer accounts at the time of the study.

[5]When customers purchase securities on margin, they must pay at least half of the purchase price, and the broker-dealer may borrow the remaining half from a bank or another broker-dealer. The lending institution will demand that the customer's broker-dealer pledge securities that exceed the value of the loan as collateral. Due to the excess collateralization requirement, SIPC can pay off the loan, recover the customer margin securities, and still recover its advance in full.

Building the SIPC fund to $1 billion would better enable it to meet such a contingency, although it would have to draw on its commercial bank line of credit to meet all the liquidity needs. SEC officials told us that the $1.24 billion estimate is highly conservative because it assumes a substantial breakdown in compliance with the customer protection rule. By incorporating the $1.24 billion conclusion of the fund adequacy study into SIPC's new fund goal, the board decided that a significant cumulative event, such as SIPC being asked to liquidate two or more major broker-dealers within a short time, was improbable because of the securities industry's regulatory and capital structure.

In assessing the reasonableness of SIPC's financial plans, we concluded that there is no methodology that SIPC could follow that would provide a completely reliable estimate of the amount of money SIPC might need in the future. SIPC has had no experience with a large liquidation, and the evidence from smaller liquidations is that the cash outlay and net cost aspects depend greatly on the particular circumstances of the firm. SIPC's estimate, therefore, must be judgmental.

We have not tried to develop our own independent estimate of SIPC's funding needs. As explained in the following paragraphs, however, we believe that SIPC's strategy represents a responsible approach to planning for future financial needs.

We base our conclusions on several factors. In general, the plan does not assume that the future will be like the past, and it anticipates the possibility that SIPC may have to liquidate a large firm. Furthermore, in the absence of recognized measures of fund adequacy, the concept of using a worst-case scenario to look at potential funding needs makes sense, although this approach is limited by the assumptions made and by the uncertainty of future developments.

While the simultaneous liquidations of several large broker-dealers, which could wipe out the SIPC fund, cannot be ruled out in an uncertain world, in assessing the adequacy of SIPC's plans it is appropriate to bear in mind the back-up role that has been laid out for SIPC. In such an event, SEC and all the other key financial agencies of the federal government, including the Federal Reserve and the Department of the Treasury, would be involved in attempting to manage what would clearly be a crisis situation. Even a market break the size of the one in 1987, which potentially could have caused many SIPC liquidations, placed no unusual demands on SIPC. Since that time, regulators' ability to contain the damage that market breaks may have on broker-dealers has been strengthened through "circuit-breaker" provisions and through improvements in communication and coordination among the agencies.[6]

Looking more directly at the $1.24 billion estimate of the amount of cash needed to liquidate the largest securities firm, the SIPC funding requirement is conservative with respect to some of its assumptions. It assumes, for example, that the failed broker-dealer's capital would be depleted to the point that its required reserves would be exhausted and that the trustee would not recover any portion of the broker-dealer's partially secured and unsecured receivables. Largely because of these assumptions, officials of SIPC and the SEC and representatives of the securities industry told us that SIPC's funding estimates were on the conservative side.

However, we cannot definitively conclude that the $1.24 billion estimate is overstated. The study SIPC used assumed that the books and records of a large failed broker-dealer would accurately reflect the firm's accounts and that the broker-dealer would be in compliance with the possession or control component of the customer protection rule. In view of the prevalence of fraud in past smaller SIPC liquidations, we believe that the possibility of fraud or of a serious breakdown of internal controls cannot be ruled out, even though SEC contends that these controls are monitored more closely in larger broker-dealers. Furthermore, the largest firms in the industry are likely to continue to grow, so the amount of money that might be needed in 1997 could be higher than the $1.24 billion estimated in 1990.

We commend the board for taking a forward-looking approach to planning the SIPC fund strategy. However, in view of the dynamic nature of the industry, it is essential that the board, together with SEC in its oversight role, assess the fund periodically to adjust the funding plans to changing SIPC needs. Among other factors, the periodic assessments of the fund's adequacy must focus on the size of the largest broker-dealers, evidence of increased risk-taking within the industry, trends with respect to the amount of customer property, and any signs that regulatory enforcement has deteriorated.

To a large degree, the new fund strategy builds in the opportunity for such periodic assessment; on an annual basis, the SIPC board must estimate its liquidation expenses and determine the revenues needed to build the fund

[6]In 1989, SEC approved new exchange and NASD rules that require temporary trading halts of 1 or 2 hours if the Dow Jones Industrial Average falls more than 250 points or more than 400 points, respectively, in a single day.

at a 10-percent annual rate and decide whether to renew 25 percent of its commercial bank line of credit.

If SIPC's Funding Needs Increase, Assessment Burden Issues Could Arise

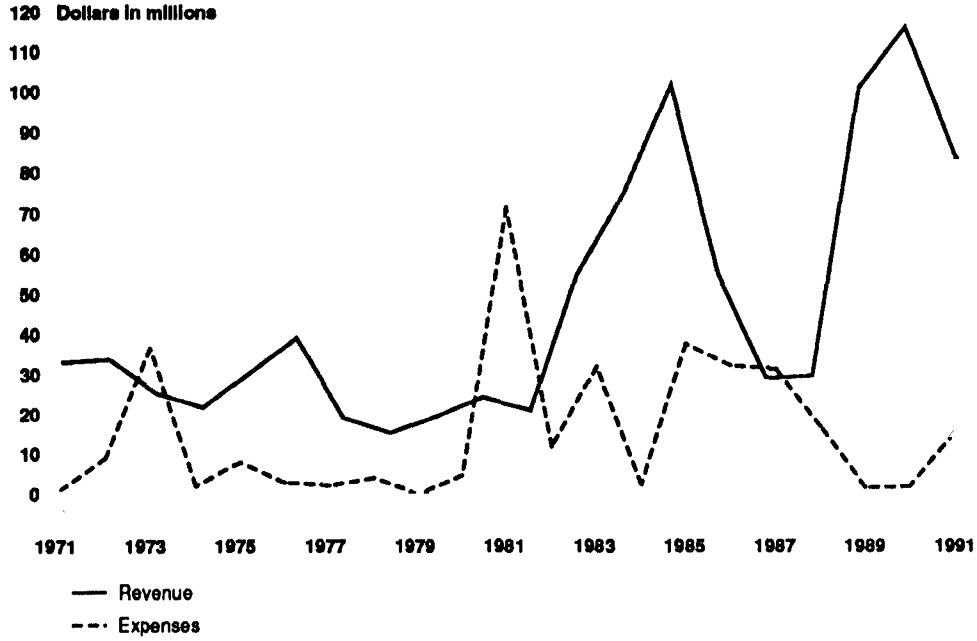
In the past, the SIPC assessment burden in most years has been quite low—less than 0.1 percent of total securities industry revenue and not more than 2 percent of the industry's pretax income. The burden was greatest in 1990 when SIPC was building its resources and industry profits were down. The assessments in that year represented approximately 10 percent of pretax income. The plan SIPC has adopted will enable it to reach the $1 billion goal by 1997 with low assessments if liquidation expenses remain low (as has been the case in the last several years). Total estimated 1991 assessments were $39 million, a 47-percent decrease from the 1990 assessments of $73 million. However, if SIPC liquidation expenses increase significantly and SIPC needs to recapitalize its fund, SIPC may have to address both the total assessment burden and the distribution of the assessment burden.

Assessment History

When SIPC was created, SIPA required each SIPC member firm to contribute 0.125 (one eighth of 1 percent) of its gross revenues for that year to start the customer protection fund. Until recently, the board has retained the gross revenue base for the assessments needed to maintain fund viability throughout SIPC's history, believing that it was the most equitable distribution of the assessment burden.[7] Also in the past, the board attempted to match assessment rate increases with declines in the fund balance, so that years of high SIPC expenses were followed by periods of higher assessments. Figure 3.1 shows how SIPC revenues and expenses have varied. In 1973 and 1981, expenses were high; consequently, the board increased revenue to cover the high expenses by increasing assessments in the years that followed. Table 3.3 shows the various assessment rates for each year.

[7]See SIPC assessable gross revenue definition in chapter 1.

Figure 3.1: SIPC Revenue and Expenses, 1971-1991



Source: SIPC

Table 3.3: History of SIPC Assessment Rates

Period	Rate
January 1971 - December 1977	0.5% of gross revenues
January 1978 - June 1978	0.25% of gross revenues
July 1978 - December 1978	0.0 %
January 1979 - December 1982	$25 flat fee
January 1983 - March 1986	0.25% of gross revenues
April 1986 - December 1988	$100 flat fee
January 1989 - December 1990	0.19% of gross revenues
January 1991 - present	0.065% of net operating revenues

Source: SIPC.

SIPC's New Assessment Base

In 1991, the board created a task force to examine the assessment strategy, and the task force concluded that steady fund growth, regardless of liquidation expense, was preferable to the previous reactive strategy. The board also directed the task force to examine the way SIPC assesses member firms to build the fund. The task force examined a variety of assessment strategies that would appear to be more closely correlated with actual SIPC losses to make the assessments risk- or exposure-based. However, the task force did not find a material relationship between either risk or exposure and SIPC losses. For example, as noted in tables 3.1 and 3.2, no correlation could be found between the level of securities and cash balances at failed broker-dealers and actual SIPC liquidation costs. Also, the riskiness of failed broker-dealers' activities did not translate into SIPC losses as long as the failed broker-dealers complied with SEC and SRO regulations.

The board adopted the task force's recommendation that revenue remains the best base for assessments, but that the existing gross revenue assessment base should be changed to net operating revenue. While the change to a net operating revenue assessment base did not tie assessments any closer to fund risk or exposure, it did address the concerns of some SIPC members, especially some of the larger broker-dealers, about the treatment of interest expense in the previous assessment base.[8]

The SIPC task force on assessments reported that the increased emphasis on activities that involve interest expense made gross revenues an inappropriate basis for assessments. Interest expense at NYSE member firms increased from 21 percent of gross revenues in 1980 to 42 percent in 1990.[9] Many large broker-dealers complained that a broker-dealer's gross revenues could increase dramatically—and with it, the SIPC assessment—with a rise in interest rates. Such an interest rate increase would cause little or no economic change for the broker-dealer because interest expense would also increase. The change to a net operating revenue base eliminated this problem by basing the assessment on the difference (spread) between interest revenue and interest expense.

In the event of a significant downturn in the health of the fund, SIPC may not be able to meet the 10-percent annual fund growth goal. Although SIPC assessments will increase if the fund experiences losses, it may not be able to achieve the annual growth goal because there is a cap on the total amount of assessments that may be collected in any 1 year. With this cap,

[8]The board also maintained an alternative assessment base that SIPC members may choose, of gross revenues less 40 percent of margin interest earned on customers' securities accounts. The SIPC task force on assessments recommended that this option be made available in an attempt to distribute the assessment burden equitably between firms that actively engage in trading and interest-rate spread transactions and firms that rely on their retail operations for income.

[9]NYSE member broker-dealers were responsible for approximately 80 percent of SIPC's total assessment revenue before the assessment change.

assessments collected in 1 year may not exceed the equivalent of 0.5 percent of gross revenues. Moreover, if the fund falls below $150 million (approximately 22 percent of its current level), the assessment base reverts back to gross revenues. The gross revenue base would shift more of the assessment burden to firms with relatively higher gross revenues, usually larger broker-dealers.

Industry criticism of the proposed changes was minimal, largely because the overall effect of the change for the near term was lower assessments for most broker-dealers in the industry. As long as the securities industry regulators vigorously enforce the net capital and customer protection rules, the incentives limiting SIPC's exposure remain, and SIPC's investments in U.S. government securities continue to generate considerable interest income, SIPC expects assessments to remain low in the near term.

Assessment Burden Issues Can Arise If SIPC Assessments Increase

The effect of the change in the assessment base should be small as long as the assessment rate remains at or near its current low level. However, in the event that a significant increase in assessments is required to meet the fund growth goal, the issue of assessment burden, for both the entire industry as well as individual broker-dealers within the industry, may require reevaluation.

While SIPC assessments have generally been small compared to industry income, 1990 SIPC assessments represented a significant percentage of industry income. Table 3.4 compares SIPC assessments to securities industry pretax income and total revenues for 1983 to 1991.

Table 3.4: SIPC Assessments, Industry Income, and Revenue, 1983-1991

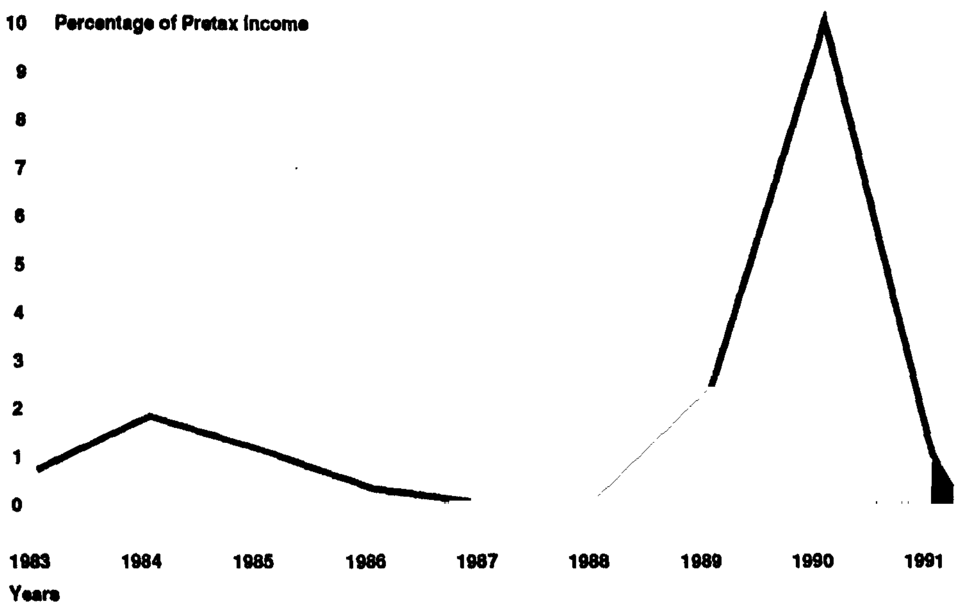
Dollars in millions

Year	Assessment revenue	Pretax income	Total revenue
1983	$36.8	$5,206.8	$36,904.1
1984	52.3	2,856.6	39,607.1
1985	71.0	6,502.4	49,844.3
1986	23.1	8,301.2	64,423.8
1987	1.0	3,209.9	66,104.4
1988	1.0	3,477.3	66,100.4
1989	66.0	2,822.9	76,864.0
1990	73.0	737.2	72,087.8
1991	39.0	7,600.0	76,900.0

Sources: SEC and SIPC.

Figure 3.2 shows the burden of assessments on the securities industry in terms of a percentage of pretax income.

Figure 3.2: SIPC Assessments as a Percentage of Securities Industry Pretax Income, 1983-1991



Source: SIPC and SEC.

A high SIPC assessment rate, combined with the change to net operating revenue-based assessments, may have a more profound effect on the distribution of the assessment burden among SIPC members than it does on the industry as a whole. By focusing SIPC assessments on net operating revenue, SIPC shifted some of the assessment burden from broker-dealers that are actively engaged in trading and interest rate spread transactions to broker-dealers that are primarily dependent on their retail brokerage business for income.

Under the new assessment structure, broker-dealers are allowed to deduct interest expense—from debt-financed activities—from SIPC assessable revenues. Generally, only large broker-dealers have a significant amount of deductible interest expense. SIPC is also continuing the broker-dealers' option of choosing to deduct 40 percent of margin interest revenue (this deduction existed prior to the change in the assessment strategy). The change to the new assessment structure would shift the assessment burden further toward broker-dealers that have primarily a retail business.[10] The issue of assessment equity has come up in the past and raised the following concerns:

- Large broker-dealers claim they have carried too much of the burden because small broker-dealers usually become SIPC liquidations.
- Small broker-dealers claim that large broker-dealers pose a more significant threat to the fund and are in a better position to carry the assessment burden.
- Broker-dealers with few or no customers claim that they receive little benefit from SIPC and consequently should not be forced to pay assessments at the same rate as broker-dealers with more customers.

However, as we discussed earlier, the impact of changing the assessment structure on both the total assessment burden and the distribution of the assessment burden among individual broker-dealers depends upon the assessment rate. As long as the rate remains low, questions concerning the equity of the assessment structure should not demand a great deal of attention. If rates rise significantly as a result of high liquidation expenses, the SIPC board may need to revisit the issue.

Alternatives or Supplements to SIPC's Financial Structure

We were also asked to look at the role of alternatives such as private insurance to supplement SIPC coverage. The Deloitte & Touche study of the SIPC fund and the SIPC task force on assessments also addressed alternative or supplemental ways to provide protection to securities investors. The task force concluded that a customer protection fund comprising cash and short-term government securities, like the current fund, is the best protection for customers and the best way to maintain public confidence in the securities industry. We agree that a cash fund is superior to private insurance, letters of credit, and lines of credit in terms of providing a basic level of customer protection and public confidence.

Historical experience with private insurance plans, like the excess customer protection insurance coverage carried by many major broker-dealers, has shown that coverage frequently cannot be obtained when it is needed most. For example, private insurance coverage for

[10] The SIPC task force on assessments proposed eliminating the option once SIPC reaches its $1 billion fund goal.

customers with account values above SIPC coverage limits was not renewed at either Drexel or Thomson McKinnon before their closing.

Although we believe that private insurance cannot adequately provide the basic customer protection currently provided by the SIPC fund, supplemental private insurers, through the pricing of their products, can provide valuable information concerning the health of the institutions they insure. In this way, private insurance fulfills a monitoring function that supplements the activities of the regulators. The Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. No. 102-242, 105 Stat. 2236) requires a study of the feasibility of a similar option for a private reinsurance system covering depository institutions.

Bank lines of credit, like SIPC's current line of credit, or bank letters of credit may be appropriate to serve as a supplement but are not appropriate to replace the current cash fund. Lines of credit can be written so that they will be honored under almost all circumstances, but the cost of such a line might be prohibitive. Banks also have the option of not renewing lines or letters of credit when they expire, and they may choose not to renew SIPC's credit when SIPC would need it most, during periods of significant losses.

Conclusions

The SIPC board's new fund strategy appears to be responsible, given SIPC's back-up role in customer protection and the regulatory framework that exists in the securities industry today. With this regulatory structure in place and diligent supervisory and enforcement efforts, it is reasonable to assume that only a small percentage of broker-dealer closures will be turned over to SIPC for liquidation, and SIPC has the resources necessary to liquidate these firms. SIPC currently has more than twice the money available to protect customers than it has spent in its entire 20-year history to meet similar obligations.

However, the reasonableness of this strategy depends entirely on the continued success of the securities industry's regulatory framework in shielding SIPC from losses. SIPC has a responsibility to regularly review its funding needs and take measures to strengthen the fund if there is evidence of any declining effectiveness of the customer protection and net capital rules. Further, in view of the importance of the regulatory protections, SEC in its oversight capacity should also regularly review the adequacy of SIPC's funding strategy.

Recommendations

We recommend that the SIPC Chairman periodically review the adequacy of SIPC's funding arrangements, taking into account any changes in the principal risk factors affecting the fund's exposure to loss.

We also recommend that the SEC Chairman review the adequacy of funding plans developed by SIPC.

Agency Comments and Our Evaluation

SIPC and SEC officials provided comments on our assessment of the adequacy of the SIPC fund. Both SIPC and SEC agreed with our assessment that SIPC acted responsibly in planning for the SIPC fund's future needs. SIPC also agreed that a cash fund is superior to private insurance, letters of credit, and lines of credit. SIPC did not comment on our recommendations, but SEC agreed that the adequacy of the SIPC fund should be reviewed periodically. SEC stated that it and SIPC have reviewed the adequacy of the fund and will continue to do so.

SIPC Can Better Prepare for Potential Liquidations

SIPC has never had to liquidate a large securities firm, and SIPC and SEC officials believe it unlikely that they will ever have to. However, should SIPC be called on to liquidate a large firm, the complexities of such a liquidation could impede the timely resolution of customer claims. Such delays, in turn, could damage public confidence in the securities industry. We believe that there are reasonable steps SEC and SIPC officials can take that would better enable them to liquidate a large firm in a timely manner should the need arise.

SIPC Has Not Made Special Preparations for Liquidating a Large Firm

The persons we contacted in the course of our review—industry officials, liquidation trustees and others involved in liquidations, and regulatory officials—generally gave SIPC high marks for its ability to conduct liquidations. Although a detailed review of the efficiency of SIPC liquidations was outside the scope of our review, we found no reason to question this assessment of SIPC's liquidation activities. However, these liquidations have all been of relatively small firms. Successful performance in the past does not, therefore, necessarily mean that SIPC is adequately prepared to move quickly to take on the liquidation of one of the largest firms. SIPC's largest liquidation to date has involved the processing of about 61,000 claims; the five largest broker-dealers each has more than 1 million customer accounts.

A decade ago, SIPC recognized the need to address the problems associated with the potential liquidation of larger firms by establishing a task force to look into the topic of how to handle large liquidations. The task force, composed of SIPC, SRO, and industry officials, was initiated in 1981 to study ways to ensure the timely return of customer property in the event a large firm with more than 100,000 customers became a SIPC liquidation. The task force was prompted by SIPC's liquidation of several relatively large firms in 1981, the largest of which, Muir, had about 16,000 accounts. The task force reported in 1981 that there were 11 securities firms carrying over 100,000 active customer accounts. (In 1990, over 50 securities firms had more than 100,000 customer accounts.)

The 1982 the task force report stated that the failure of a major broker-dealer would pose substantial challenges to SIPC and its normal liquidation procedures. The report stressed the problems that could confront the trustee and SIPC's efforts to promptly satisfy customer claims in a large liquidation. For example, the trustee, SIPC, and the regulators would generally try to arrange a bulk transfer and avoid the need to process customer claims.[1] However, as we pointed out in chapter 2, this process may not always be possible due to the quality of the firm's accounts and the reliability of its books and records. Bulk transfers could also prove time consuming, particularly if SIPC had to simultaneously negotiate transfer agreements with one or more acquiring firms. Acquiring firms would want to ensure that the accounts meet internal credit standards, and extensive computer programming efforts may be required to ensure that no errors occur in the transfer process.

To minimize these and other potential problems, the task force recommended that SIPC develop a plan for large liquidations. The task force suggested that SIPC work with industry officials to negotiate agreements needed to ensure the timely liquidation of a large broker-dealer. For example, SIPC could negotiate standby agreements on data processing services.[2]

Since the task force report, SIPC officials have not attempted to strengthen their planning processes or make special preparations for a large broker-dealer liquidation. In response to the task force recommendation, a committee composed of SIPC and SEC officials developed a list of operational information that should be available from a large debtor broker-dealer at the beginning of a liquidation. (See table 4.1.) However, no action was taken to implement the recommendation.

[1]Amendments to SIPA in 1978 allowed SIPC to pay claims directly in some small cases and bulk transfer customer accounts to other acquiring firms.

[2]The task force also recommended that SIPC be given the authority to operate large troubled firms so that customers could continue to trade in their accounts and thereby avoid market losses. SIPC and SEC officials said the recommendation was not adopted because it would involve rescuing failed firms and that no other brokers would be willing to serve as counterparties to a bankrupt firm.

Table 4.1: Operational Information Recommended by a 1985 SIPC-SEC Committee to Help Ensure the Timely Liquidation of a Large Broker-Dealer

1.	Current list of branch offices
2.	Location of leases for branch offices
3.	Location of equipment leases and other executory contracts
4.	List of banks or financial institutions with funds or securities on deposit and banks with outstanding loans (both customer and firm)
5.	Location of vaults and other secure locations
6.	Location and description of computer databases and services used
7.	Location of mail drops, e.g., post office boxes and other depositories
8.	Chart of interlocking corporate relationships between the broker-dealer and its affiliates
9.	List of key personnel
10.	Accurate count of active customer accounts

Source: SIPC.

Senior SIPC officials said that they do not see the need to implement the 1982 task force recommendation or take other special measures to develop a plan for large liquidations. SEC officials agreed and said it would be impossible to develop a single plan that would be applicable to all troubled firms. We believe that the views of SIPC and SEC do not take seriously enough the problems that would result were SIPC to have to conduct the liquidation of a large firm.

In support of their position, SIPC and SEC officials said it is unlikely that they will have to liquidate a large firm. They pointed out that over the past decade the regulators have demonstrated the ability to protect the customers of such firms without SIPC involvement. However, as we noted in chapter 3, when we discussed SIPC's financing needs, the regulators and SIPC officials cannot afford to become complacent about the possibility of a large broker-dealer ending up in a SIPC liquidation. SEC officials told us that the financially troubled Thomson McKinnon and Drexel firms could have become SIPC liquidations, and in 1990 four major broker-dealers had to be recapitalized by their parent companies.

Another reason SIPC and SEC officials say that special preparations for large liquidations are not needed is that SIPC can readily adapt the procedures developed for smaller firms to the liquidation of larger ones. They point out that larger firms are more likely than smaller ones to have well-functioning computerized information systems that are the key to being able to move quickly to protect customer accounts.

We agree that the experience SIPC has gained in liquidating firms over the years has certainly enabled it to develop and improve its ability to liquidate firms. Throughout the past 20 years, SIPC has continued to upgrade its procedures and its automated liquidation system to improve its ability to conduct timely liquidations. While we appreciate and support SIPC's ongoing improvement efforts, we also believe that SIPC would be in a better position to protect customers if it were to take reasonable steps, in coordination with SEC, to prepare for the contingency of a large firm liquidation. In view of the risks to market stability that may accompany the failure of a large firm, we think it reasonable for SIPC to do everything possible to be able to protect customers should it be called on to conduct such a liquidation. Experience from the last several years, reviewed in the next section, suggests strongly that additional measures can be taken to help customers of large firms gain access to their property as quickly as possible should any such firm fail.

Measures to Enhance SIPC's Ability to Liquidate a Large Firm on a Timely Basis

The ability of SIPC and trustees to satisfy customer claims in a timely fashion can be directly related to actions taken within the first hectic days of a liquidation's commencement. By better planning with regard to obtaining information about failing firms and securing automation support, SIPC can increase the chances that a large liquidation can proceed without delay, should such a liquidation prove necessary.

Operational Information Could Be Collected Sooner

In the early stages of a liquidation, the trustee—with SIPC advisement—must simultaneously gain control of the failed firm's headquarters and branch offices, freeze all customer accounts and creditor claims against the firm, identify the location and availability of customer cash and securities, and determine the feasibility of arranging a bulk transfer. SIPC officials also (1) advise the trustees on the hiring of key liquidation staff such as accounting firms and (2) review and approve customer claim forms with the liquidation staff.[3]

We found that SIPC officials have generally received high marks from trustees and other individuals involved in SIPC liquidations for the guidance and assistance they provided in the conduct of liquidations. For example, the Blinder Robinson trustee said that SIPC provided excellent legal advice, which he used to defend against challenges to his authority by the former

[3]SIPC had not established specific documents that customers must file to support their claims. Instead, customers are encouraged to submit the ordinary documentation broker-dealers normally provide, such as monthly statements, purchase and sale confirmations, and canceled checks.

owner of the firm, and the FDR trustee praised SIPC's valuable legal and technical assistance.

However, we also learned from SIPC staff and trustees of complications they experienced in acquiring the necessary information and automated liquidation systems during past liquidations. We believe such complications are indicative of the types of problems in obtaining operational information that, should they occur in the liquidation of much larger firms, could potentially result in significant delays for a large number of customers. For example, the trustee for Blinder Robinson, which had been on the 5(a)[4] list 11 months prior to its failure, said his staff did not trust the accuracy of the information the firm provided about the locations of its branch offices. In addition, the staff did not locate certain of the firm's bank accounts until 10 months after the start of the liquidation.

Similarly, the trustee of the FDR liquidation also experienced problems gathering all the information he needed. For example, it took two employees 4 to 6 weeks to find all the firm's branch office leases. Also, the trustee estimated that it took three staff members between 60 to 75 days to examine each of the firm's customer accounts to determine whether it was active before a bulk transfer could be arranged.

In the above examples, the trustees had some difficulty in obtaining operational information concerning the location of offices and accounts. In each instance, the trustees did not believe that these complications had interfered with the timely processing of customer claims. But even if they did result in delays, relatively few customers were affected, and there was no potential for adverse impact on confidence in securities markets in general. For a large liquidation the stakes would be higher. We therefore believe it wise to initiate procedures to be sure that SIPC has as much operational information as possible before it would actually have to undertake the liquidation of a large firm.

The potential impact that lack of operational information of the type referred to in table 4.1 could have on the liquidation of a major dealer can be illustrated by the events surrounding the failure of Thomson McKinnon in 1989. Although SIPC did not have to initiate liquidation proceedings for Thompson McKinnon, SIPC officials had made few preparations when they were informed of its imminent demise. Thomson McKinnon had about

[4]Under SIPA section 5(a), the regulators must notify SIPC about broker-dealers that are in or approaching financial difficulty.

500,000 customer accounts, 170,000 more customers than SIPC had protected in its 20-year history. As discussed earlier, NYSE and SEC arranged for the transfer of Thomson McKinnon's accounts to Prudential-Bache, but SEC officials said the firm could have become a SIPC liquidation when the merger negotiations broke down temporarily.

NYSE first warned SIPC that Thomson McKinnon was experiencing financial problems in May 1989. But information SIPC received about Thomson McKinnon was primarily financial information, such as the firm's quarterly financial reports, which identify its net capital level and aggregate data on the value of bank loans secured by customer margin securities. At the request of SEC, SIPC's general counsel went to New York on Friday, July 14, 1989, to prepare to initiate liquidation proceedings, possibly as early as the following week. After SEC notified SIPC, the staff began intensive efforts to collect operational information about the firm, such as the location of branch offices, and plan for the liquidation.

We believe that the regulators should provide SIPC with operational information needed to liquidate troubled firms so that SIPC can begin preparations before firms fail. With such information, SIPC officials could assess, on a case-by-case basis, the impact that a liquidation would have on customers days or weeks in advance and make plans to return customers' property as quickly as possible.

SEC officials said that requiring the regulators and troubled firms to provide the information in updated form to SIPC would impose unnecessary administrative burdens, particularly as they try to protect customers without SIPC involvement. However, we question how great a burden such a requirement would impose on SIPC, the regulators, and troubled firms. As SEC officials and the Blinder Robinson and FDR trustees told us, much of the information is already collected by the regulators and available at the start of the liquidation process. Furthermore, if the regulators are attempting to protect customers by transferring accounts to another firm, they would need virtually all of this information.

The burden of being certain that SIPC has as much operational information as possible before it has to undertake a liquidation could be minimized if the requirement is limited to 5(a) referrals (perhaps only exceeding a certain size) and other troubled firms at the discretion of the regulators.[5] For example, the regulators may decide that SIPC should take

[5]Between 1988 and 1991, SIPC received 63 new 5(a) referrals, of which 18 (29 percent) became SIPC liquidations.

precautionary steps and plan for the liquidation of a large firm, with numerous customers and a nationwide branch office network, whose capital has fallen to the early warning levels but was not on the 5(a) list. SIPC had advance warning via the 5(a) list of 67 percent of the firms that were liquidated between 1988 and 1991. SIPC, SEC, and the SROs should work together to identify operational information that SIPC will need to plan for potential liquidations and that the regulators and troubled firms can reasonably be expected to provide.

SIPC Has Not Addressed Cost-Effective Automation System Options

Another important tool used by SIPC to promptly respond to the demands of any liquidation is an automated liquidation system. An automated liquidation system is the computer software program or programs that help trustees organize liquidations and pay customer claims promptly. SIPC developed its own automated system in 1985 and has periodically modified the system to upgrade software and hardware capability. The system is designed for typical-sized liquidations and to be used either alone or in conjunction with modifications to the failed broker-dealer's system.

We support SIPC's efforts to develop a system that meets the needs of typical liquidations and SIPC's policy of acquiring the most cost-effective automated liquidation systems. However, it is not clear what automated system SIPC would use in situations where either its own system or the failed broker-dealer's automated systems could not be readily adapted to meet the liquidation's needs. SIPC's system has not been used in a liquidation involving more than 30,000 customer claims.

Although SIPC officials have stated that their system could be modified to handle liquidations of any size, they also recognize that it may not be cost effective to modify their system for a large liquidation. To date, SIPC has relied primarily on one supplier to meet its automated liquidation system needs for liquidations where SIPC's system cannot be used. When Blinder Robinson failed, SIPC advised the trustee to use that supplier's system even though the trustee had made arrangements to use another supplier. To the extent that it is relying on one supplier, SIPC is incurring a management risk that could delay efforts to return customer property. For example, the system may be unavailable in an emergency, or it may cost more than other competitive systems.

We are concerned about SIPC's ability to acquire the most cost-effective automated system in a timely manner because they have not analyzed various data processing options or compared cost data to determine system costs and capabilities. While SIPC officials stated that all major public accounting firms are capable of meeting their automation needs, they had only had experience with one firm, and they did not have cost data from any other firms. If the process of analyzing system comparisons does not take place until a SIPC liquidation is initiated, unnecessary delays could result in acquiring the automated system that is key to the processing of customer claims. We believe that SIPC would be in a better position to ensure that trustees acquire cost-effective automated liquidation systems on a timely basis by systematically analyzing automated system options and developing plans to meet diverse requirements of potential liquidations.

More Effective Oversight by SEC Is Needed

As the federal agency responsible for overseeing the securities industry, SEC has a vital interest in the protection of customers and the continued stability of the securities markets. SEC also has the responsibility for overseeing SIPC's operations, and in many cases would itself have to take action to ensure that SIPC can fulfill its responsibilities in the best possible manner. For example, SEC would have to issue any rule that would require the SROs to provide operational information to SIPC about troubled firms.

In the past, SEC has carried out its oversight responsibilities by participating in SIPC task forces, reviewing monthly and annual reports on SIPC's expenditures, investigating customer complaints about SIPC, and meeting with SIPC staff regarding liquidation issues. Moreover, SEC officials said the director of SEC's Division of Market Regulation began attending SIPC board meetings at the invitation of SIPC beginning in 1991.

While such contacts between SEC and SIPC are important, we question whether SEC has paid sufficient attention to its SIPC oversight responsibilities. In particular, SEC has not taken steps to ensure that SIPC develops plans to liquidate large troubled firms as the 1982 task force recommended. Additionally, according to SEC and SIPC officials, SEC has evaluated SIPC's operations only once, in 1985. Although SEC found at that time that SIPC was doing a good job selecting trustees and overseeing the liquidation process, it also identified actions that would speed the payment of customer claims, such as the development of an automated liquidation system. However, SEC never followed up on the 1985 evaluation to determine if SIPC's automation program met SIPC's various liquidation requirements. Without more active oversight efforts by SEC, investors and Congress cannot be assured that SIPC has fully implemented proposals designed to strengthen its operations.

Conclusions

SIPC has a responsibility to ensure that trustees liquidate failed firms efficiently so that customers are protected against unnecessary market losses and risks to the financial system are minimized. SEC and trustees have complimented SIPC's guidance and assistance in past liquidations. However, we believe that SIPC can enhance its ability to protect customers by improving its preparations for liquidations of large troubled firms. Specifically, SIPC should (1) collect information needed to liquidate troubled firms sooner and (2) assess the cost effectiveness of various automation options to ensure the timely acquisition of an automated liquidation system. Also, additional oversight by SEC could help ensure that SIPC was as prepared as possible for responding to the demands that would result from the liquidation of a large firm. Unless SIPC and SEC address these concerns, SIPC may not be in a position to manage liquidations efficiently and protect customers from unnecessary market losses resulting from delays in the liquidation process.

Recommendations

We recommend that the chairmen of SIPC and SEC work with the SROs to plan for the timely liquidation of a large broker-dealer by improving the timeliness of information provided to SIPC by the regulators that is needed to liquidate a troubled firm. We further recommend that the Chairman of SIPC, in coordination with the SEC Chairman, systematically determine SIPC's automation needs for various sized liquidations and develop appropriate plans and procedures to ensure that trustees will promptly acquire cost-effective automated liquidation systems.

Finally, we recommend that the SEC Chairman periodically review SIPC's operations and its efforts to ensure timely and cost-effective liquidations.

Agency Comments and Our Evaluation

SIPC and SEC officials commented on our recommendations to improve SIPC's preparations for liquidations. On our first recommendation to improve information collection, both agencies questioned the need for additional information. However, they both agreed to thoroughly review this matter. In commenting on our second recommendation to improve SIPC's automation program, SIPC stated that they continuously review their own automation system, determine their automation needs at the inception of a liquidation proceeding, and can make any necessary modifications without delaying the liquidation proceedings. Both agencies agreed to again review SIPC's system and consider all of our comments. Finally, SEC agreed with our third recommendation to initiate periodic reviews of SIPC operations and has taken steps to begin such a review.

SIPC and SEC responded to our report by stating that there are no indications of any problems with the information currently collected on financially troubled firms and that the evidence cited in the report is anecdotal. They also expressed concern that our report did not recognize SIPC's efforts to develop and upgrade its own automated liquidation system or that SIPC's decision to use its automated system, either alone or in conjunction with possible modifications to the debtor's automated system, is based on SIPC's assessment of the most cost-effective solution.

The responses by SEC and SIPC officials did not address our main concern, which is the issue of improving SIPC's preparations for the liquidation of a large broker-dealer. Instead, the comments suggested that we were criticizing SIPC for the way it had conducted liquidations and for alleged deficiencies in the automation system it has developed.

We modified the text and recommendations in chapter 4 to emphasize that our focus was on preparing for potential large liquidations because, as we noted in the draft, our main concern was with market stability. We did not assess the quality of specific SIPC liquidations or features of SIPC's automated liquidation system. Our recommendations to improve SIPC's preparations for large liquidations are prompted by a concern we share with previous SIPC and SEC chairmen that SIPC's ordinary liquidation procedures may not be sufficient to liquidate a large broker-dealer on a timely basis.

SIPC's ability to promptly process customers claims is critical to maintaining public confidence and stability in the financial system. Our recommendations focus on the two areas where timeliness could be key in a large liquidation: (1) the collection of information needed in the liquidation and (2) the acquisition of an automated liquidation system. In the first area, a SIPC task force, as well as some trustees experienced in SIPC liquidations, suggested that it would be useful to have specific operational information available to plan for a liquidation. We believe that SIPC and SEC officials could work together with the SROs to ensure that the collection of this information is not unduly burdensome for the regulators or troubled firms.

In the automation area, we agree that SIPC deserves credit for developing an automated system to meet its typical liquidation needs and have noted in the report that SIPC has made periodic improvements to the system. We also agree with SIPC's policy of integrating the most cost-effective automated data processing solutions into the assistance and support it provides to trustees appointed under SIPA. We do not question SIPC's ability in any case to use its own system or modify other systems. However, SIPC has not collected any cost data or compared various automation options. Therefore, we are concerned about whether these determinations can be accomplished without delay to the liquidation proceedings, particularly in situations involving large liquidations and liquidations where SIPC's own system could not be used. SIPC would be in a better position to make both timely and cost-effective decisions if it analyzed cost data for various automation options to plan for potential liquidations.

Discrepancies in Disclosing Customer Protections

Disclosure is an important feature of securities regulation so that customers have adequate information to make informed investment decisions and retain confidence in financial institutions and markets. Within the scope of this review, we were asked to discuss several aspects of disclosure related to SIPC membership. Specifically, we were asked to determine what information is provided to customers about SIPC's coverage and whether customers are informed of whether they are dealing with a SIPC member.

SIPC members are required to disclose their SIPC status to their customers. For the most part this disclosure seems adequate, although we found some areas where improvements could be made. There is, however, no requirement for non-SIPC members regulated by SEC to disclose their lack of membership in SIPC. In certain situations, customers have been confused because some nonmember firms are involved in similar securities activities as member firms, such as the purchase and sale of securities to customers. In addition, customers could be harmed because they may be subjected to undisclosed risks of loss or misappropriation of their funds or securities. If these nonmember firms were required to disclose that they were not SIPC members, investors would be better informed about the relevance of SIPC coverage to their investment decisions. We, therefore, believe that SEC should require nonmember firms that serve as intermediaries in customers' purchases of securities and have temporary access to customer funds to disclose their SIPC status.

Disclosure Requirements for SIPC Members

SIPC requires its members to inform customers about their SIPC status. SIPC members generally must display the SIPC logo in their principal and branch offices and in most advertising. These firms may also refer to SIPC in other material such as statements of account. SIPC may, however, prevent members from displaying the logo when it would be misleading—for example, if the firm's principal business was in products such as commodity options that are not covered by SIPC.

Disclosure regarding some of the features of SIPC coverage is also important. Even if a broker-dealer is a SIPC member, customers do not have SIPC protection for products not covered by SIPC. Furthermore, customers of failed firms lose SIPC protection if they do not submit their claims within 6 months after SIPC or the trustee publishes notification of a SIPC direct payment procedure or liquidation.[1] SIPC has developed an official

[1]SIPC may use a direct payment procedure rather than a formal court-supervised liquidation to resolve small firm liquidations if each customer claim is within the limits of SIPC protection and the claims of all customers total less than $250,000.

brochure to explain SIPC coverage and provides the brochure to its members for voluntary distribution to their customers. SIPC's brochure generally explains what SIPC does and does not cover.[2]

SIPC officials do not believe that customers of SIPC-member firms have a significant information problem relating to SIPC's coverage because most customers purchase typical securities products that are clearly covered by SIPC. Nevertheless, questions concerning customers' eligibility for SIPC coverage have been raised in correspondence and litigation relating to SIPC liquidations where some customers found out too late—after their firm failed or after the deadline for filing claims had passed—that they were not entitled to SIPC protection. Some of these customers had transacted business with an affiliate of the broker-dealer that was not a SIPC member. Others had not submitted their claim forms by the designated deadline.

SIPC's official brochure was recently revised to address potential customer confusion regarding the SIPC status of SIPC-member affiliates. The SIPC brochure now advises customers that some affiliates of SIPC members may not be SIPC members and that they should make checks payable only to SIPC members.

We agree that the SIPC brochure provides a useful mechanism for including or clarifying information that customers may need to know. In addition to SIPC's recent changes, we believe that SIPC should consider revising other areas of the brochure to address potential confusion. One area that SIPC should review involves specifically explaining the 6-month deadline for filing a claim in order to be eligible for SIPC protection. The brochure currently states only that customers should file their claims promptly within the time limits set forth in the notice and in accordance with the instructions to the claim form; no deadline is mentioned. This issue was raised in some customers' letters to SIPC when customer claims were denied because they were not filed within the designated time frame. If customers do not receive a notice from the trustee or see the newspaper notifications for a SIPC liquidation or direct payment procedure and, therefore, do not file within the 6-month period, they will not be protected by SIPC.

[2]SIPC's official brochure lists the securities that SIPC covers when purchased from a SIPC-member firm as notes, stocks, bonds, debentures, and certificates of deposit. Also, SIPC protects shares of mutual funds, publicly registered investment contracts or certificates of participation or interest in any profit-sharing agreement or in any oil, gas, or mineral royalty or lease. Finally, warrants or rights to purchase, sell, or subscribe to the securities mentioned above and to any other instrument commonly referred to as a security are protected under SIPA. On the other hand, the brochure explains that SIPC does not protect some securities-related products such as unregistered investment contracts; gold, silver, and other commodities; and commodity contracts or options.

Another area the brochure does not address is what customers should do if their broker-dealer fails or goes out of business but does not go through a SIPC liquidation. This information is important because 99 percent of broker-dealers that are liquidated or go out of business do so without going through SIPC. Customers should know that they still need to check to ensure that all of their securities and cash have been returned or transferred to another firm. If they find that this has not been done, they must notify SIPC or the regulators within 180 days after the firm's registration is withdrawn so that SIPC may consider whether to initiate formal liquidation or direct payment proceedings. They also should check on the status of their firm if regular statements about their accounts are not received.

Differences in Customer Disclosure Need to Be Addressed

As mentioned, there are no requirements for firms in the securities industry that are registered with SEC but not members of SIPC to disclose this fact to their customers. This lack of disclosure often poses no problem because many such firms do not have access to customer funds. However, there are situations in which this lack of disclosure could harm investors. These situations involve nonmember firms that serve as intermediaries in customers' purchases and sales of securities and may temporarily have access to customer funds. Should they fail or go out of business, these firms could expose customers to loss. If SIPC nonmembers with access to customer funds were required to disclose their SIPC status, there would be greater assurance that investors would be informed about the relevance of SIPC coverage to their investment decisions.

SIPC and SEC officials did not know the extent to which customers may have difficulties because of the differences in protections provided by nonmember firms. We agree that extensive evidence is hard to come by. However, the potential harm to investors is demonstrated by evidence that

- customers of SIPC nonmembers that have access to customer property are exposed to the same type of fraud that has been prevalent in SIPC-liquidated firms and
- some customers have had problems with SIPC nonmember firms that are affiliated or associated with member firms.

The spirit of the securities laws dating back to 1933 emphasizes the need to provide investors with information necessary or appropriate for their protection so that they can make informed decisions. In our judgment, for customers to be fully informed about the risks and differences in protection associated with different types of financial firms, disclosure of the SIPC status of nonmember firms that serve an intermediary role with customers and have access to customer property should be required.

Customers May Face Similar Risks From Members and Nonmembers

Information about the SIPC status of financial firms is important to customers when they face similar risks, but different protections, in purchasing similar types of products. Although most of the SEC-registered financial firms that are not SIPC members do not hold customer accounts, some types of firms play an intermediary role by accepting funds from customers for the purchase of securities products and, accordingly, have discretionary access to customer accounts. These intermediary firms are subject to the risks of misappropriating or losing customer funds. Nonmember intermediary firms include SIPC-exempt broker-dealers and certain types of investment advisory firms.

According to SIPC data as of year-end 1991, about 440 SEC-registered broker-dealers were excluded from SIPC membership. Broker-dealers that are not SIPC members include those whose business is involved exclusively in the following areas:

- selling shares of mutual funds or unit investment trusts,
- selling variable annuities or insurance,
- providing investment advisory services to registered investment companies or insurance company separate accounts,
- transacting business as a government securities specialist dealer,[3] or
- transacting principal business outside the United States and its territories and possessions.

Investment advisory firms are required under the Investment Advisers Act of 1940 to register with SEC. These firms may be involved in a variety of services, such as supervising individual clients' portfolios, participating in the purchase or sale of financial products, providing investment advice and developing financial plans for clients, and publishing market reports for subscribers. An SEC official estimated that about half of the approximately 17,500 investment advisory firms are involved in the purchase and sale of securities products to customers and may temporarily have access to customer funds. The other investment advisory firms provide primarily advisory or information services and do not serve an intermediary role or handle customer property. When these firms

[3]For further discussion of the SIPC exclusion of government securities specialist dealers, see our report, U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO/GGD-90-114, Sept. 14, 1990), pp. 60-63.

register with SEC, they must specify whether they will have custody or access to client accounts and identify any material relationship with a broker-dealer. In a previous review of investment advisers, we found, although precise figures were unavailable, some examples where investment advisory firms had misappropriated client funds.[4]

The importance of customers' choices between SIPC-member and nonmember firms may be illustrated by the purchase of a common securities product, mutual fund shares. Customers may purchase fund shares directly from mutual fund investment companies, which would not involve an intermediary from another firm. However, customers may also use an intermediary firm in their purchase of mutual fund shares. Customers may select different types of intermediaries, including SIPC-member broker-dealers, nonmember broker-dealers, investment advisers, and other types of financial firms not registered with SEC.[5] In these cases, the customer deals with a sales agent or intermediary who directs the customer funds to the mutual fund where the customers' shares are held. In 1991, SIPC-member broker-dealers earned about $4.2 billion in revenues from the sale of mutual fund shares while the revenues for nonmember broker-dealers were about $600 million.

In cases where customers are dealing with intermediaries, only customers of SIPC-member firms would be protected by SIPC if the firm holding their securities failed and required a SIPC liquidation. However, the potential for fraud exists in all intermediary situations. SIPC officials noted that in the last 5 years, 26 of 39 SIPC liquidations involved failures resulting from fraud on the part of introducing firms that did not retain customer accounts. In addition, during 1991 SIPC liquidated a broker-dealer involved primarily in selling mutual funds that failed due to the fraudulent misappropriation of about $1.8 million in customer funds. In these cases, the firms did not hold onto customer money or establish customer accounts. These firms failed due to fraud resulting primarily from agents misappropriating customer funds instead of passing them on to either the mutual fund sponsor or other broker-dealers.

[4]See our report Investment Advisers: Current Level of Oversight Puts Investors at Risk (GAO/GGD-90-83, June 26, 1990), pp. 11-12.

[5]Customers may also purchase mutual fund shares from banks and other depository institutions. However, we have limited the scope of our review in this report to those financial firms that are registered with SEC.

Nonmember Affiliates and Associates of SIPC-Member Broker-Dealers

One problem area regarding the SIPC status of nonmember intermediary firms involves those firms that are affiliated with (formally tied within the same financial holding company) or associated with (having a material relationship with) a SIPC-member broker-dealer. Here, in addition to the underlying risk of misappropriated funds, there is the additional complication of confusion regarding a possible tie to a SIPC member.

One of the major changes over the last 2 decades within the financial industry has been the emergence of large holding company structures headed by a parent company and comprising many (sometimes hundreds) affiliated insured and uninsured companies involved in diversified activities. In several highly publicized incidents, customers lost money because they unknowingly purchased uninsured products from uninsured affiliates of insured depository firms.[6] One such example involved the customers of the failed Lincoln Savings and Loan. Some Lincoln customers purchased uninsured bonds of the parent holding company in the lobby of the savings and loan.

Similar problems have occurred with customers of SIPC nonmember financial firms that were affiliated with SIPC broker-dealers. Under financial holding company structures, some firms may be allowed to sell securities products to customers but must have a broker-dealer execute securities trades and hold the customer accounts. SEC officials acknowledged that most of the problems that they are aware of relate to how the SIPC logo is displayed at SIPC-member broker-dealers that share common space with nonmember affiliates.

One example of the confusion over nonmember affiliates was addressed in a recent SIPC lawsuit involving the liquidation of a SIPC-member broker-dealer, Waddell Jenmar Securities, Inc., in North Carolina.[7] In this case, SIPC conceded that several customers were defrauded by Guilford T. Waddell, the president of both the SEC-registered broker-dealer and a nonmember investment advisory firm, Waddell Benefit Plans, Inc. (WBP), which administered pension plans. However, SIPC protection depended on whether these customers had been customers of the SIPC member broker-dealer. Some customers instructed Mr. Waddell to purchase stocks with funds from their pension fund accounts, which were held by WBP. Mr. Waddell never purchased the stocks and misappropriated customer funds. When SIPC liquidated the broker-dealer beginning in April 1989, several

[6] We reported on customer problems relating to the insured status of financial products offered by banks in our report Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

[7] In re Waddell Jenmar Securities, Inc., 126 Bankr. 935 (E.D. N.C. 1991).

customers disagreed with the trustee's refusal to honor their claims and appealed to the U.S. Bankruptcy Court. The judge decided in May 1991 that the claimants of the pension plan fund were not eligible for SIPC protection because they were not customers of the broker-dealer. Instead, the court held that the claimants' missing funds and securities were held by WBP.

Similar confusion has been raised in customer correspondence concerning nonmember firms that were associated, rather than formally affiliated, with a SIPC member. Often, these firms also transact business directly with customers and transfer customer funds to an associated broker-dealer that executes the securities transactions or hold the customer accounts. Some customers wrote to SIPC seeking clarification of these firms' SIPC status in situations involving investment advisory firms associated with SIPC-member broker-dealers. One such customer inquiry asked if SIPC protected the funds and securities invested with a nonmember financial planning firm and held by a SIPC-member broker-dealer. In this situation, if the financial planning firm failed and had not delivered the customer funds to a member broker-dealer, the customer would not be eligible for SIPC protection. But if the customer funds or securities were held in an account with a member broker-dealer, the customer property would have SIPC protection.

SEC Should Address Differences in Customer Protection

Differences in customer protection and differences in the disclosure of customer protection are two distinct and important issues. This review does not address the former issue. We believe that the disclosure differences among SEC-registered firms that transact securities-related business with customers and have access to customer funds need to be addressed so that customers can make more informed investment decisions. At a minimum, customers should know whether an SEC-registered firm that is subject to the risks of losing or misappropriating customer property is a member of SIPC. Congress has considered several legislative proposals that would require affiliates of SIPC-member broker-dealers to disclose their nonmember status. Another option is for SEC to address discrepancies in its regulatory disclosure requirements for registered firms that serve as intermediaries with customers and have access to customer funds or securities.

SEC officials said that they would prefer to address the disclosure issue by amending their regulations rather than by amending SIPA. They are considering revising their regulations to require affiliates of broker-dealers, and possibly nonmember broker-dealers, to disclose that they are not SIPC members, but they do not know when the proposal would be issued for comment. If SEC is to take the lead on this issue, it should identify and require those SEC-registered firms that serve as intermediaries in selling securities products to customers and have access to customer funds or securities to disclose that they are not SIPC members.[8]

We recognize that other financial firms outside SEC's jurisdiction also sell securities and securities-related products but are not required to disclose their SIPC status. This report is limited to financial firms under SEC's jurisdiction. In a previous study we have recommended that it would be appropriate for Congress to address the issue of uniform disclosure of federally insured and uninsured products.[9]

Conclusions

In today's financial markets, customers may receive different protection for similar securities-related products, depending on the type of firm from which they purchase the product. Only SIPC-member firms are required to inform their customers of their SIPC status. Some confusion has occurred over the protections available to customers, particularly those involving financial firms affiliated or associated with SIPC-member broker-dealers. Customers should have adequate information about the SIPC status of financial firms that serve as intermediaries in selling securities products so that they can make more informed investment decisions. SIPC and SEC can improve the information available to customers by addressing the current discrepancies in the disclosure requirements among those SEC-registered firms that serve as intermediaries with customers and have access to customer funds and securities.

Recommendations

We recommend that the SIPC Chairman review and revise, as necessary, SIPC's official brochure to better inform customers of what they should do if their securities firm fails or otherwise goes out of business and to specify the amount of time that customers have to respond in order to qualify for SIPC protection.

[8]The SEC-registered firms that are serving an intermediary role and that should be required to disclose their non-SIPC status would include those SIPC-exempt broker-dealers that assist customers in buying and selling securities much as introducing broker-dealers do. Also included should be those investment advisory firms that manage discretionary or nondiscretionary accounts. These firms have temporary custody of customer property and are subject to the risks of losing or misappropriating customer property.

[9]See GAO/GGD-91-26, p. 143.

We also recommend that SEC revise its regulations to require SEC-registered financial firms that serve in an intermediary role with customers and have access to customer funds or securities to disclose to their customers that they are not SIPC members.

Agency Comments and Our Evaluation

SIPC and SEC commented on our recommendations to provide customers with better information on SIPC liquidation proceedings and to require certain additional securities firms to disclose their SIPC status to customers. Both SIPC and SEC generally agreed to address our concerns. Although we do not agree with SIPC's comments that our report concludes that there are no substantial gaps in disclosure to customers about the SIPC program, SIPC has agreed to clarify its official SIPC brochure as soon as feasible.

SEC's comments indicate that while views within SEC differed regarding disclosure of SIPC status to customers, SEC is considering expanding disclosure requirements for some of the financial firms that serve in an intermediary role with customers. SEC's letter stated that its Division of Market Regulation is considering recommending a rule that would require disclosure of the absence of SIPC coverage on the part of (1) non-SIPC firms that are affiliated with registered broker-dealers and that have similar names or use the same personnel or office space and (2) non-SIPC registered broker-dealers. We support this effort, although if enacted it would leave a third category of firms—firms that are neither broker-dealers nor affiliates of broker-dealers that serve in an intermediary capacity—without a SIPC disclosure requirement. Additional efforts will still be needed to ensure that all SEC-registered firms make adequate disclosure regarding SIPC coverage in the event of misappropriation of customer funds.

Although SEC's Division of Investment Management believes there is some merit in our concern about the possibility of investor confusion, they do not believe that additional disclosure is necessary for two reasons. First, because investment advisers are excluded from SIPC membership, "there is no more reason to require investment advisers with custody of client funds or securities to disclose their non-SIPC status than there is reason to require investment advisers to disclose that they are not members of the Federal Deposit Insurance Corporation." Second, if investment advisers were required to disclose their non-SIPC status, they run the risk that customers will have the false impression that the funds and securities they manage or hold have less protection than other financial firms outside

SEC's jurisdiction (e.g., banks and future commission merchants) that also sell securities and securities-related products and are not required to disclose their SIPC status.

In response to the first reason cited by SEC's Division of Investment Management, we do not believe that the analogy to the FDIC status of investment advisory firms is valid. Investment advisory firms are not involved in transactions involving deposits, but certain investment advisory firms are involved in the purchase and sale of securities products—sometimes through an affiliation with a SIPC-member broker-dealer. Also, customers could be confused because investment advisory firms may be involved in many types of securities-related activities—including, as SEC's letter points out, having temporary custody of customer property. Officials in both SEC divisions agreed that there is a possibility of customer confusion about a firm's SIPC status, particularly with firms that are affiliated with SIPC-member broker-dealers. For this reason, we believe that it is important to inform customers of the SIPC status of firms with whom they transact securities-related business.

In response to the second reason, we focused our recommendations in this report on actions within SEC's jurisdiction, which includes only SEC-registered firms. While we cannot say whether customers will think that SIPC nonmember firms required to disclose have less protection than nonmember firms that are not required to disclose, we believe it is important that customers have better information to make more informed investment decisions. We also recognized in this report that some other financial firms (e.g., banks) involved in the purchase and sale of securities products are not required to disclose their SIPC status. This report notes that in a previous study we recommended that it would be appropriate for Congress to address the issue of uniform disclosure of federally insured and uninsured products.

SEC Customer Protection and Net Capital Rules

The Securities and Exchange Commission's (SEC) customer protection rule (15c3-3) and uniform net capital rule (15c3-1) form the foundation of the securities industry's customer protection framework. The net capital rule is designed to protect securities customers by requiring that broker-dealers have sufficient liquid resources on hand or in their control at all times to promptly satisfy customer claims. The customer protection rule is designed to ensure that customer property in the custody of broker-dealers is adequately safeguarded.

Customer Protection Rule Restricts Broker-Dealer Use of Customer Property

In the Securities Investor Protection Act of 1970 (SIPA), Congress directed SEC to promulgate rules and regulations necessary to provide financial responsibility safeguards including, but not limited to, the acceptance of custody and use of customer securities and free credit balances. SEC rule 15c3-3, restricting the use of customer property, was a result of this congressional directive. According to SEC, rule 15c3-3 attempts to

- ensure that customers' funds held by broker-dealers and cash that is realized through lending, hypothecation,[1] and other permissible uses of customer securities are used to service customers or are deposited in a segregated account for the exclusive benefit of customers;
- require broker-dealers to promptly obtain possession or control of all fully paid and excess-margin securities carried by the broker-dealers for customers;
- separate the brokerage operation of the firm's business from that of its firm activities, such as underwriting and trading;
- require broker-dealers to maintain more current records, including the daily determination of the location of customer property (for possession or control purposes) and the periodic calculation of the cash reserve;
- motivate the securities industry to process transactions more expeditiously;
- inhibit the unwarranted expansion of broker-dealer business activities through the use of customer funds;
- augment SEC's broad program of broker-dealer responsibility; and
- facilitate the liquidations of insolvent broker-dealers and protect customer assets in the event of a Securities Investor Protection Corporation (SIPC) liquidation.

Rule 15c3-3 has two requirements: (1) broker-dealers must maintain possession or control of all customer fully paid and excess-margin

[1]Pledging customer securities as collateral for a loan.

securities[2] and (2) broker-dealers must segregate all customer credit balances and cash obtained through the use of customer property that has not been used to finance transactions of other customers.

Part 1: Possession or Control

SEC's requirement that broker-dealers maintain possession or control of customer fully paid and excess-margin securities substantially limits broker-dealers' abilities to use customer securities. Rule 15c3-3 requires broker-dealers to determine, each business day, the number of customer fully paid and excess-margin securities in their possession or control and the number of fully paid and excess-margin securities that are not in the broker-dealer's possession or control. Should a broker-dealer determine that fewer securities are in possession or control than are required, rule 15c3-3 specifies time frames by which these securities must be placed in possession or control. For example, securities that are subject to a bank loan[3] must be returned to the possession or control of the broker-dealer within 2 days. Securities that are on loan to another financial institution must be returned to possession or control within 5 days of the determination. Once a broker-dealer obtains possession or control of customer fully-paid or excess-margin securities, the broker-dealer must thereafter maintain possession or control of those securities.

Rule 15c3-3 also specifies where a security must be located to be considered "in possession or control" of the broker-dealer. "Possession" of securities means the securities are physically located at the broker-dealer. "Control" locations are a clearing corporation or depository, free of any lien; a Special Omnibus Account under Federal Reserve Board Regulation T[4] with instructions for segregation; a bona fide item of transfer of up to 40 days; foreign banks or depositories approved by SEC; a custodian bank; in transit between offices of the broker-dealer or held by a guaranteed corporate subsidiary of the broker-dealer; in the possession of a majority-controlled subsidiary of the broker-dealer; or in any other location designated by SEC, such as in transit from any control location for no more than 5 business days.

[2]Excess-margin securities in a customer account are those securities with a market value greater than 140 percent of the customer's debit balance (the amount the customer owes the broker-dealer for the purchase of the securities).

[3]Securities that have been pledged to a bank as collateral.

[4]Federal Reserve System Regulation T (12 C.F.R. 220) regulates the extension of credit by and to broker-dealers. For the purposes of SEC rule 15c3-3, it deals primarily with broker-dealer margin accounts.

Part 2: Segregation of Customer Cash and the Reserve Formula

The second requirement of rule 15c3-3 dictates how broker-dealers may use customer cash credit balances and cash obtained from the permitted uses of customer securities, including from the pledging of customer margin securities. Essentially, the customer protection rule restricts the use of customer cash or margin securities to activities directly related to financing customer securities purchases.

The rule requires a broker-dealer to periodically (weekly for most broker-dealers) compute the amount of funds obtained from customers or through the use of customer securities (credits) and compare it to the total amount it has extended to finance customer transactions (debits). If credits exceed debits, the broker-dealer must have on deposit in an account for the exclusive benefit of customers[5] at least an equal amount of cash or cash-equivalent securities. For most broker-dealers, the calculation must be made every Friday, and any required deposit must be made by the following Tuesday.

Tables I.1, I.2, and I.3 show samples of the individual components of the cash reserve portion of rule 15c3-3 as they appear in the routine Financial and Operational Combined Uniform Single (FOCUS) reports submitted by broker-dealers to SEC. First, we will explain the numbered items as they relate to SIPC, and then we will use the items to demonstrate how the reserve calculation works.

The numbered items in table I.1 make up the credits portion of the reserve calculation. These accounts generally represent accounts payable by the broker-dealer to customers and money borrowed by the broker-dealer using customer property as collateral. Item 1 is the amount of cash in customer accounts that SIPC would be required to return to customers in a liquidation. Items 2 and 3 show the amount of customer property pledged as collateral for bank loans or involved in stock loans. Generally, the securities involved in these transactions come from customer margin accounts and are used to secure the customers' margin loans. Customers may also volunteer their fully paid securities for use in stock loans if the broker-dealer provides the customer with liquid collateral; however, when they do so they forfeit the SIPC protection covering those securities. These items also show the amount SIPC may need to advance to recover customer

[5]Rule 15c3-3 requires that broker-dealers maintain a bank account that is separate from any other account of the broker-dealer and specified as a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (reserve account). The broker-dealer must also obtain written notification from the bank that all cash or qualified securities within the reserve account are being held for the exclusive benefit of customers; cannot be used directly or indirectly as security for any loan to the broker-dealer by the bank; and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

property pledged as collateral at banks or involved in stock loans with other broker-dealers.

Table I.1: Credits Component of the Reserve Formula Calculation

	Credit balances	Week 1	Week 2
1.	Free credit balances and other credit balances in customers' security accounts.	$10,000,000	$10,000,000
2.	Monies borrowed collateralized by securities carried for the accounts of customers.	3,000,000	3,000,000 + 50,000
3.	Monies payable against customers' securities loaned.	5,000,000	5,000,000
4.	Customers' securities failed to receive.	4,000,000	4,000,000
5.	Credit balances in firm accounts which are attributable to principal sales to customers.	4,000,000	4,000,000
6.	Market value of stock dividends, stock splits, and similar distributions receivable outstanding over 30 calendar days.	1,000,000	1,000,000
7.	Market value of short security count differences over 30 calendar days old.	2,000,000	2,000,000
8.	Market value of short securities and credits (not to be offset by longs or by debits) in suspense accounts over 30 calendar days.	500,000	500,000
9.	Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days.	1,000,000	1,000,000
10.	Other (list)		
11.	**Total credits**	**$30,500,000**	**$30,550,000**

Source: SEC FOCUS Report.

The numbered items in table I.2 make up the debits portion of the reserve calculation. These accounts generally represent transactions that the broker-dealer has financed for customers; item 18 is analogous to the broker-dealer's loss reserve for the loans made to customers.[6] The loans to customers aggregated in these accounts are secured by customer property. If at some point the market value of the customer property securing the debit falls sufficiently to make the debit unsecured or partially secured, the unsecured portion of that account is taken out of the reserve

[6]See Molinari and Kibler, Broker-Dealer's Financial Responsibility under the Uniform Net Capital Rule—A Case for Liquidity, 72 Geo L.J. 1 (1983).

calculation, given a haircut, and charged against the net capital of the broker-dealer.

In a SIPC liquidation, the customer has the option to either pay the remaining debit balance or allow the trustee to liquidate securities in that customer's account to pay the balance. If the debit balance in the account is greater than the value of the securities in the account, the trustee usually liquidates the securities and attempts to recover the remaining debit balance.

The Federal Reserve and the self-regulatory organizations (SROs) set initial margin account requirements that must be met before a customer may effect new securities transactions and commitments. In addition, the SROs and broker-dealers set maintenance margin requirements to limit the likelihood that margin loans to customers will become unsecured. These requirements specify how much equity each customer must have in an account when securities are purchased and how much equity must be maintained in that account. For example, the New York Stock Exchange (NYSE) requires that customers of its member firms maintain at least 25 percent equity for all equity securities long in an account. This means that the customer must maintain equity of at least 25 percent of the current market value of the securities in the account. The equity balance of a margin account is calculated by subtracting the current market value of all securities short and the amount of the customer's debit balance (the amount the customer owes the broker-dealer for the purchase of the securities) from the current market value of the securities held long in the account plus the amount of any credit balance.

Table I.2: Debits Component of the Reserve Formula Calculation

	Debit balances	Week 1	Week 2
12.	Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection net of deductions pursuant to rule 15c3-3.	$10,000,000	$10,000,000 + 50,000
13.	Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver.	1,000,000	1,000,000
14.	Failed to deliver of customers' securities not older than 30 calendar days.	4,000,000	4,000,000
15.	Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer accounts.	2,000,000	2,000,000
16.	Other (list).		
17.	Aggregate debit items.	17,000,000	17,050,000
18.	Less 3 percent (for alternative net capital requirement calculation method only).	(510,000)	(511,500)
19.	**Total debits**	**$16,490,000**	**$16,538,500**

Source: SEC FOCUS Report.

The numbered items in table I.3 show how the aggregate credit and debit items come together to determine the required segregated reserve. If aggregate credits are greater than aggregate debits, the broker-dealer must ensure that it has sufficient funds in its reserve account to cover the difference. If debits are greater than credits, no reserve is required.

Table I.3: Reserve Calculation

	Reserve computation	Week 1	Week 2
20.	Excess of total debits over total credits (line 19 less line 11).		
21.	Excess of total credits over total debits (line 11 less line 19).	$14,010,000	$14,011,500
22.	If computation permitted on a monthly basis, enter 105 percent of excess total credits over total debits.		
23.	Amount held on deposit in "Reserve Bank Account(s)", including value of qualified securities, at end of reporting period.	14,000,000	14,010,000
24.	Amount of deposit (or withdrawal) including 0 value of qualified securities.	10,000	1,500
25.	New amount in Reserve Bank Account(s) after adding deposit or subtracting withdrawal including 0 value of qualified securities.	$14,010,000	$14,011,500
26.	Date of deposit	1-7-92	1-14-92

Source: SEC FOCUS Report.

To demonstrate how the reserve formula works with regard to customer credit balances and margin accounts, we prepared this example. The column labeled "Week 1" in tables I.1, I.2, and I.3 shows the account balances of a hypothetical broker-dealer. During week 2, customer A purchased $100,000 worth of securities on margin by paying $50,000. The broker-dealer borrowed $50,000 from a bank, using $70,000 of customer A's securities as collateral.

Item 2 in table I.1 records the use of customer securities for the bank loan, and item 12 in table I.2 records the $50,000 that customer A borrowed (debit) to buy the securities. Item 11 shows total credits increasing by $50,000 in week 2. Item 17 shows aggregate debits also increasing $50,000; however, total debits only increased by $48,500, reflecting the 3-percent charge from item 18. The effect of customer A's transaction is also reflected in the broker-dealer's cash reserve requirement in table I.3, item 21.

Had the broker-dealer chosen to fund customer A's margin account purchase with free credit cash from other customers, the credit balances shown in table I.1 would not change from week 1 to week 2. The debit balances shown in table I.2 would reflect the $50,000 increase in item 12, increasing total debits. The required reserve in this second example would decrease by $48,500, and the broker-dealer would be allowed to withdraw that amount from the reserve account. These examples show that broker-dealers must either segregate customer cash in a reserve account (example 1) or use it to lend to other customers (example 2).

Net Capital Rule Stresses Liquidity

In 1975, SEC established the uniform net capital rule (a modification of rule 15c3-1) as the basic capital rule for broker-dealers, which is applicable to all SIPC members.[7] This rule was designed to make sure that broker-dealers maintain sufficient liquid assets to cover their liabilities. In order to comply with rule 15c3-1, the broker-dealer must first compute its net capital, the net worth plus subordinated debt less nonallowable assets and deductions that take into account risk in the broker-dealer's securities and commodities positions. Second, the broker-dealer determines its net capital requirement in one of two ways: (1) the basic method, where aggregate indebtedness cannot exceed 15 times net capital, or (2) the alternative method, where net capital must be at least 2 percent of aggregate debits from the cash reserve calculation of rule 15c3-3.

Computing Net Capital

The process of calculating a broker-dealer's net capital is really a process of separating its liquid and nonliquid assets. For the purposes of calculating net capital, only assets that are readily convertible into cash—on the broker-dealer's initiative-count in the capital computation. For example, fixed assets (such as furniture and exchange seats) as well as unsecured receivables (such as unsecured customer debits, described in the previous section) cannot be included as allowable assets in the net capital calculation.

The process of computing net capital also involves computing the market value of broker-dealer assets and accounting for the price volatility of broker-dealer securities. The net capital rule applies a discount (haircut) to proprietary securities according to their risk characteristics, i.e., price volatility. For example, debt obligations of the U.S. government receive a haircut depending on their time to maturity—from a 0-percent haircut for obligations with less than 3 months to maturity to a 6-percent haircut for obligations with more than 25 years to maturity.

[7]This rule also applies to SEC-registered broker-dealers that are not SIPC members, but SEC has the authority to exempt some SIPC nonmember firms from the rule.

Basic Net Capital Requirement

Calculating a broker-dealer's required capital, using the basic method, involves calculating the broker-dealer's aggregate indebtedness. Generally, aggregate indebtedness means the total liabilities of the broker-dealer, including some collateralized liabilities and liabilities subordinated to the claims of other creditors or customers. For broker-dealers that choose to use the basic net capital requirement, the minimum dollar net capital requirement for broker-dealers engaging in the general securities business, which involves customers, is $25,000. For broker-dealers that generally do not carry customer accounts (introducing brokers), the minimum capital requirement is $5,000.

SEC has proposed that these minimum net capital standards be raised to $250,000 for broker-dealers that hold customer property. Clearing firms that do not hold customer property and introducing firms that routinely receive customer property would be required to hold at least $100,000 in net capital. Introducing broker-dealers that do not routinely receive customer property would be required to hold at least $50,000 in net capital.

Alternative Net Capital Requirement

SEC offered broker-dealers an alternative to the basic net capital requirement that is based on the broker-dealers' responsibilities to customers rather than aggregate indebtedness. This requirement option (most commonly used by large broker-dealers), in conjunction with rule 15c3-3, is designed to ensure that sufficient liquid capital exists to return all property to customers, repay all creditors, and have a sufficient amount of capital remaining to pay for a liquidation if the broker-dealer fails. The broker-dealer's ability to return customer property is addressed by rule 15c3-3. The repayment of creditors and the payment of the broker-dealer's liquidation expenses is addressed by the 2-percent net capital requirement and the deductions from net worth for illiquid assets and risk in securities and commodities positions.

SEC believed the alternative requirement would promote customer protection and still allow broker-dealers to allocate capital as they see fit by

- acting as an effective early warning device to provide reasonable assurance against loss of customer property,
- avoiding inefficient and costly misallocations of capital in the securities industry,

- eliminating competitive restraints on the securities industry in its interaction with other diversified financial institutions,
- making the capital structures of broker-dealers more understandable to suppliers of capital to the public, and
- providing some reasonable and finite limitation on broker-dealer expansion.

Broker-dealers using the alternative capital requirement must hold at least $100,000 in capital. The new minimum standards proposed by SEC would also apply to broker-dealers using the alternative method. Generally, broker-dealers maintain capital levels far in excess of the minimum requirement; this amount is recorded in item 28 of table I.4. Table I.4 shows the items included in the alternative capital requirement calculation.

Table I.4: Alternative Net Capital Calculation

	Computation of alternative net capital requirement
22.	Two percent of combined aggregate debit items as shown in Formula for Reserve Requirements (rule 15c3-3), prepared as of the date on the net capital computation, including both brokers or dealers and consolidated subsidiaries' debits.
23.	Minimum dollar net capital requirement of reporting broker or dealer and minimum net capital requirement of subsidiaries.
24.	Net capital requirement (greater of line 22 or line 23).
25.	Excess net capital (total net capital less line 24).
26.	Percentage of net capital to aggregate debits.
27.	Percentage of net capital after anticipated capital withdrawals to aggregate debits.
28.	Net capital in excess of the greater of 5 percent of aggregate debit items or $120,000.

Source: SEC FOCUS Report.

Comments From the Securities Investor Protection Corporation

SIPC

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OFFICE OF THE GENERAL COUNSEL

June 22, 1992

Richard L. Fogel
Assistant Comptroller General
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Washington, D.C. 20548

Dear Mr. Fogel:

We are pleased to have this opportunity to offer the comments of the Securities Investor Protection Corporation ("SIPC") on the GAO Draft Report on SIPC. As the Executive Summary of your report notes, the Congressional committees asked GAO to report on three principal issues: "1) the exposure and adequacy of the SIPC fund, 2) the effectiveness of SIPC's liquidation oversight efforts, and 3) the disclosure of SIPC protections to customers." Draft Report Executive Summary ("ES") at 1. We are pleased to note that in each of these areas the GAO report gives SIPC a vote of confidence. Indeed, it follows from the report's principal findings that the program of investor protection enacted in the Securities Investor Protection Act of 1970 ("SIPA") has been a major success.

Now on p. 2.

SIPC's role is viewed in the proper perspective as an element in a statutorily mandated program to promote investor confidence by upgrading broker-dealer financial responsibility and by providing protection to customers of failed broker-dealers. The report reflects that the Securities and Exchange Commission ("SEC"), under authority granted in SIPA, has devised, promulgated, and, together with the self-regulatory organizations, enforced effective financial responsibility rules for SIPC members which have sharply curtailed the need for investor protection through SIPC financed customer protection proceedings.

Set forth below are our comments on the matters covered by the report, including our responses to some comments with which we disagree. We have submitted a separate memorandum alerting GAO to a few technical problems we find in the Draft Report. SIPC will not in this letter offer comments on those parts of the report which deal with the SEC or the SEC's role in the SIPC program.

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The Exposure and Adequacy of the SIPC Fund

The proper measure of SIPC's exposure and the adequacy of SIPC's resources appear to be the main reasons that GAO was asked to do the study. We note that you have "determined that no quantifiable measure exists to judge the exposure of the SIPC fund and the adequacy of its reserves. . . ." (Draft Report at 1.16) and that "[i]n assessing the reasonableness of SIPC's financial plans, [you] concluded that there is no methodology that SIPC could follow which would provide a completely reliable estimate of the amount of money SIPC might need in the future. * * * SIPC's estimate, therefore, must be judgmental." Draft Report at 3.9. In light of your determinations, with which we fully concur, we are gratified that GAO has stated its belief "that SIPC's strategy represents a responsible approach for planning for future needs" (Draft Report at 3.9); that "SIPC officials have acted responsibly in adopting a financial plan that would increase Fund reserves to $1 billion by 1997" (ES at 9); and that "based strictly on the historical record, SIPC resources would seem to be adequate." Draft Report at 3.5.

Now on p. 19.
Now on p. 44.
Now on p. 44.
Now on p. 5.
Now on p. 42.

The report suggests that the principal threat to the continued effectiveness of the SIPC program is the possibility that SIPC and the regulators might become complacent. As a theoretical statement, we cannot disagree, but in fact the report itself shows no reason to believe that either SIPC or the regulators are becoming complacent. Indeed, the recent decisions of the SIPC Board with regard to the fund size and the line of credit demonstrate just the opposite.

We concur with the report's position that "a cash fund is superior to private insurance, letters of credit, or lines of credit in terms of providing a basic level of customer protection and public confidence." Draft Report at 3.23. We believe lines of credit, however, are a useful supplement to a cash fund.

Now on p. 51.

SIPC Should Not Be Given Authority to Examine Its Members

The report states that GAO does "not believe that SIPC needs the authority to individually examine its members" (Draft Report at 2.1), and concludes that providing SIPC with investigative or regulatory authority is not warranted. Draft Report at 2.34. This fully accords with SIPC's long standing views on this subject. The reasons given in the report are the same reasons SIPC has articulated in the past. One additional reason, not mentioned in the report, is our perception that, by divorcing the regulatory function from the customer protection function, the authority and responsibility of the regulator and the protector are both enhanced and clarified.

Now on p. 22.
Now on p. 38.

The Effectiveness of SIPC's Liquidation Oversight Efforts

We, of course, are pleased the report concludes that "SIPC's role in providing back-up protection for customers' cash and securities has worked well."

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Now on p. 4.
Now on p. 54.
Now on p. 54.

(ES at 7); that "the assistance SIPC provides trustees during liquidations has received high marks. . . " (Draft Report at 4.1); and that the GAO has "no reason to question the quality of the assistance SIPC provides after a liquidation begins. . . . " Draft Report at 4.2.

Disclosure of SIPC Membership and Protections to Customers

Now on p. 65.

The report concludes that there are no substantial gaps in disclosure to customers about the SIPC program, noting that "[f]or the most part this disclosure seems adequate. . . " Draft Report at 5.1. The report does recommend that disclosure as to the time limits for filing claims in a SIPC liquidation and the time limits on SIPC's jurisdiction to initiate liquidation proceedings be enhanced. We note that the published notices of liquidation proceedings set forth the time limits for customers to file claims and that the notice, claim forms, and instructions mailed to customers set forth these time limits in large, bold faced type. Nevertheless, we recognize the merit in GAO's comments, and we will revise the question and answer booklet with a view toward implementing your suggestions as soon as feasible.

Planning for a Very Large Liquidation Proceeding

The report expresses concern that SIPC does not take adequate steps to gather operational information on firms which may be liquidated prior to the initiation of a liquidation proceeding. The evidence cited in the report for the need for this information is anecdotal. There is no indication whatsoever that the problems discussed were more than an inconvenience or that these matters delayed the processing or satisfaction of customer claims.

SIPC does, of course, receive information on members in financial difficulty from the regulators and frequently requests as much information as it can in order to make its independent determination of the need for SIPC protection and to select a trustee and counsel with adequate experience and resources to meet the needs of the undertaking. We will, however, thoroughly review this matter with the SEC and the SROs.

SIPC's Automation Policies

SIPC has pursued a policy of integrating the most cost effective automated data processing solutions into the assistance and support SIPC provides to trustees appointed under SIPA. SIPC has achieved some important successes, including the conception, definition, and creation of the first and only automated liquidation system designed for use in the liquidation of broker-dealers under SIPA. The GAO Report, however, expresses concerns about SIPC's efforts and preparedness in this area. For the reasons set forth below, we believe those

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concerns are based on erroneous assumptions and a misunderstanding of the liquidation process.

Now on pp. 60 - 61.

Now on p. 60.

Now on pp. 60 - 61.

Now on p. 60.

Now on p. 60.

The GAO Report states, "[w]e believe it is critical that SIPC review its automation practices and develop policies which ensure that trustees acquire capable automated liquidation systems on a timely basis." Draft Report at 4.12. The report defines automated liquidation systems as "computer software programs that help trustees organize liquidations and pay customer claims promptly." Draft Report at 4.12. The report reflects concern that "SIPC has not assessed current practices to ensure that the trustees of large liquidations acquire automated systems." Draft Report at 4.15. The report states that in cases too large for SIPC's own system "SIPC relies primarily on one supplier that has developed a system SIPC officials believe exceed the capabilities of others on the market." Draft Report at 4.14. The report observes that SIPC's reliance on "one supplier" incurs the risk that "the system may be unavailable in an emergency or may cost more than other competitive systems." Draft Report at 4.15. The difficulty with the Draft Report's position is that, except for what SIPC has developed, there is no off-the-shelf "automated liquidation system" for stockbroker liquidations and there is, therefore, no "supplier" of such systems.

At the inception of a liquidation proceeding, the SIPC staff reviews the automated data processing capabilities of the debtor, with a view toward determining whether to use SIPC's system alone; SIPC's system in conjunction with the debtor's existing data processing capability; or the debtor's capability, modified for the needs of the liquidation. This determination and any modifications necessary can be accomplished without delay to the liquidation proceeding. The trustee and SIPC select a public accounting firm which is best qualified to supply the accounting services required for that liquidation, which includes the automated data processing expertise needed for the unique requirements of a SIPA liquidation. In SIPC's view, all major public accounting firms are capable, in terms of experience and data processing expertise, of supplying those services. SIPC, and the trustee, engage the public accounting firm judged the best positioned to meet requirements of that liquidation at the lowest cost. The firm selected may well be one with a track record in SIPA proceedings and one which has developed relevant experience and expertise.

SIPC's "automated liquidation system" was planned to interface with a debtor's own computer system. As stated by Charles Cash of KMPG Peat Marwick, SIPC's consultant on its data processing requirements, *"The system was not to be a replacement for the broker dealer's own back office accounting system.* We designed the system to support the liquidation process with enough back office functionality to handle routine needs. For larger, more complex liquidations, the broker dealer's existing system can be used to meet back office needs." (Exhibit A. Cash Ltr. June 15, 1992, at 2. Hereinafter "the Cash Letter.") (Emphasis in original.)

SIPC's software package can 1) generate a broad variety of reports needed by a trustee and SIPC, 2) provide an automated capability of claims

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matching and sorting according to the results of the match, and 3) to assist in the satisfaction of customer claims. It is a complex and highly sophisticated system. (Attached as Exhibit B is a copy of the table of contents of the user's manual.) The SIPC software package provides the only existing automated capability for matching customer claims with the debtor's records and reporting on the results of the match.

SIPC's system was designed for cases of the magnitude most frequently encountered by SIPC although it can now be used in cases larger than originally contemplated.1/ It is employed in all cases where its use will be most efficient and cost-effective, for example, in cases in which the debtor broker-dealer does not have an existing, staffed computer system which can be adapted to meet the special requirements of a SIPC liquidation.

The SIPC software package is continuously reviewed and critiqued. You can be confident that we will again review our automation system with all of the GAO comments in mind. If the addition of a capability is considered feasible and cost-effective, it will be added. "Each new user requirement and new technological development is reviewed in terms of other alternatives available, cost and potential use on other liquidations." Cash Letter at 3. *See also* Cash Letter at 4.

Differences Between Securities Industry and Banking Industry

We believe it is important to call attention to that part of the report which correctly notes the significant differences between the obligations of SIPC member broker-dealers to their customers and the obligations of banks to their depositors. An example would be the report's conclusion that the "risks to the taxpayer inherent in SIPC are thus less than those associated with the deposit insurance system." ES at 3. Broker-dealers hold securities and cash entrusted to them by investors and are prohibited, except in a very limited manner, from using the securities or cash in their own business. Banks must use their resources, including insured deposits, to generate the income necessary for profits, operating expenses, and interest to depositors.

1/ "While it was not initially capable of handling 50,000 to 60,000 customer claims, this is not the case today. If we were to add high performance workstations and faster printing devices to the network, the system could handle substantially more than 50,000 to 60,000 customer claims. *The advances in microcomputer technology, networks, high performance systems, and high speed printers make it almost impossible to place a practical limit on its ability to handle a large number of claims.* These additions are easily added on an as needed basis and only involve a nominal cost. To suggest that the system will only 'handle the small number of claims that SIPC trustees typically liquidate' does not reflect its true capability." Cash Letter at 3. (Emphasis added.)

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In the case of SIPC members, then, the risk of loss and the possibility of gain through appreciation or loss in value of securities is that of the investor. Banks, however, are obligated to depositors for principal and interest on deposits but the risk of nonperformance of the bank's portfolio of assets is the bank's. Thus, the SIPC member broker-dealer's financial condition is not threatened by the vagaries of the economy in the same manner as is a bank's.

Conclusion

The report's descriptions of and conclusions as to SIPC depict a successful program. The costs of SIPC's operations to the taxpayer have been zero. We believe we have taken all reasonable steps to ensure that continues. SIPC has met all its obligations in an environment of major changes in the industry, has absorbed losses of customer property resulting from massive frauds and, in short, has been equal to all the challenges it has faced.

Although the SIPC fund is at its highest level in history, the report correctly notes the assessment burden has been low. SIPC has taken responsible measures to ensure the financial strength required to continue to meet its obligations and, as the report notes, assessments should remain low. It would seem fair to conclude that SIPC has achieved its objectives in a cost-effective manner and the success of the undertaking makes it a fine example of industry and government cooperation.

Very truly yours,

James G. Stearns
Chairman

JGS:ved

Enclosures

Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

July 21, 1992

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I am writing in response to your letter of June 1, 1992, to Chairman Breeden requesting our comments on the General Accounting Office's ("GAO's") draft report entitled Securities Investor Protection Corporation: The Regulatory Framework has Minimized SIPC's Losses (the "Report").

We concur with the Report's central conclusion that the Securities Investor Protection Corporation ("SIPC") has been successful in protecting customers against losses. We are pleased to note that the Report also concludes that the Securities and Exchange Commission ("Commission") and the self-regulatory organizations ("SROs") have effectively enforced their financial responsibility rules and thus have minimized losses to SIPC. The Commission's promulgation and enforcement of Rules 15c3-1 and 15c3-3 under the Securities Exchange Act of 1934 (the "Act"), 17 CFR §§ 240.15c3-1 and 15c3-3, are noted for their particular importance in preventing such losses.

With regard to protection of the investing public, the Report accurately relates that SIPC serves in a backup role to the regulatory activities of the Commission and the SROs. Additionally, the Report correctly describes the means by which the Commission and the SROs ensure that broker-dealers comply with their rules. The Commission and SROs monitor compliance by, among other things: conducting routine examinations of broker-dealers; requiring firms whose capital falls below early-warning levels to notify the Commission and the SROs; requiring broker-dealers to prepare and file financial reports on a monthly and quarterly basis; and requiring firms to undergo annual audits by independent public accountants. To summarize, the Report describes a successful program of investor protection. SIPC's financial resources are at an all-time high, no taxpayer funds have ever been used, and SIPC's funding strategy represents a responsible approach for dealing with the SIPC fund's (the "Fund's") potential exposure.

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In the Report, the GAO offers five recommendations regarding the Commission's oversight responsibilities with respect to SIPC. In response to GAO's recommendations, we have reassessed the adequacy of earlier initiatives which sought to address the same concerns expressed in the Report.

See p. 53.

1. <u>Taking into account changes in the principal risks to the Fund, the Commission and SIPC should periodically assess SIPC's funding arrangements to ensure that the Fund is adequate.</u>

We agree that the adequacy of the SIPC fund should be reviewed periodically. SIPC and the Commission have done so, and we will continue to do so. During the last 7 years, SIPC has commissioned two task forces[1] and Deloitte & Touche[2] to review the adequacy of the SIPC fund and funding arrangements. The Commission staff has participated on these task forces. We have discussed the adequacy of the SIPC fund with the SIPC Board of Directors and SIPC staff. The adequacy of the SIPC fund is a matter of concern to us at all times.[3]

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[1]The task forces were composed of representatives from the securities industry, SIPC and the government.

[2]<u>Deloitte & Touche, Special Study of the SIPC Fund and Funding Requirements, October 8, 1990</u>. The Deloitte & Touche study used a very conservative "worst case analysis" which we believe substantially overstates the SIPC advances likely required in liquidating a large broker-dealer.

[3]The Report suggests that massive fraud at a major firm or the simultaneous failures of several of the largest broker-dealers could result in losses to SIPC of over $1 billion. Fraud on such an enormous scale, while theoretically possible, is highly unlikely. In small firms, fraud has resulted in misappropriation of a significant proportion of customer assets held by a broker-dealer. However, the proportion of customer assets misappropriated in smaller firms cannot be used to reasonably estimate possible losses in larger firms. Larger firms have active internal surveillance and compliance departments that would most likely uncover such fraud well before it could jeopardize large amounts of customer assets. In addition, the Commission and the SROs have significantly more frequent inspection schedules and reporting requirements for larger firms as a means of preventing such fraudulent activity.
(continued...)

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2. <u>The Commission, SIPC, and the self-regulatory organizations should develop rules that require regulators to provide SIPC with information about troubled firms that the regulators can reasonably be expected to collect.</u>

See p. 62.

Specifically, the Report recommends that the regulators provide SIPC with the following information in advance of liquidation: (1) a list of branch offices; (2) the location of leases for branch offices; (3) the location of equipment leases and other executory contracts; (4) a list of banks or financial institutions with funds or securities on deposit; (5) location of vaults and other secure locations; (6) location and description of computer data bases and services used; (7) location of mail drops; (8) a chart of interlocking corporate relationships between the broker-dealer and its affiliates; (9) a list of key personnel; and (10) an accurate idea of the number of active customer accounts.

Currently, the Commission's regulations require broker-dealers to prepare and preserve in an accessible place a considerable amount of information relating to their business.[4] When a SIPC member's financial condition may warrant SIPC intervention, the Commission and SRO staffs immediately begin to collect data and documentation that could be used in liquidation proceedings. This information is shared with SIPC as soon as it is obtained.

The Report implies that the satisfaction of customer claims may be delayed by a lack of readily accessible documentation. Indeed, reluctant, uncooperative owners or managers--who may have been involved in fraud or wrongdoing--are unlikely to provide

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[3](...continued)
Also, given the operation of the Commission's and SROs' regulatory program, simultaneous failures of several of the largest broker-dealers requiring SIPC intervention are highly unlikely.

Finally, because of the strong regulatory program, the Commission and the SROs have been able to wind down the operations of many broker-dealers experiencing difficulty without the need for SIPC intervention. Large broker-dealers such as Drexel Burnham Lambert, Inc. and Thomson McKinnon Securities Inc. have been wound down in this fashion.

[4]The information that a broker-dealer must maintain is listed in Rules 17a-3 and 17a-4 under the Act, 17 CFR §§ 240.17a-3 and 17a-4.

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important information. The Report, however, does not identify any cases in which the absence of the above information actually impeded the satisfaction of customer claims. Nevertheless, we will review this recommendation with SIPC and the SROs in an effort to improve the information gathering and distribution process.

See p. 62.

3. <u>The Commission, in coordination with SIPC, should systematically review SIPC's automation needs to ensure that SIPC has adequate computer facilities to carry out liquidations in a timely fashion.</u>

The Report expresses concern that SIPC's automation practices may be inadequate, particularly with regard to the system's ability to handle liquidation of a major broker-dealer. The Report suggests that the Commission, in its oversight capacity, should identify and correct shortcomings with the current SIPC liquidation system, determine SIPC's automation needs with regard to liquidation of firms of various sizes, and ensure that SIPC trustees promptly acquire efficient automated liquidation systems.

We have previously expressed these same concerns to SIPC, and SIPC, in our view, has adequately responded. In 1985, we recommended to SIPC that it expedite automation of its liquidation process. SIPC retained KPMG Peat Marwick as consultants to develop an automated liquidation system. Both the Commission and SIPC staffs anticipated that automating the liquidation process would provide greater uniformity in liquidation proceedings and expedite satisfaction of customer claims.

KPMG Peat Marwick designed SIPC's automated liquidation system to interface with broker-dealers' existing computer systems. The system was designed to allow SIPC quickly to: match and sort customer claims for, and a liquidating broker-dealer's records of, cash and securities; generate reports that the SIPC trustee is required to complete; and otherwise meet information processing requirements in broker-dealer liquidations. KPMG Peat Marwick also designed the system to be user-friendly and not to require SIPC to maintain a large staff solely to operate the computers.

Initially, SIPC and KPMG Peat Marwick decided that the system should be able to process the types of cases most frequently encountered by SIPC--those cases with approximately 10,000 to 15,000 customer claims. The software was at first operable only on a single IBM personal computer. The system has

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been progressively upgraded and now may be incorporated into a network with multiple workstations. Although the Report indicates that SIPC's automation system is currently capable only of liquidating a firm with fewer than 60,000 customers, in a letter to SIPC from a representative of KPMG Peat Marwick, the representative stated that it is almost impossible to place a practical numerical limit on the system's ability to handle claims. The only practical limitation on the automation system relates to computer hardware. If a large broker-dealer must be liquidated, SIPC can promptly acquire or rent the hardware necessary to complete the liquidation, or it can use the broker-dealer's existing computer systems.[5]

Notwithstanding our present assessment of SIPC's automation program, we have resolved to consider this matter further. The Commission is currently undertaking an inspection of SIPC's operations. This inspection should be completed during the last quarter of 1992. SIPC's automation system is one of the areas that will be examined by the Commission staff. Upon completion of the inspection, we will take such action as appears appropriate.

See p. 62.

4. <u>The Commission should periodically review SIPC's operations and its efforts to ensure that SIPC performs timely and cost-effective liquidations.</u>

The Commission is engaged in constant oversight of SIPC's activities. Commission staff members hold quarterly meetings with SIPC staff members to discuss matters that concern or require the attention of the Commission. In the course of day-to-day operations, the two staffs communicate regularly by telephone. The Director of the Commission's Division of Market Regulation[6] attends the meetings of SIPC's Board of Directors. Bylaws passed by SIPC's Board of Directors must be submitted to the Commission before they take effect. SIPC's rules must be approved by the Commission. The Commission receives monthly reports from SIPC concerning the status of the Fund and current

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[5]In fact, a representative of KPMG Peat Marwick has stated that there is no practical limit on the number of claims that can be processed under the existing system. <u>See</u> Letter from James G Stearns to Richard L. Fogel (June 22, 1992)(KPMG Peat Marwick's letter to SIPC responding to the GAO's draft report is attached as an appendix to Mr. Stearns' letter).

[6]The Division of Market Regulation is responsible for, among other things, regulating the activities of broker-dealers.

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liquidations. SIPC submits after the end of each calendar year an annual report to the Commission that includes independently audited financial statements. This report is forwarded to Congress with such comment as the Commission deems appropriate. Personnel at the Commission's regional offices assist as needed in SIPC liquidations.

Members of the Commission's staff monitor SIPC operations in other ways. In 1991, an Associate Director of the Division of Market Regulation served on a SIPC-appointed task force formed to analyze and make recommendations on SIPC assessments. This committee recommended, and SIPC's Board of Directors implemented, a program under which SIPC intends to build the Fund to $1 billion. This year, Commission staff members are participating in a subcommittee of the Market Transactions Advisory Committee[7] that will make recommendations regarding procedures to be followed in the event that a firm registered as both a broker-dealer and a futures commission merchant must be liquidated.

In addition, the Commission performed an inspection of SIPC's operations in 1985. As previously mentioned, another inspection is underway. As noted in the Report, however, we have not established a periodic inspection schedule designating fixed dates on which the Commission is to inspect SIPC's operations. We agree with the recommendation that such a schedule should be established, and we will inspect SIPC according to a set schedule in the future. We will determine the appropriate timetable after evaluating the results of our current inspection.

See p. 73.

5. The Commission should require registered firms that have access to customer funds or securities and that serve in an intermediary role in customer transactions to disclose to customers that they are not members of SIPC.

The Report notes that under the Securities Investor Protection Act of 1970 ("SIPA") and SIPC's bylaws, SIPC members[8]

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[7]The Market Transactions Advisory Committee was formed pursuant to the Market Reform Act of 1990, Pub. L. No. 101-432 § 104 Stat. 963 (1990).

[8]SIPC members include all registered broker-dealers other than (1) those whose principal business, in the determination of SIPC, is conducted outside the United States; (2) those whose business consists exclusively of distribution of shares of registered open end investment companies or unit investment (continued...)

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must inform customers of their membership in SIPC, while non-SIPC firms that are registered with the Commission need not disclose their non-membership in SIPC. The Report recommends that the Commission draft a rule requiring registered investment advisers and other Commission-registered "intermediaries"[9] that have custody of client funds to disclose to clients that they are not SIPC members.

In the GAO's view, the rationale for such a requirement is two-fold. First, the securities activities of these non-SIPC intermediaries subject their customers to the same risks of loss or misappropriation as do SIPC members. Second, for advisers and other non-SIPC intermediaries that are affiliated or associated with SIPC broker-dealers, there is the additional risk that investors will be confused as to whether or not funds held by the adviser or intermediary are protected by SIPC. According to the Report, if these non-member firms were required to disclose that they were not SIPC members, investors would be better informed about the scope of SIPC's coverage and about its relevance to their investment decisions. The required non-membership disclosure would also diminish the potential for confusion arising from affiliations or associations between SIPC and non-SIPC firms.

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[8](...continued)
trusts, the sale of variable annuities, the business of insurance, or the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts; and (3) broker-dealers whose securities business is limited to U.S. Government securities and who are registered with the Commission under a provision of law which does not require SIPC membership.

See p. 72.

[9]At several places in the Report, GAO suggests that investment advisers are "intermediaries" because they sell securities products to customers. See, e.g., Report at 5.9. This is an incorrect statement. Investment advisers do not sell securities products to their customers. The Report is accurate, however, when it states that investment advisory firms may "manage discretionary or non-discretionary accounts . . . and have temporary 'custody' of customer property . . .." Report at 5.15, n.7.

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Regarding intermediaries registered as investment advisers, the Commission's Division of Investment Management[10] has communicated to us that it does not believe that it is necessary or appropriate to require investment advisers with custody of client funds to disclose their non-membership in SIPC. Under the SIPA, investment advisers are excluded from SIPC membership. Consequently, there is no more reason to require investment advisers with custody of client funds or securities to disclose their non-SIPC status than there is reason to require investment advisers to disclose that they are not members of the Federal Deposit Insurance Corporation.

The Division of Investment Management commented that, as the Report recognizes, other financial firms outside the Commission's jurisdiction also sell securities and securities-related products without being required to disclose their SIPC-membership status e.g., banks and future commission merchants. To require registered investment advisers with custody of client funds to disclose their non-membership in SIPC thus runs the risk of creating the false impression that funds and securities that they manage or hold are afforded less protection than funds and securities held by financial firms outside the Commission's jurisdiction.[11]

Regarding intermediaries registered as broker-dealers, the Division of Market Regulation is considering recommending to the Commission a rule that addresses some of the issues raised by GAO. The rule under consideration would require disclosure in those instances where customer confusion concerning SIPC protection may result (i.e., when a non-SIPC affiliate has a similar name, and the same personnel and offices, as a SIPC member). The rule may also address disclosure requirements for non-SIPC, registered broker-dealers.

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[10]The Division of Investment Management is responsible for, among other things, regulating the activities of registered investment advisers.

See p. 72.

[11]The Division of Investment Management believes there is some merit in GAO's contention that there is a possibility of investor confusion concerning the availability of SIPC protection for registered investment advisers that are affiliated with SIPC broker-dealers. As discussed below, the Division of Market Regulation is considering rulemaking that addresses this issue, and the Division of Investment Management will assist that Division.

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We appreciate the opportunity to comment on the draft report. We would be happy to meet with the GAO staff at your convenience to discuss our comments further. If you have any questions regarding this letter, please feel free to telephone me at (202) 272-3000, or if you have any questions regarding registered investment advisers, please contact Gene Gohlke, Associate Director, Division of Investment Management, at (202) 272-2043.

Sincerely,

William H. Heyman

William H. Heyman
Director

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