

Y4
.In 8/4
95-77

1019

95-77
In 8/4
44-26-77

GOVERNMENT DOCUMENTS

Storage

R 18 107R

PARRELL LIBRARY
KANSAS STATE UNIVERSITY

HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION

AND FINANCE

OF THE

COMMITTEE ON

INTERSTATE AND FOREIGN COMMERCE

HOUSE OF REPRESENTATIVES

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

H.R. 8331

A BILL TO AMEND THE SECURITIES INVESTOR PROTECTION
ACT OF 1970

AUGUST 1, 2, AND 3, 1977

Serial No. 95-77

Printed for the use of the
Committee on Interstate and Foreign Commerce



U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1978

22-537 O

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION



KSU LIBRARIES



A11900 817659

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

HARLEY O. STAGGERS, West Virginia, *Chairman*

JOHN E. MOSS, California
JOHN D. DINGELL, Michigan
PAUL G. ROGERS, Florida
LIONEL VAN DEERLIN, California
FRED B. ROONEY, Pennsylvania
JOHN M. MURPHY, New York
DAVID E. SATTERFIELD III, Virginia
BOB ECKHARDT, Texas
RICHARDSON PREYER, North Carolina
CHARLES J. CARNEY, Ohio
RALPH H. METCALFE, Illinois
JAMES H. SCHEUER, New York
RICHARD L. OTTINGER, New York
HENRY A. WAXMAN, California
ROBERT (BOB) KRUEGER, Texas
TIMOTHY E. WIRTH, Colorado
PHILIP R. SHARP, Indiana
JAMES J. FLORIO, New Jersey
ANTHONY TOBY MOFFETT, Connecticut
JIM SANTINI, Nevada
ANDREW MAGUIRE, New Jersey
MARTY RUSSO, Illinois
EDWARD J. MARKEY, Massachusetts
THOMAS A. LUKEN, Ohio
DOUG WALGREN, Pennsylvania
BOB GAMMAGE, Texas
ALBERT GORE, Jr., Tennessee
BARBARA A. MIKULSKI, Maryland

SAMUEL L. DEVINE, Ohio
JAMES T. BROYHILL, North Carolina
TIM LEE CARTER, Kentucky
CLARENCE J. BROWN, Ohio
JOE SKUBITZ, Kansas
JAMES M. COLLINS, Texas
LOUIS FREY, Jr., Florida
NORMAN F. LENT, New York
EDWARD R. MADIGAN, Illinois
CARLOS R. MOORHEAD, California
MATTHEW J. RINALDO, New Jersey
W. HENSON MOORE, Louisiana
DAVE STOCKMAN, Michigan
MARC L. MARKS, Pennsylvania

W. E. WILLIAMSON, *Chief Clerk and Staff Director*

KENNETH J. PAINTER, *First Assistant Clerk*

ELEANOR A. DINKINS, *Assistant Clerk*

FRANK W. MAHON, *Printing Editor*

Professional Staff

ELIZABETH HARRISON
JEFFREY H. SCHWARTZ
BRIAN R. MOIR
KAREN F. NELSON
ROSS DAVID AIN

CHRISTOPHER E. DUNNE
WILLIAM M. KITZMILLER
MARK J. RAABE
THOMAS M. RYAN
RICHARD D. LINDSAY, M.D.

NANCY A. NORD, *Minority Staff Assistant*

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

BOB ECKHARDT, Texas, *Chairman*

RALPH H. METCALFE, Illinois
ROBERT (BOB) KRUEGER, Texas
CHARLES J. CARNEY, Ohio
JAMES H. SCHEUER, New York
THOMAS A. LUKEN, Ohio
HARLEY O. STAGGERS, West Virginia
(ex officio)

JAMES T. BROYHILL, North Carolina
MATTHEW J. RINALDO, New Jersey
SAMUEL L. DEVINE, Ohio (ex officio)

JANIE KINNEY, *Counsel/Staff Coordinator*
FRANZ F. OPPER, *Counsel*

CONTENTS

	Page
Hearings held on—	
August 1, 1977.....	1
August 2, 1977.....	221
August 3, 1977.....	293
Text of H.R. 8331	3
Statement of—	
Boggs, George T., attorney, Dickstain, Shapiro and Morin.....	331
Crawford, Donald J., vice president, Securities Industry Association	323
Fink, Matthew, general counsel, Investment Company Institute	253
Focht, Theodore H., general counsel and secretary, Securities Investor Protection Corporation (SIPC)	67
Klein, Roger, executive director, Public Securities Association	253, 280
Loomis, Philip A., Jr., Commissioner, Securities and Exchange Commission	222
McChesney, Lloyd, vice president, finance, Securities Investor Protection Corporation (SIPC)	67
Macklin, Gordon, president, National Association of Securities Dealers, Inc	204
Mason, Paul J., chief counsel, securities, American Council of Life Insurance	253
Millstone, Robert J., senior special counsel, Division of Marketing Regulation, Securities and Exchange Commission	222
O'Brien, Edward I., president, Securities Industry Association	323
Owens, Hon. Hugh F., chairman, Securities Investor Protection Corporation (SIPC)	67
Shepard, Judith G., associate house counsel, Goldman, Sachs & Co	294
Sher, Allan, executive vice president, Merrill Lynch, Pierce, Fenner & Smith, Inc.....	294, 304
Silver, David, president, Investment Company Institute	253, 263
Weinberg, Hyman, general partner, Goldman, Sachs & Co	294
Wilson, Frank J., senior vice president for regulatory policy and general counsel, National Association of Securities Dealers, Inc.	204
Additional material submitted for the record by—	
American Council of Life Insurance, statement of Robert R. Gooins, vice president, and general counsel	256
Goldman, Sachs & Co., attachment to Mr. Weinberg's statement, appendix A—Proposed amendment No. 1 to sec. 6(g) of H.R. 8331	302
Merrill Lynch, Pierce, Fenner & Smith, Inc., letter dated August 18, 1977 from Mr. Sher, executive vice president to Chairman Eckhardt in response to request of Representative Metcalfe and subcommittee staff for information pertaining to the scope of purchases of money market instruments by individual investors	317
National Association of Securities Dealers, Inc., attachments to Mr. Macklin's prepared statement:	
Attachment A—Total SIPC excluded income	217
Supplemental statement of Gordon S. Macklin re H.R. 8064	213
Securities and Exchange Commission, attachment to Mr. Loomis' statement, written comments of the SEC on H.R. 8331	236
Securities Investor Protection Corporation, attachments to Mr. Owens' prepared statement:	
Letter dated August 26, 1977, Hugh F. Owens, chairman to Hon. James T. Broyhill re to what extent has SIPC paid out on customer claims involving money market instruments	193
Report to the Board of Directors of the Securities Investor Protection Corporation of the special task force to consider possible amendments to the Securities Investor Protection Act of 1970	99
Section-by-section explanation of H.R. 8331 amendments to Securities Investor Protection Act	167

IV

Letters submitted for the record by—

New York Stock Exchange:

Letter dated June 7, 1977 from Robert M. Bishop, senior vice president to Chairman Eckhardt	349
Letter dated August 17, 1977 from William M. Batten, chairman and chief executive officer to Chairman Eckhardt with statement on H.R. 8331 attached	350
Scudder, Stevens & Clark, letter dated August 3, 1977 from W. Russell Peabody, senior vice president	355

SECURITIES INVESTOR PROTECTION ACT AMENDMENTS OF 1977

MONDAY, AUGUST 1, 1977

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:15 a.m., in room 2218, Rayburn House Office Building, Hon. Thomas A. Luken, chairman, presiding.

Mr. LUKEN. The Subcommittee on Consumer Protection and Finance will be in order.

This morning the subcommittee begins 3 days of hearings of H.R. 8331, the Securities Investor Protection Act Amendments of 1977.

The Securities Investor Protection Corporation was created by Congress in 1970 to provide insurance protection for customers of brokerage firms which had failed, or were in danger of failing to meet their obligations.

SIPC was created in response to the back office paper crisis and bear market which occurred between 1968 and 1970, during which a number of brokerage firms folded and public confidence in the securities markets declined sharply.

In the view of both Congress and the securities industry, SIPC was the most immediate and effective way of restoring that lost investor confidence.

In its first years of operation, SIPC discovered difficulties in the operation of the statute it administers. Liquidation procedures are administratively cumbersome, time-consuming and expensive. The procedure proved particularly unsatisfactory in the liquidation of small brokerage firms, which have comprised the vast majority of SIPC's work.

SIPC appointed a special task force to review the act and to propose possible amendments. That task force submitted its recommendations in 1974 for changes in the act, which were incorporated into a predecessor bill, H.R. 8064.

Hearings were held on that bill in 1975. However it was never reported out by the subcommittee. This bill, which closely resembles its predecessor, would streamline the liquidation procedure by reducing administrative complexities and expense.

The amendments reflect a fundamental departure from the 1970 act by permitting a customer to receive securities to the maximum extent possible instead of cash, in satisfaction of a claim for securities. Equally important, the amendments would increase the extent of SIPC protection for customers' securities from \$50,000 to

\$100,000. However, the level of protection for cash in customer accounts would remain at \$20,000.

In addition to procedural changes, which constitute the primary thrust of the legislation, the bill would also accomplish several other objectives. Although unrelated to the liquidation procedure itself, these proposed amendments have attracted the greatest controversy.

As currently written, the bill would eliminate the exemption from SIPC assessment for mutual funds, variable annuities and unit investment trusts. The amendments would also permit SIPC assessment of transactions involving money market instruments, and would confer upon SIPC authority to require its members to advertise their membership in SIPC.

These hearings will provide the subcommittee with an opportunity to hear the opposing arguments on each of these issues, and assist us in reaching final decisions as to their disposition.

Without objection the text of H.R. 8331 will be printed at this point in the record.

[Testimony resumes on P. 67.]

[Text of H.R. 8331 follows:]

95TH CONGRESS
1ST SESSION

H. R. 8331

IN THE HOUSE OF REPRESENTATIVES

JULY 14, 1977

Mr. ECKHARDT introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

A BILL

To amend the Securities Investor Protection Act of 1970.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 SHORT TITLE

4 SECTION 1. This Act may be cited as the "Securities
5 Investor Protection Act Amendments of 1977".

6 MEMBERSHIP OF SIPC

7 SEC. 2. (a) Section 3 (a) (2) of the Securities Investor
8 Protection Act of 1970 (15 U.S.C. 78ccc (a) (2)) is
9 amended to read as follows:

10 "(2) be a membership corporation the members of
11 which shall be all persons registered as brokers or dealers

1 under section 15 (b) of the 1934 Act, other than persons
2 whose principal business, in the determination of SIPC,
3 taking into account business of affiliated entities, is con-
4 ducted outside the United States or its territories or pos-
5 sessions, except that SIPC shall provide by rule that such
6 persons may become members of SIPC under such con-
7 ditions and upon such terms as SIPC shall require by
8 rule, taking into account such matters as the availability
9 of assets and the ability to conduct a liquidation, if neces-
10 sary; and”.

11 (b) Section 3 (f) of such Act (15 U.S.C. 78ccc (f)) is
12 repealed.

13 POWERS OF SIPC

14 SEC. 3. Section 3 (b) of such Act (15 U.S.C. 78ccc (b))
15 is amended—

16 (1) in paragraph (1) , by striking out “court, State,
17 or Federal” and inserting “State, Federal, or other
18 court” in lieu thereof; and

19 (2) by striking out paragraph (3) , redesignating
20 paragraphs (4) through (8) as paragraphs (5)
21 through (9) , respectively, and inserting immediately
22 after paragraph (2) the following new paragraphs:

23 “(3) to adopt, amend, and repeal, by its Board of
24 Directors, such bylaws as may be necessary or appro-

1 piate to carry out the purposes of this Act, including by-
2 laws relating to—

3 “(A) the conduct of its business; and

4 “(B) the indemnity of its directors, officers,
5 and employees (including any such person acting
6 as trustee or otherwise in connection with a liquida-
7 tion proceeding) for liabilities and expenses actually
8 and reasonably incurred by any such person in con-
9 nection with the defense or settlement of an action
10 or suit if such person acted in good faith and in a
11 manner reasonably believed to be consistent with
12 and not opposed to the purposes of this Act.

13 “(4) to adopt, amend, and repeal, by its Board of
14 Directors, such rules as may be necessary or appropriate
15 to carry out the purposes of this Act, including rules
16 relating to—

17 “(A) the definition of terms used in this Act;

18 “(B) the procedures for the liquidation of
19 members and direct payment procedures, including
20 the transfer of customer accounts, the distribution of
21 customer property, and the advance and payment
22 of SIPC funds; and

23 “(C) the exercise of all other rights and pow-
24 ers granted to it by this Act;

BOARD OF DIRECTORS

1

2 SEC. 4. (a) Section 3 (c) (2) (C) (ii) of such Act
3 (15 U.S.C. 78ccc (c) (2) (C) (ii)) is amended by striking
4 out "associated with any" and all that follows through
5 "group" and inserting in lieu thereof "persons associated
6 with a broker or dealer or persons associated with a national
7 securities exchange, within the meaning of section 3 (a) (18)
8 or section 3 (a) (21), respectively, of the 1934 Act,".

9 (b) Section 3 (c) (5) of such Act (15 U.S.C. 78ccc
10 (c) (5)) is amended to read as follows:

11 "(5) COMPENSATION.—All matters relating to
12 compensation of directors shall be as provided in the
13 bylaws of SIPC."

14

BYLAWS AND RULES

15 SEC. 5. Section 3 (e) of such Act (15 U.S.C. 78ccc (e))
16 is amended to read as follows:

17 "(e) BYLAWS AND RULES.—

18 "(1) PROPOSED BYLAW CHANGES.—After the date
19 of the enactment of this paragraph, the Board of Di-
20 rectors of SIPC shall file with the Commission a copy
21 of any proposed bylaw or any proposed amendment
22 to or repeal of any bylaw of SIPC (hereinafter in this
23 paragraph collectively referred to as a 'proposed bylaw
24 change'), accompanied by a concise general statement of
25 the basis and purpose of such proposed bylaw change.

1 Each such proposed bylaw change shall take effect
2 thirty days after the date of the filing of a copy thereof
3 with the Commission, or upon such later date as SIPC
4 may designate or such earlier date as the Commission
5 may determine, unless—

6 “(A) the Commission, by notice to SIPC set-
7 ting forth the reasons therefor, disapproves such
8 proposed bylaw change as being contrary to the
9 public interest or contrary to the purposes of this
10 Act; or

11 “(B) the Commission finds that such proposed
12 bylaw change involves a matter of such significant
13 public interest that public comment should be ob-
14 tained, in which case it may, after notifying SIPC
15 in writing of such finding, require that the proce-
16 dures set forth in paragraph (2) be followed with
17 respect to such proposed bylaw change, in the same
18 manner as if such proposed bylaw change were a
19 proposed rule change within the meaning of such
20 paragraph.

21 “(2) PROPOSED RULE CHANGES.—

22 “(A) FILING OF PROPOSED RULE CHANGES.—

23 After the date of enactment of this paragraph, the Board
24 of Directors of SIPC shall file with the Commission, in
25 accordance with such rules as the Commission may pre-

1 scribe, a copy of any proposed rule or any proposed
2 amendment to or repeal of any rule of SIPC (hereinafter
3 in this subsection collectively referred to as a 'proposed
4 rule change'), accompanied by a concise general state-
5 ment of the basis and purpose of such proposed rule
6 change. The Commission shall, upon the filing of any
7 proposed rule change, publish notice thereof, together
8 with the terms of substance of such proposed rule change
9 or a description of the subjects and issues involved. The
10 Commission shall give interested persons an opportunity
11 to submit written data, views, and arguments with re-
12 spect to such proposed rule change. No proposed rule
13 change shall take effect unless approved by the Commis-
14 sion or otherwise permitted in accordance with the pro-
15 visions of this paragraph.

16 “(B) ACTION BY THE COMMISSION.—Within
17 thirty-five days after the date of publication of
18 notice of the filing of a proposed rule change, or
19 within such longer period as the Commission may
20 designate of not more than ninety days after such
21 date if it finds such longer period to be appropriate
22 and publishes its reasons for so finding, or as to
23 which SIPC consents, the Commission shall—

24 “(i) by order approve such proposed rule
25 change; or

1 “(ii) institute proceedings to determine
2 whether such proposed rule change should be
3 disapproved.

4 “(C) PROCEEDINGS.—Proceedings instituted
5 with respect to a proposed rule change pursuant to
6 subparagraph (B) (ii) shall include notice of the
7 grounds for disapproval under consideration and
8 opportunity for hearing, and shall be concluded
9 within one hundred and eighty days after the date
10 of publication of notice of the filing of such proposed
11 rule change. At the conclusion of such proceedings,
12 the Commission shall, by order, approve or dis-
13 approve such proposed rule change. The Commis-
14 sion may extend the time for conclusion of such
15 proceedings for not more than sixty days if it finds
16 good cause for such extension and publishes its
17 reasons for so finding, or for such longer period as
18 to which SIPC consents.

19 “(D) GROUNDS FOR APPROVAL OR DIS-
20 APPROVAL.—The Commission shall approve a pro-
21 posal rule change if it finds that such proposed rule
22 change is in the public interest and is consistent with
23 the purposes of this Act, and any proposed rule
24 change so approved shall be given force and effect as
25 if prescribed by the Commission. The Commission

1 shall disapprove a proposed rule change if it does not
2 make the finding referred to in the preceding sen-
3 tence. The Commission shall not approve any pro-
4 posed rule change prior to thirty days after the date
5 of publication of notice of the filing thereof, unless
6 the Commission finds good cause for so doing and
7 publishes its reasons for so finding.

8 “(E) EXCEPTION.—Notwithstanding any other
9 provision of this paragraph, a proposed rule change
10 may take effect—

11 “(i) upon the date of filing with the Com-
12 mission, if such proposed rule change is desig-
13 nated by SIPC as relating solely to matters
14 which the Commission, consistent with the pub-
15 lic interest and the purposes of this subsection,
16 determines by rule do not require the procedures
17 set forth in this paragraph; or

18 “(ii) upon such date as the Commission
19 shall for good cause determine.

20 At any time within sixty days after the effective
21 date of any rule change which has taken effect pur-
22 suant to this subparagraph, the Commission may
23 summarily abrogate such rule change and require
24 that it be refiled in accordance with the provisions
25 of this paragraph, if the Commission finds that such

11 “(3) ACTION REQUIRED BY COMMISSION.—The
12 Commission may, by such rules as it determines to be
13 necessary or appropriate in the public interest or to
14 carry out the purposes of this Act, require SIPC to
15 adopt, amend, or repeal any SIPC bylaw or rule, when-
16 ever adopted.”.

18 SEC. 6. (a) Section 4(a) of such Act (15 U.S.C.
19 78ddd (a)) is amended—

23 (2) by amending paragraph (2) (C) to read as
24 follows:

1 “(C) Such confirmed lines of credit as SIPC
2 may from time to time maintain, other than those
3 maintained pursuant to paragraph (4).”; and
4 (3) by adding at the end thereof the following new
5 paragraph:

6 “(4) OTHER LINES.—SIPC may maintain such
7 other confirmed lines of credit as it considers necessary
8 or appropriate, and such other confirmed lines of credit
9 shall not be included in the balance of the fund, but
10 amounts received from such lines of credit may be dis-
11 bursed by SIPC under this Act as though such amounts
12 were part of the fund.”.

13 (b) Section 4 (c) of such Act (15 U.S.C. 78ddd (c))
14 is amended—

15 (1) by striking out “or rule” each place it appears;

16 (2) in paragraph (3), by striking out “(other
17 than section 3 (f))”;

18 (3) by striking out “, and” at the end of paragraph

19 (3) (B) and inserting in lieu thereof a period; and

20 (4) by striking out paragraph (3) (C).

21 (c) Section 4 (d) (1) of such Act (15 U.S.C. 78ddd
22 (d) (1)) is amended by adding at the end thereof the follow-
23 ing new subparagraph:

24 “(C) MINIMUM ASSESSMENT.—The minimum
25 assessment imposed upon each member of SIPC

1 shall be \$25 per annum through the year ending
2 December 31, 1979, and thereafter shall be the
3 amount from time to time set by SIPC bylaw, but
4 in no event shall the minimum assessment be greater
5 than \$150 per annum.”.

6 (d) Section 4 (e) of such Act (15 U.S.C. 78ddd (e))
7 is amended—

8 (1) in paragraph (1), by striking out “members”
9 and inserting “its members who are also members or
10 participants” in lieu thereof; and

11 (2) by amending paragraph (2) to read as follows:

12 “(2) OVERPAYMENTS.—To the extent that any
13 payment by a member exceeds the maximum rate per-
14 mitted by subsection (c) of this section, the excess shall
15 be recoverable only against future payments by such
16 member except as otherwise provided by SIPC bylaw.”;
17 and

18 (3) by amending paragraph (3) to read as follows:

19 “(3) UNDERPAYMENTS.—If a member fails to pay
20 when due all or any part of an assessment made upon
21 such member, the unpaid portion thereof shall bear in-
22 terest at such rate as may be determined by SIPC by-
23 law and, in addition to such interest, SIPC may impose
24 such penalty charge as may be determined by SIPC by-
25 law. Any such penalty charge imposed upon a SIPC

1 member shall not exceed 25 per centum of any unpaid
2 portion of the assessment. SIPC may waive such penalty
3 charge in whole or in part in circumstances where it con-
4 siderers such waiver appropriate.”.

5 (e) Section 4(f) of such Act (15 U.S.C. 78ddd(f))
6 is amended by striking out “examining authority as”.

7 (f) Section 4(f) of such Act (15 U.S.C. 78ddd(f)) is
8 amended by striking out the last two sentences and inserting
9 in lieu thereof the following: “For the purposes of the next
10 preceding sentence, (1) the fee shall be based upon the
11 total dollar amount of each purchase; (2) the fee shall not
12 apply to any purchase on a national securities exchange or in
13 an over-the-counter market by or for the account of a broker
14 or dealer registered under section 15(b) of the 1934 Act
15 unless such purchase is for an investment account of such
16 broker or dealer (and for this purpose any transfer from a
17 trading account to an investment account shall be deemed a
18 purchase at fair market value); and (3) the Commission
19 may, by rule, exempt any transaction in the over-the-counter
20 markets or on any national securities exchange where neces-
21 sary to provide for the assessment of fees on purchasers in
22 transactions in such markets and exchanges on a comparable
23 basis. Such fee shall be collected by the broker or dealer
24 effecting the transaction for or with the purchaser, or by
25 such other person as provided by the Commission by rule,

1 and shall be paid to SIPC in the same manner as assessments
2 imposed pursuant to subsection (c), but without regard to
3 the limits on such assessments.”.

4 (g) Section 4 (i) of such Act (15 U.S.C. 78ddd (i))
5 is amended to read as follows:

6 “(i) CONSOLIDATED GROUP.—Except as otherwise
7 provided by SIPC bylaw, gross revenues from the securities
8 business of a member of SIPC shall be computed on a
9 consolidated basis for such member and all entities which
10 control, are controlled by, or are under common control with
11 such member, and the operations of a member of SIPC
12 shall include those of any business to which such member
13 has succeeded.”.

14 PROTECTION OF INVESTORS

15 SEC. 7. (a) Section 5 (a) of such Act (15 U.S.C.
16 78eee (a)) is amending by striking out paragraphs (2)
17 and (3) and inserting in lieu thereof the following new
18 paragraphs:

19 “(2) ACTION BY SELF-REGULATORY ORGANIZA-
20 TION.—If a self-regulatory organization has given notice
21 to SIPC pursuant to subsection (a) (1) with respect to
22 a broker or dealer, and such broker or dealer undertakes
23 to liquidate or reduce its business either pursuant to the
24 direction of a self-regulatory organization or voluntarily,
25 such self-regulatory organization may render such assist-

1 ance or oversight to such broker or dealer as it considers
2 appropriate to protect the interests of customers of such
3 broker or dealer. The assistance or oversight by a self-
4 regulatory organization shall not be deemed the assump-
5 tion or adoption by such self-regulatory organization
6 of any obligation or liability to customers, other creditors,
7 shareholders, or partners of the broker or dealer, and
8 shall not prevent or act as a bar to any action by SIPC
9 pursuant to a liquidation proceeding or a direct payment
10 procedure.

11 “(3) ACTION BY SIPC.—If SIPC determines
12 that—

13 “(A) any member of SIPC (including any
14 person who was a member within one hundred and
15 eighty days prior to such determination) has failed
16 or is in danger of failing to meet its obligations to
17 customers; and

18 “(B) one or more of the conditions specified
19 in subsection (b) (1) exist with respect to such
20 member,

21 SIPC may, upon notice to such member, file an appli-
22 cation for a protective decree with any court of compe-
23 tent jurisdiction specified in section 21 (e) or 27 of
24 the 1934 Act, except that no such application shall be
25 filed with respect to a member the only customers of

1 which are persons whose claims could not be satisfied
2 by SIPC advances pursuant to section 9.

3 “(4) EFFECT OF OTHER PENDING ACTIONS.—An
4 application with respect to a member of SIPC filed with
5 a court under paragraph (3) —

6 “(A) may, with the consent of the Commis-
7 sion, be combined with any action brought by the
8 Commission with respect to such member, including
9 an action by the Commission for a temporary re-
10 ceiver pending an appointment of a trustee under
11 subsection (b) (3) ; and

12 “(B) may be filed notwithstanding the pend-
13 ency in the same or any other court of any bank-
14 ruptcy, mortgage, foreclosure, or equity receivership
15 proceeding or any proceeding to reorganize, con-
16 serve, or liquidate such member or its property, or
17 any proceeding to enforce a lien against property
18 of such member.”.

19 (b) Section 5 (b) of such Act (15 U.S.C. 78eee (b))
20 is amended to read as follows:

21 “(b) COURT ACTION.—

22 “(1) ISSUANCE OF PROTECTIVE DECREE.—Upon
23 receipt of an application by SIPC under subsection (a)
24 (3), the court shall forthwith issue a protective decree
25 if the debtor consents thereto, if the debtor fails to con-

1 test such application, or if the court finds that such
2 debtor—

3 “(A) is insolvent within the meaning of the
4 Bankruptcy Act, or is unable to meet its obligations
5 as they mature;

6 “(B) has committed an act of bankruptcy
7 within the meaning of the Bankruptcy Act;

8 “(C) is the subject of a proceeding pending
9 in any court or before any agency of the United
10 States or any State in which a receiver, trustee, or
11 liquidator for such member has been appointed;

12 “(D) is not in compliance with applicable
13 requirements under the 1934 Act or rules of the
14 Commission or any self-regulatory organization with
15 respect to financial responsibility or hypothecation
16 of customers’ securities; or

17 “(E) is unable to make such computations as
18 may be necessary to establish compliance with
19 such financial responsibility or hypothecation rules.

20 Unless the debtor consents to the issuance of a protec-
21 tive decree, the application shall be heard three business
22 days after the date on which it is filed, or at such other
23 time as the court shall determine, taking into considera-
24 tion the urgency which the circumstances require.

25 “(2) JURISDICTION AND POWERS OF COURT,—

1 “(A) EXCLUSIVE JURISDICTION.—Upon fil-
2 ing an application with a court for a protective
3 decree with respect to a debtor, such court—

4 “(i) shall have exclusive jurisdiction of
5 such debtor and its property wherever located
6 (including property located outside the terri-
7 torial limits of such court and property held by
8 any other person as security for a debt or sub-
9 ject to a lien),

10 “(ii) shall have exclusive jurisdiction of
11 any suit against the trustee with respect to a
12 liquidation proceeding; and except as incon-
13 sistent with the provisions of this Act,

14 “(iii) shall have the jurisdiction, powers,
15 and duties conferred upon a court of bankruptcy
16 by the Bankruptcy Act, together with such
17 other jurisdiction, powers, and duties as are pre-
18 scribed by this Act.

19 “(B) STAY OF PENDING ACTIONS.—Pending
20 the issuance of a protective decree under paragraph
21 (1), the court with which an application has been
22 filed—

23 “(i) shall stay any pending bankruptcy,
24 mortgage foreclosure, equity receivership, or
25 other proceeding to reorganize, conserve, or

1 liquidate the debtor or its property and any
2 other suit against any receiver, conservator, or
3 trustee of the debtor or its property, and shall
4 continue such stay upon appointment of a trustee
5 pursuant to paragraph (3) ;

6 “(ii) may stay any proceeding to enforce
7 a lien against property of the debtor or any
8 other suit against the debtor, including a suit
9 by stockholders of the debtor which interferes
10 with prosecution by the trustee of claims against
11 former directors, officers, or employees of the
12 debtor, and may continue such stay upon ap-
13 pointment of a trustee pursuant to paragraph
14 (3) ;

15 “(iii) may, for such period of time as may
16 be appropriate, stay enforcement of, but shall
17 not abrogate, the right of setoff provided in
18 section 68 of the Bankruptcy Act, and the right
19 to enforce a valid, nonpreferential lien or pledge
20 against the property of the debtor, and may
21 continue such stay upon appointment of a
22 trustee pursuant to paragraph (3) ; and

23 “(iv) may appoint a temporary receiver.

24 “(3) APPOINTMENT OF TRUSTEE AND ATTOR-
25 NEY.— If the court issues a protective decree under para-

graph (1), such court shall forthwith appoint, as trustee for the liquidation of the business of the debtor and as attorney for the trustee, such persons as SIPC, in its sole discretion, specifies. The persons appointed as trustee and as attorney for the trustee may be associated with the same firm. SIPC may, in its sole discretion, specify itself or one of its employees as trustee in any case in which SIPC has determined that the liabilities of the debtor to unsecured general creditors and to subordinated lenders appear to aggregate less than \$750,000 and that there appear to be fewer than five hundred customers of such debtor. No person may be appointed to serve as trustee or attorney for the trustee if such person is not disinterested within the meaning of paragraph (6), except that for any specified purpose other than to represent a trustee in conducting a liquidation proceeding, the trustee may, with the approval of SIPC and the court, employ an attorney who is not disinterested. A trustee appointed under this paragraph shall qualify by filing a bond in the manner prescribed by the applicable provisions of the Bankruptcy Act, except that neither SIPC nor any employee of SIPC shall be required to file a bond when appointed as trustee.

“(4) REFERENCE TO REFEREE IN BANKRUPTCY.—
If the court issues a protective decree and appoints

1 a trustee under this section, such court may, at any
2 stage of the proceeding, refer the proceeding to a ref-
3 eree in bankruptcy to hear and determine any or all
4 matters, or to a referee in bankruptcy as special master
5 to hear and report generally or upon specified matters.
6 Only under special circumstances shall a reference be
7 made to a special master who is not a referee in
8 bankruptcy.

9 “(5) COMPENSATION FOR SERVICES AND REIM-
10 BURSEMENT OF EXPENSES.—

11 “(A) ALLOWANCES IN GENERAL.—The court
12 shall grant reasonable compensation for services
13 rendered and reimbursement for proper costs and
14 expenses incurred (hereinafter in this paragraph re-
15 ferred to as “allowances”) by a trustee appointed
16 under paragraph (3), and by the attorney for such
17 a trustee, in connection with a liquidation proceed-
18 ing. No allowances (other than reimbursement for
19 proper costs and expenses incurred) shall be granted
20 to SIPC or any employee of SIPC for serving as
21 trustee. Allowances may be granted on an interim
22 basis during the course of the liquidation proceeding
23 at such times and in such amounts as the court
24 considers appropriate.

25 “(B) ALLOWANCES TO REFEREE.—In the

1 event a proceeding has been referred to a referee
2 in bankruptcy, the district judge may grant reason-
3 able allowances to a referee in bankruptcy or a
4 special master, in the manner provided for in a case
5 filed under chapter X of the Bankruptcy Act, as
6 now in effect or as amended from time to time.

7 “(C) APPLICATION FOR ALLOWANCES.—Any
8 person seeking allowances pursuant to this para-
9 graph shall file an application with the court which
10 complies in form and content with the provisions of
11 the Bankruptcy Act governing applications for al-
12 lowances under such Act. A copy of such applica-
13 tion shall be served upon SIPC when filed. The
14 court shall fix a time for holding a hearing on such
15 application, and notice of such hearing shall be
16 given to the applicant, the trustee, the debtor, the
17 creditors, SIPC, and such other persons as the court
18 may designate, except that notice need not be given
19 to customers whose claims have been or will be
20 satisfied in full or to creditors who cannot reason-
21 ably be expected to receive any distribution during
22 the course of the liquidation proceeding.

23 “(D) RECOMMENDATIONS OF SIPC AND
24 AWARDED OF ALLOWANCES.—Whenever an appli-
25 cation for allowances is filed pursuant to subpara-

1 graph (C), SIPC shall file its recommendation with
2 respect to such allowances with the court prior to
3 the hearing on such application and shall, if it so
4 requests, be allowed a reasonable time after such
5 hearing within which to file a further recommenda-
6 tion. In any case in which such allowances are to
7 be paid by SIPC without reasonable expectation
8 of recoupment thereof as provided in this Act and
9 there is no difference between the amounts requested
10 and the amounts recommended by SIPC, the court
11 shall award the amounts recommended by SIPC.
12 In determining the amount of allowances in all other
13 cases, the court shall give due consideration to the
14 nature, extent, and value of the services rendered,
15 and shall place considerable reliance on the recom-
16 mendation of SIPC.

17 “(E) APPLICABLE RESTRICTIONS.—The re-
18 strictions on sharing of compensation set forth in
19 the Bankruptcy Act shall apply to allowances under
20 this paragraph.

21 “(F) CHARGE AGAINST ESTATE.—Allowances
22 granted by the court, including interim allowances,
23 shall be charged against the general estate of the
24 debtor as a cost and expense of administration. If
25 the general estate is insufficient to pay allowances

1 in whole or in part, SIPC shall advance such funds
2 as are necessary for such payment.

3 “(6) DISINTERESTEDNESS.—

4 “(A) STANDARDS.—For purposes of para-
5 graph (3), a person shall not be deemed disinter-
6 ested if—

7 “(i) such person is a creditor (including
8 a customer), stockholder, or partner of the
9 debtor; or

10 “(ii) such person is or was an underwriter
11 of any of the outstanding securities of the debtor
12 or within five years prior to the filing date was
13 the underwriter of any securities of the debtor;

14 “(iii) such person is, or was within two
15 years prior to the filing date, a director, partner,
16 officer, or employee of the debtor or such an
17 underwriter, or an attorney for the debtor or
18 such an underwriter; or

19 “(iv) it appears that such person has, by
20 reason of any other direct or indirect relation-
21 ship to, connection with, or interest in the debtor
22 or such an underwriter, or for any reason an
23 interest materially adverse to the interests of any
24 class of creditors (including customers) or
25 stockholders,

1 except that SIPC shall in all cases be deemed dis-
2 interested, and an employee of SIPC shall be
3 deemed disinterested if such employee would, except
4 for his association with SIPC, meet the standards
5 set forth in this subparagraph.

6 “(B) HEARING.—The court shall fix a time for
7 a hearing on disinterestedness, to be held promptly
8 after the appointment of a trustee. Notice of such
9 hearing shall be mailed at least ten days prior
10 thereto to each person who, from the books and
11 records of the debtor, appears to have been a custo-
12 mer of the debtor with an open account within the
13 past twelve months, to the address of such person
14 as it appears from the books and records of the
15 debtor, and to the creditors and stockholders of the
16 debtor, to SIPC, and to such other persons as the
17 court may designate. The court may, in its discre-
18 tion, also require that notice be given by publication
19 in such newspaper or newspapers of general circula-
20 tion as it may designate. At such hearing, at any
21 adjournment thereof, or upon application, the court
22 shall hear objections to the retention in office of a
23 trustee or attorney for a trustee on the grounds that
24 such person is not disinterested within the meaning
25 of this paragraph.”.

1 (c) Section 5 of such Act (15 U.S.C. 78eee) is amended
2 by adding at the end thereof the following new subsection:

3 “(d) SIPC PARTICIPATION.—SIPC shall be deemed
4 to be a party in interest as to all matters arising in a liquida-
5 tion proceeding, with the right to be heard on all such
6 matters, and shall be deemed to have intervened with respect
7 to all such matters with the same force and effect as if a
8 petition for such purpose had been allowed by the court.”.

9 GENERAL PROVISIONS OF A LIQUIDATION PROCEEDING

10 SEC. 8. Section 6 of such Act (15 U.S.C. 78fff) is
11 amended to read as follows:

12 “SEC. 6. GENERAL PROVISIONS OF A LIQUIDATION PRO-
13 CEEDING.

14 “(a) PURPOSES.—The purposes of a liquidation pro-
15 ceeding under this Act shall be—

16 “(1) as promptly as possible after the appointment
17 of a trustee in such liquidation proceeding, and in ac-
18 cordance with the provisions of this section—

19 “(A) to deliver customer name securities to or
20 on behalf of the customers of the debtor entitled
21 thereto as provided in section 8 (c) (2) ; and

22 “(B) to distribute customer property and (in
23 advance thereof or concurrently therewith) other-
24 wise satisfy net equity claims of customers to the
25 extent provided in this section;

1 “(2) to sell or transfer offices and other productive
2 units of the business of the debtor;

3 “(3) to enforce rights of subrogation as provided
4 in this Act; and

5 “(4) to liquidate the business of the debtor

6 “(b) APPLICATION OF BANKRUPTCY ACT.—To the
7 extent consistent with the provisions of this Act, a liquida-
8 tion proceeding shall be conducted in accordance with, and
9 as though it were being conducted under, the Bankruptcy
10 Act. For purposes of applying the Bankruptcy Act to this
11 Act, any reference in the Bankruptcy Act to the date of
12 commencement of proceedings under the Bankruptcy Act
13 shall be deemed to be a reference to the filing date under
14 this Act.

15 “(c) DETERMINATION OF CUSTOMER STATUS.—In a
16 liquidation proceeding under this Act, whenever a person
17 has acted with respect to cash or securities with the debtor
18 after the filing date and in a manner which would have
19 given him the status of a customer with respect to such cash
20 or securities had the action occurred prior to the filing date,
21 and the trustee is satisfied that such action was taken by the
22 customer in good faith and prior to the appointment of the
23 trustee, the date on which such action was taken shall be
24 deemed to be the filing date for purposes of determining the

1 net equity of such customer with respect to such cash or
2 securities.

3 “(d) APPORTIONMENT.—In a liquidation proceeding
4 under this Act, any cash or securities remaining after the
5 liquidation of a lien or pledge made by a debtor shall be
6 apportioned between his general estate and customer prop-
7 erty in the proportion in which the general property of the
8 debtor and the cash and securities of the customers of such
9 debtor contributed to such lien or pledge. Securities appor-
10 tioned to the general estate under this subsection shall be
11 subject to the provisions of section 16 (5) (A).

12 “(e) COSTS AND EXPENSES OF ADMINISTRATION.—
13 All costs and expenses of administration of the estate of the
14 debtor and of the liquidation proceeding shall be borne by
15 the general estate of the debtor to the extent it is sufficient
16 therefor, and the priorities of distribution from the general
17 estate shall be as provided in the Bankruptcy Act. Costs and
18 expenses of administration shall include payments pursuant
19 to section 8 (e) and section 9 (c) (1) and costs and ex-
20 penses of SIPC employees utilized by the trustee pursuant to
21 section 7 (a) (2). All funds advanced by SIPC to a trustee
22 for such costs and expenses of administration shall be re-
23 coupled from the general estate as a first priority under the
24 Bankruptcy Act.”.

1 NEW SECTIONS OF THE SECURITIES INVESTOR PROTECTION

2 ACT OF 1970

3 SEC. 9. The Securities Investor Protection Act of 1970
4 (15 U.S.C. 78aaa et seq.) is amended by redesignating sec-
5 tions 7 through 12 as sections 11 through 16, respectively,
6 and by inserting immediately after section 6 the following
7 new sections:

8 "SEC. 7. POWERS AND DUTIES OF A TRUSTEE.

9 "(a) TRUSTEE POWERS.— A trustee shall be vested
10 with the same powers and title with respect to the debtor and
11 the property of the debtor, including the same rights to
12 avoid preferences, as a trustee in bankruptcy under the
13 Bankruptcy Act has with respect to a bankrupt and the
14 property of a bankrupt. In addition, a trustee may, with the
15 approval of SIPC but without any need for court approval—

16 "(1) hire and fix the compensation of all personnel
17 (including officers and employees of the debtor and of
18 its examining authority) and other persons (including
19 but not limited to accountants) that are deemed by the
20 trustee necessary for all or any purposes of the liquida-
21 tion proceeding;

22 "(2) utilize SIPC employees for all or any purposes
23 of a liquidation proceeding; and

24 "(3) margin and maintain customer accounts of
25 the debtor for the purposes of section 8 (f) .

1 “(b) TRUSTEE DUTIES.—To the extent consistent with
2 the provisions of this Act or as otherwise ordered by the
3 court, a trustee shall be subject to the same duties as a
4 trustee in bankruptcy, except that a trustee may, but shall
5 have no duty to, reduce to money any securities constituting
6 customer property or in the general estate of the debtor.
7 In addition, the trustee shall—

8 “(1) deliver securities to or on behalf of custo-
9 mers to the maximum extent practicable in satisfac-
10 tion of customer claims for securities of the same class
11 and series of an issuer; and

12 “(2) subject to the prior approval of SIPC but
13 without any need for court approval, pay or guarantee
14 all or any part of the indebtedness of the debtor to
15 a bank, lender, or other person if the trustee deter-
16 mines that the aggregate market value of securities
17 to be made available to the trustee upon the payment
18 or guarantee of such indebtedness does not appear to
19 be less than the total amount of such payment or
20 guarantee.

21 “(c) REPORTS BY TRUSTEE TO COURT.—The trustee
22 shall make to the court and to SIPC such written reports
23 as may be required by the Bankruptcy Act, and shall in-
24 clude in such reports information with respect to the progress
25 made in distributing cash and securities to customers. Such

1 reports shall be in such form and detail as the Commission
2 determines by rule to present fairly the results of the liquida-
3 tion proceeding as of the date of or for the period covered
4 by such reports, having due regard for the requirements of
5 section 17 of the 1934 Act and the rules prescribed under
6 such section and the magnitude of items and transactions
7 involved in connection with the operations of a broker or
8 dealer.

9 “(d) INVESTIGATIONS.—The trustee shall—

10 “(1) as soon as practicable, investigate the acts,
11 conduct, property, liabilities, and financial condition of
12 the debtor, the operation of its business, and any other
13 matter, to the extent relevant to the liquidation proceed-
14 ing, and report thereon to the court;

15 “(2) examine, by deposition or otherwise, the di-
16 rectors and officers of the debtor and any other witnesses
17 concerning any of the matters referred to in para-
18 graph (1);

19 “(3) report to the court any facts ascertained by
20 the trustee with respect to fraud, misconduct, misman-
21 agement, and irregularities, and to any causes of action
22 available to the estate; and

23 “(4) as soon as practicable, prepare and submit, to
24 SIPC and such other persons as the court designates and
25 in such form and manner as the court directs, a statement

1 of his investigation of the property, liabilities, and finan-
2 cial condition of the debtor, and the operation of its
3 business.

4 "SEC. 8. SPECIAL PROVISIONS OF A LIQUIDATION PRO-
5 CEEDING.

6 "(a) NOTICE AND CLAIMS.—

7 "(1) NOTICE OF PROCEEDINGS.—Promptly after
8 the appointment of the trustee, such trustee shall cause
9 notice of the commencement of proceedings under this
10 section to be published in one or more newspapers of
11 general circulation in the form and manner determined
12 by the court, and shall cause a copy of such notice to
13 be mailed to each person who, from the books and
14 records of the debtor, appears to have been a customer of
15 the debtor with an open account within the past twelve
16 months, to the address of such person as it appears from
17 the books and records of the debtor. Notice to creditors
18 other than customers shall be given in the manner pre-
19 scribed by the Bankruptcy Act, except that such notice
20 shall be given by the trustee.

21 "(2) STATEMENT OF CLAIM.—A customer shall
22 file with the trustee a written statement of claim but
23 need not file a formal proof of claim, except that no obli-
24 gation of the debtor to any person associated with the
25 debtor within the meaning of section 3 (a) (18) or sec-

1 tion 3 (a) (21) of the 1934 Act, any beneficial owner
2 of 5 per centum or more of the voting stock of the debtor,
3 or any member of the immediate family of any such
4 person or owner may be satisfied without formal proof of
5 claim.

6 “(3) TIME LIMITATIONS.—No claim of a customer
7 or creditor of the debtor which is received by the trustee
8 after the expiration of the six-month period beginning
9 on the date of publication of notice under paragraph (1)
10 shall be allowed, except that the court may, upon appli-
11 cation within such period and for cause shown, grant a
12 reasonable, fixed extension of time for the filing of a
13 claim by the United States, by a State or political sub-
14 division thereof, or by an infant or incompetent person
15 without a guardian. Any claim of a customer for net
16 equity which is received by the trustee after the expira-
17 tion of such period of time as may be fixed by the court
18 (not exceeding sixty days after the date of publication
19 of notice under paragraph (1)) need not be paid or
20 satisfied in whole or in part out of customer property,
21 and, to the extent such claim is satisfied from moneys
22 advanced by SIPC, it shall be satisfied in cash or secu-
23 rities (or both) as the trustee determines is most eco-
24 nomical to the estate.

25 “(4) EFFECT ON CLAIMS.—Except as otherwise

1 provided in this section, and without limiting the powers
2 and duties of the trustee to discharge obligations promptly
3 as specified in this section, nothing in this section shall
4 limit the right of any person, including any subrogee, to
5 establish by formal proof or otherwise as the court may
6 provide such claims as such person may have against the
7 debtor, including claims for the payment of money and
8 the delivery of specific securities, without resort to
9 moneys advanced by SIPC to the trustee.

10 “(b) PAYMENTS TO CUSTOMERS.—After receipt of a
11 written statement of claim pursuant to subsection (a) (1),
12 the trustee shall promptly discharge, in accordance with the
13 provisions of this section, all obligations of the debtor to a
14 customer relating to, or net equity claims based upon, secu-
15 rities or cash, by the delivery of securities or the making of
16 payments to or for the account of such customer (subject
17 to the provisions of subsection (d) and section 9(a)) insofar
18 as such obligations are ascertainable from the books and
19 records of the debtor or are otherwise established to the satis-
20 faction of the trustee. For purposes of distributing securities
21 to customers, all securities shall be valued as of the close
22 of business on the filing date. For purposes of this subsection,
23 the court shall, among other things—

24 “(1) with respect to net equity claims, authorize
25 the trustee to satisfy claims out of moneys made available

1 to the trustee by SIPC notwithstanding the fact that
2 there has not been any showing or determination that
3 there are sufficient funds of the debtor available to
4 satisfy such claims; and

5 " (2) with respect to net equity claims relating to
6 securities of a class and series of an issuer which are
7 ascertainable from the books and records of the debtor or
8 are otherwise established to the satisfaction of the trustee,
9 authorize the trustee to deliver securities of such class
10 and series if and to the extent available to satisfy such
11 claims in whole or in part, with partial deliveries to be
12 made pro rata to the greatest extent considered prac-
13 ticable by the trustee.

14 Any payment or delivery of property pursuant to this sub-
15 section may be conditioned upon the trustee requiring claim-
16 ants to execute, in a form to be determined by the trustee,
17 appropriate receipts, supporting affidavits, releases, and
18 assignments, but shall be without prejudice to any right of
19 a claimant to file formal proof of claim within the period
20 specified in subsection (a) (3) for any balance of securities
21 or cash to which such claimant considers himself entitled.

22 " (c) CUSTOMER RELATED PROPERTY.—

23 " (1) ALLOCATION OF CUSTOMER PROPERTY.—The
24 trustee shall allocate customer property of the debtor as
25 follows:

1 “(A) first, to SIPC in repayment of advances
2 made by SIPC pursuant to section 9 (c) (1), to the
3 extent such advances recovered securities which
4 were apportioned to customer property pursuant to
5 section 6 (d) ;

6 “(B) second, to customers of such debtor, who
7 shall share ratably in such customer property on
8 the basis and to the extent of their respective net
9 equities;

10 “(C) third, to SIPC as subrogee for the claims
11 of customers;

12 “(D) fourth, to SIPC in repayment of ad-
13 vances made by SIPC pursuant to section 9 (c) (2) .

14 Any customer property remaining after allocation in
15 accordance with this paragraph shall become part of the
16 general estate of the debtor. To the extent customer
17 property and SIPC advances pursuant to section 9 (a)
18 are not sufficient to pay or otherwise satisfy in full the
19 net equity claims of customers, such customers shall be
20 entitled, to the extent only of their respective unsatisfied
21 net equities, to participate in the general estate as un-
22 secured creditors. For purposes of allocating customer
23 property under this paragraph, securities to be delivered
24 in payment of net equity claims for securities of the same

1 class and series of an issuer shall be valued as of the close
2 of business on the filing date.

3 “(2) DELIVERY OF CUSTOMER NAME SECURI-
4 TIES.—The trustee shall deliver customer name securities
5 to or on behalf of a customer of the debtor entitled
6 thereto if the customer is not indebted to the debtor. If
7 the customer is so indebted, such customer may, with the
8 approval of the trustee, reclaim customer name securities
9 upon payment to the trustee, within such period of
10 time as the trustee determines, of all indebtedness of such
11 customer to the debtor.

12 “(3) RECOVERY OF TRANSFERS.—Whenever cus-
13 tomer property is not sufficient to pay in full the claims
14 set forth in subparagraphs (A) through (D) of para-
15 graph (1), the trustee may recover any property trans-
16 ferred by the debtor which, except for such transfer,
17 would have been customer property. Such recovered
18 property shall be treated as customer property if and to
19 the extent that such transfer is voidable or void under
20 the provisions of the Bankruptcy Act. For purposes of
21 such recovery, the property so transferred shall be
22 deemed to have been the property of the debtor and, if
23 such transfer was made to a customer or for his benefit,
24 such customer shall be deemed to have been a creditor,
25 the laws of any State to the contrary notwithstanding.

1 “(d) PURCHASE OF SECURITIES.—The trustee shall, to
2 the extent that securities can be purchased in a fair and
3 orderly market, purchase securities as necessary for the
4 delivery of securities to customers in satisfaction of their
5 claims for net equities based on securities under section 7
6 (b) (1) and for the transfer of customer accounts under sub-
7 section (f), in order to restore the accounts of such customers
8 as of the filing date. To the extent consistent with subsection
9 (c), customer property and moneys advanced by SIPC
10 may be used by the trustee to pay for securities so purchased.
11 Moneys advanced by SIPC for each account of a separate
12 customer may not be used to purchase securities to the extent
13 that the aggregate value of such securities on the filing date
14 exceeded the amount permitted to be advanced by SIPC
15 under the provisions of section 9 (a).

16 “(e) CLOSEOUTS.—

17 “(1) IN GENERAL.—Any contract of the debtor for
18 the purchase or sale of securities in the ordinary course
19 of its business with other brokers or dealers which is
20 wholly executory on the filing date shall not be com-
21 pleted by the trustee, except to the extent permitted by
22 SIPC rule. Until such time as SIPC adopts rules with
23 respect to the completion or closeout of such a contract,
24 such a contract shall be closed out in accordance with
25 Commission Rule S6 (d) -1 as in effect on the effective

1 date of this Act, or any comparable rule of the Commis-
2 sion subsequently adopted, to the extent not inconsistent
3 with the provisions of this subsection. To the extent that
4 the completion of such a contract has not been authorized
5 by SIPC rule, the other broker or dealer shall close out
6 such contract, without unnecessary delay, in the best
7 available market and pursuant to SIPC rules with
8 respect to closeouts.

9 “(2) NET PROFIT OR LOSS.—A broker or dealer
10 shall net all profits and losses on all contracts closed out
11 under this subsection and—

12 “(A) if such broker or dealer shows a net profit
13 on such closed-out contracts, he shall pay such net
14 profit to the trustee; and

15 “(B) if such broker or dealer sustains a net
16 loss on such closed-out contracts, he shall be entitled
17 to file a claim against the debtor with the trustee in
18 the amount of such net loss.

19 To the extent that a net loss sustained by a broker or
20 dealer arises from contracts pursuant to which such
21 broker or dealer was acting for its own customer, such
22 broker or dealer shall be entitled to receive funds ad-
23 vanced by SIPC to the trustee in the amount of such
24 loss, except that such broker or dealer may not receive
25 more than \$40,000 for each separate customer with

1 respect to whom it sustained a loss. With respect to a net
2 loss which is not payable under the preceding sentence
3 from funds advanced by SIPC, the broker or dealer shall
4 be entitled to participate in the general estate as an
5 unsecured creditor.

6 “(3) CLEARING CORPORATIONS.—Neither a clear-
7 ing corporation which by its rules has an established
8 procedure for the closing-out of open contracts between
9 an insolvent broker or dealer and its participants, nor
10 its participants to the extent such participants’ claims
11 are or may be processed within the clearing corporation,
12 shall be entitled to receive SIPC funds in payment of
13 any losses on such contracts. If such clearing corporation
14 or its participants sustain a net loss on the closing-out of
15 such contracts with the debtor, they shall have the right
16 to participate in the general estate as unsecured creditors
17 to the extent of such loss. Any funds or other property
18 owed to the debtor, after the closing-out of such contracts,
19 shall be promptly paid to the trustee.

20 “(4) DEFINITION.—For purposes of this subsection,
21 the term ‘customer’ does not include any person who—

22 “(A) is a broker or dealer;

23 “(B) had a claim for cash or securities which
24 by contract, agreement, or understanding, or by
25 operation of law, was part of the capital of the

1 claiming broker or dealer or was subordinated to
2 the claims of any or all creditors of such broker or
3 dealer; or

4 “(C) had a relationship of the kind specified in
5 section 9 (a) (5) with either the debtor or the claim-
6 ing broker or dealer.

7 A claiming broker or dealer shall be deemed to have
8 been acting on behalf of its customer if it acted as agent
9 for such customer or if it held such customer's order
10 which was to be executed as a part of its contract with
11 the debtor.

12 “(f) TRANSFER OF CUSTOMER ACCOUNTS.—In order
13 to facilitate the prompt satisfaction of customer claims and
14 the orderly liquidation of the debtor, the trustee may, pur-
15 suant to terms satisfactory to him and subject to the prior
16 approval of SIPC, sell or otherwise transfer to another mem-
17 ber of SIPC, without consent of any customer, all or any
18 part of the account of a customer of the debtor. In connec-
19 tion with any such sale or transfer to another member of
20 SIPC and subject to the prior approval of SIPC, the trustee
21 may—

22 “(1) waive or modify the need to file a written
23 statement of claim pursuant to subsection (a) (2); and

24 “(2) enter into such agreements as the trustee
25 considers appropriate under the circumstances to in-

1 demnify any such member of SIPC against shortages of
2 cash or securities in the customer accounts sold or
3 transferred.

4 The funds of SIPC may be made available to guarantee or
5 secure any indemnification under paragraph (2). The prior
6 approval of SIPC to such indemnification shall be condi-
7 tioned, among such other standards as SIPC may establish,
8 upon a determination by SIPC that the probable cost of
9 any such indemnification can reasonably be expected not
10 to exceed the cost to SIPC of proceeding under section 9 (a)
11 and section 9 (b).

12 "SEC. 9. SIPC ADVANCES.

13 "(a) ADVANCES FOR CUSTOMERS' CLAIMS.—In order
14 to provide for prompt payment and satisfaction of net equity
15 claims of customers of the debtor, SIPC shall advance to the
16 trustee such moneys, not to exceed \$100,000 for each cus-
17 tomer, as may be required to pay or otherwise satisfy claims
18 for the amount by which the net equity of each customer
19 exceeds his ratable share of customer property, except that—

20 "(1) if all or any portion of the net equity claim
21 of a customer in excess of his ratable share of customer
22 property is a claim for cash, as distinct from a claim for
23 securities, the amount advanced to satisfy such claim
24 for cash shall not exceed \$20,000 for each such customer;

25 "(2) a customer who holds accounts with the debtor

1 in separate capacities shall be deemed to be a different
2 customer in each capacity;

3 “(3) if all or any portion of the net equity claim
4 of a customer in excess of his ratable share of customer
5 property is satisfied by the delivery of securities pur-
6 chased by the trustee pursuant to section 8(d), the
7 securities so purchased shall be valued as of the filing
8 date for purposes of applying the dollar limitations of
9 this subsection;

10 “(4) if all or any portion of the net equity of a
11 customer is determined pursuant to section 6(c), SIPC
12 may, but shall not be required to, make an advance with
13 respect to the portion so determined;

14 “(5) no advance shall be made by SIPC to the
15 trustee to pay or otherwise satisfy, directly or indirectly,
16 any net equity claim of a customer who is a general
17 partner, officer, or director of the debtor, a beneficial
18 owner of 5 per centum or more of any class of equity
19 security of the debtor (other than a nonconvertible stock
20 having fixed preferential dividend and liquidation
21 rights), a limited partner with a participation of 5 per
22 centum or more in the net assets or net profits of the
23 debtor, or a person who, directly or indirectly and
24 through agreement or otherwise, exercised or had the

1 power to exercise a controlling influence over the man-
2 agement or policies of the debtor; and

3 “(6) no advance shall be made by SIPC to the
4 trustee to pay or otherwise satisfy any net equity claim
5 of any customer who is a broker or dealer or bank, other
6 than to the extent that it shall be established to the satis-
7 faction of the trustee, from the books and records of the
8 debtor or from the books and records of a broker or
9 dealer or bank, or otherwise, that the net equity claim
10 of such broker or dealer or bank against the debtor arose
11 out of transactions for customers of such broker or dealer
12 or bank (which customers are not themselves a broker
13 or dealer or bank or a person described in paragraph
14 (5)), in which event each such customer of such broker
15 or dealer or bank shall be deemed a separate customer of
16 the debtor.

17 To the extent moneys are advanced by SIPC to the trustee
18 to pay or otherwise satisfy the claims of customers, in addi-
19 tion to all other rights it may have at law or in equity, SIPC
20 shall be subrogated to the claims of such customers with the
21 rights and priorities provided in this section, except that
22 SIPC as subrogee may assert no claim against customer
23 property until after the allocation thereof to customers as
24 provided in section 8 (c).

1 “(b) OTHER ADVANCES.—SIPC shall advance to the
2 trustee—

3 “(1) such moneys as may be required to carry out
4 section 8 (e) ;

5 “(2) to the extent the general estate of the debtor
6 is not sufficient to pay any and all costs and expenses of
7 administration of the estate of the debtor and of the
8 liquidation proceeding, the amount of such costs and
9 expenses.

10 “(c) DISCRETIONARY ADVANCES.—SIPC may advance
11 to the trustee such moneys as may be required to—

12 “(1) pay or guarantee indebtedness of the debtor
13 to a bank, lender, or other person under section 7 (b)
14 (2) ;

15 “(2) guarantee or secure any indemnity under sec-
16 tion 8 (f) ; and

17 “(3) purchase securities under section 8 (d) .

18 **“SEC. 10. DIRECT PAYMENT PROCEDURE.**

19 “(a) DETERMINATION REGARDING DIRECT PAY-
20 MENTS.—If SIPC determines that—

21 “(1) any member of SIPC (including a person
22 who was a member within one hundred and eighty days
23 prior to such determination by SIPC) has failed or is in
24 danger of failing to meet its obligations to customers;

1 “(2) one or more of the conditions specified in
2 section 5 (b) (1) exist with respect to such member;

3 “(3) the claim of each customer of the member is
4 within the limits of protection provided in section 9 (a) ;

5 “(4) the claims of all customers of the member
6 aggregate less than \$250,000;

7 “(5) the cost to SIPC of satisfying customer claims
8 under this section will be less than the cost under a
9 liquidation proceeding; and

10 “(6) such member’s registration as a broker-dealer
11 under section 15 (b) of the 1934 Act has been termi-
12 nated, or such member has consented to the use of the
13 direct payment procedure set forth in this section,
14 SIPC may, in its discretion, use the direct payment proce-
15 dure set forth in this section, in lieu of instituting a liquida-
16 tion proceeding with respect to such member.

17 “(b) NOTICE.—Promptly after a determination under
18 subsection (a) that the direct payment procedure is to be
19 used with respect to a member, SIPC shall cause notice of
20 such direct payment procedure to be published in one or more
21 newspapers of general circulation in a form and manner
22 determined by SIPC, and at the same time shall cause to be
23 mailed a copy of such notice to each person who appears,
24 from the books and records of such member, to have been

1 a customer of the member with an open account within the
2 past twelve months, to the address of such person as it ap-
3 pears from the books and records of such member. Such
4 notice shall state that SIPC will satisfy customer claims
5 directly, without a liquidation proceeding, and shall set forth
6 the form and manner in which claims may be presented. A
7 direct payment procedure shall be deemed to commence on
8 the date of first publication under this subsection and no
9 claim by a customer shall be paid or otherwise satisfied by
10 SIPC unless filed and received within the six-month period
11 beginning on such date, except that SIPC shall, upon applica-
12 tion within such period, and for cause shown, grant a
13 reasonable, fixed extension of time for the filing of a claim by
14 the United States, by a State or political subdivision thereof,
15 or by an infant or incompetent person without a guardian.

16 “(c) PAYMENTS TO CUSTOMERS.—SIPC shall prompt-
17 ly satisfy all obligations of the member of each of its cus-
18 tomers relating to, or net equity claims based upon, securi-
19 ties or cash by the delivery of securities or the effecting of
20 payments to such customer (subject to the provisions of sec-
21 tion 8(d) and section 9(a), except that all references in
22 such sections to the trustee shall be deemed references to
23 SIPC) insofar as such obligations are ascertainable from the
24 books and records of the member or are otherwise established
25 to the satisfaction of SIPC. For purposes of distributing secu-

1 rities to customers, all securities shall be valued as of the close
2 of business on the date of publication under subsection (b).
3 An payment or delivery of securities pursuant to this section
4 may be conditioned upon the execution and delivery, in a
5 form to be determined by SIPC, of appropriate receipts,
6 supporting affidavits, releases, and assignments. To the extent
7 moneys of SIPC are used to satisfy the claims of customers,
8 in addition to all other rights it may have at law or in equity,
9 SIPC shall be subrogated to the claims of such customers
10 against the member.

11 “(d) EFFECT ON CLAIMS.—Except as otherwise pro-
12 vided in this section, nothing in this section shall limit the
13 right of any person, including any subrogee, to establish by
14 formal proof or otherwise such claims as such person may
15 have against the member, including claims for the payment
16 of money and the delivery of specific securities, without
17 resort to moneys of SIPC.

18 “(e) JURISDICTION OF DISTRICT COURTS.—After
19 SIPC has published notice of the institution of a direct pay-
20 ment procedure under this section, any person aggrieved by
21 any determination of SIPC with respect to his claim under
22 subsection (c) may, within six months following mailing
23 by SIPC of its determination with respect to such claim,
24 seek a final adjudication of such claim. The district courts
25 of the United States shall have original jurisdiction of any

1 civil action for the adjudication of such claim, without regard
2 to the citizenship of the parties or the amount in controversy.
3 Any such action shall be brought in the district where the
4 head office of the debtor is located. Any determination of the
5 rights of a customer under subsection (c) shall not prejudice
6 any other right or remedy of the customer against the
7 member.

8 “(f) DISCONTINUANCE OF DIRECT PAYMENT PROCE-
9 DURES.—If, at any time after the institution of a direct pay-
10 ment procedure with respect to a member, SIPC determines,
11 in its discretion, that continuation of such direct payment
12 procedure is not appropriate, SIPC may cease such direct
13 payment procedure and, upon so doing, may seek a protec-
14 tive decree pursuant to section 5. To the extent payments of
15 cash, distributions of securities, or determinations with respect
16 to the validity of a customer's claim are made under this
17 section, such payments, distributions, and determinations
18 shall be recognized and given full effect in the event of any
19 subsequent liquidation proceeding. Any action brought under
20 subsection (e) and pending at the time of the appointment
21 of a trustee under section 5(b)(3) shall be permanently
22 stayed by the court at the time of such appointment, and the
23 court shall enter an order directing the transfer or removal
24 to it of such suit. Upon such removal or transfer the com-
25 plaint in such action shall constitute the plaintiff's claim in

1 the liquidation proceeding, if appropriate, and shall be
2 deemed received by the trustee on the date of his appoint-
3 ment regardless of the date of actual transfer or removal of
4 such action.”.

5 SECURITIES AND EXCHANGE COMMISSION FUNCTIONS

6 SEC. 10. (a) Section 11 (a) of such Act (15 U.S.C.
7 78ggg (a)), as redesignated by this Act, is amended by
8 striking out “or regulations pursuant to section 3 (e) and
9 section 9 (f) ” and inserting “pursuant to section 3 (e) (4)
10 and section 13 (f) ”.

11 (b) Section 11 (d) of such Act (15 U.S.C. 77ggg
12 (d)), as redesignated by this Act, is repealed.

13 EXAMINING AUTHORITY FUNCTIONS

14 SEC. 11. Section 12 of such Act (15 U.S.C. 78hhh),
15 as redesignated by this Act, is amended—

16 (1) by inserting “, or collection agent if a collection
17 agent has been designated pursuant to section 13 (a),”
18 immediately after “examining authority” the first place
19 it appears; and

20 (2) by inserting “or collection agent” immediately
21 after “examining authority” the second place it appears.

22 FUNCTIONS OF SELF-REGULATORY ORGANIZATIONS

23 SEC. 12. Section 13 (a) of such Act (15 U.S.C. 78iii
24 (a)) is amended to read as follows:

25 “(a) COLLECTION AGENT.—Each self-regulatory orga-

1 nization shall act as collection agent for SIPC to collect the
2 assessments payable by all members of SIPC for whom such
3 self-regulatory organization is the examining authority, unless
4 SIPC designates a self-regulatory organization other than the
5 examining authority to act as collection agent for any mem-
6 ber of SIPC who is a member of more than one self-regula-
7 tory organization. The collection agent shall be obligated to
8 remit to SIPC assessments made under section 4 only to the
9 extent that payments of such assessment are received by such
10 collection agent. Members of SIPC who are not members of
11 a self-regulatory organization shall make payments of assess-
12 ments due directly to SIPC.”

13 (b) Section 13 (b) of such Act (15 U.S.C. 78iii (b)),
14 as redesignated by this Act, is amended by inserting “and
15 section 5 (a) (2)” immediately after “section 5 (a) (1)”.

16 (c) Section 13 (c) of such Act (15 U.S.C. 78iii (c).),
17 as redesignated by this Act, is amended to read as follows:

18 “(c) INSPECTIONS.—The self-regulatory organization
19 of which a member of SIPC is a member or participant shall
20 inspect or examine such member for compliance with appli-
21 cable financial responsibility rules, except that—

22 “(1) if the self-regulatory organization is a regis-
23 tered clearing agency, the Commission may designate
24 itself as responsible for the examination of such member

1 for compliance with applicable financial responsibility
2 rules; and

3 “(2) if a member of SIPC is a member of more
4 than one self-regulatory organization, the Commission
5 shall designate one of such self-regulatory organizations
6 or itself as responsible for the examination of such mem-
7 ber for compliance with applicable financial responsi-
8 bility rules.”.

9 (d) Section 13 (f) of such Act (15 U.S.C. 78iii (f)),
10 as redesignated by this Act, is amended to read as follows:

11 “(f) FINANCIAL CONDITION OF MEMBERS.—The Com-
12 mission may, by such rules as it determines necessary or
13 appropriate in the public interest and to carry out the pur-
14 poses of this Act, require any self-regulatory organization to
15 furnish SIPC with reports and records (or copies thereof)
16 relating to the financial condition of members or participants
17 of such self-regulatory organization.”.

18 PROHIBITED ACTS

19 SEC. 13. (a) Section 14 (a) of such Act (15 U.S.C.
20 78jjj (a)), as redesignated by this Act, is amended—

21 (1) by inserting “and penalty” immediately after
22 “interest”; and

23 (2) by striking out “he” each place it appears and
24 inserting “it” in lieu thereof.

1 (b) Section 14 (b) of such Act (15 U.S.C. 78jjj (b)),
2 as redesignated by this Act, is amended—

3 (1) by inserting “or for whom a direct payment
4 procedure has been initiated” immediately after “Act”
5 each place it appears; and

6 (2) in the subsection heading, by inserting “OR
7 INITIATION OF DIRECT PAYMENT PROCEDURE” im-
8 mediately after “TRUSTEE”.

9 (c) Section 14 (c) of such Act (15 U.S.C. 78jjj (c))
10 is amended to read as follows:

11 “(c) CONCEALMENT OF ASSETS; FALSE STATEMENTS
12 OR CLAIMS.—

13 “(1) SPECIFIC PROHIBITED ACTS.—Any person
14 who—

15 “(A) knowingly and fraudulently conceals
16 from SIPC, the receiver, custodian, trustee, mar-
17 shal, or other officer of the court charged with the
18 control or custody of property, or from creditors
19 in any liquidation proceeding or direct payment
20 procedure, any property belonging to the estate
21 of a debtor;

22 “(B) knowingly and fraudulently makes a
23 false statement or account in or in relation to any
24 liquidation proceeding or direct payment procedure;

25 “(C) knowingly and fraudulently presents any

1 false claim for proof against the estate of a debtor,
2 or uses any such claim in any liquidation proceeding
3 or direct payment procedure, personally, or by
4 agent, proxy, or attorney, or as agent, proxy, or
5 attorney;

6 “(D) knowingly and fraudulently receives any
7 material amount of property from a debtor after the
8 filing date with intent to defeat this Act;

9 “(E) knowingly and fraudulently gives, offers,
10 receives, or attempts to obtain any money or prop-
11 erty, remuneration, compensation, reward, advan-
12 tage, or promise thereof, for acting or forbearing
13 to act in any liquidation proceeding or direct pay-
14 ment procedure;

15 “(F) either individually or as an agent or offi-
16 cer of any person or corporation, in contemplation
17 of a liquidation proceeding or direct payment pro-
18 cedure by or against him or any other person or
19 corporation, or with intent to defeat this Act,
20 knowingly or fraudulently transfers or conceals any
21 of his property or the property of such other per-
22 son or corporation;

23 “(G) after the filing date or in contemplation
24 thereof, knowingly and fraudulently conceals, de-
25 stroys, mutilates, falsifies, make a false entry in,

1 or otherwise falsifies any document affecting or
2 relating to the property or affairs of a debtor;

3 “(H) after the filing date, knowingly and
4 fraudulently withholds from SIPC, the receiver,
5 custodian, trustee, marshal, or other officer of the
6 court entitled to its possession, any document affect-
7 ing or relating to the property or affairs of a debtor;
8 or

9 “(I) knowingly and fraudulently steals, ab-
10 stracts, willfully converts to his own use or to the
11 use of another, or embezzles any of the moneys,
12 securities, or other assets of SIPC, or otherwise de-
13 frauds or attempts to defraud SIPC or a trustee by
14 any means, shall be fined not more than \$50,000 or
15 imprisoned not more than five years, or both.

16 “(2) DEFINITION.—For purposes of this subsec-
17 tion, the term ‘debtor’ includes a member of SIPC sub-
18 ject to a direct payment procedure.”.

19 LIABILITY, ADVERTISING, AND OTHER MISCELLANEOUS
20 PROVISIONS

21 SEC. 14. (a) Section 15(d) of such Act (15 U.S.C.
22 78kkk(d)), as redesignated by this Act, is amended—

23 (1) by inserting “, officers, or employees” im-
24 mediately after “Directors”; and

25 (2) in the subsection heading, by inserting “, Of-

1 now in effect or as amended from time to time, and
2 includes the rules of bankruptcy procedure promulgated
3 with respect to such provisions, but does not include the
4 provisions of section 60e of the Bankruptcy Act, relating
5 to stockbroker bankruptcies.

6 “(2) COMMISSION.—The term ‘Commission’ means
7 the Securities and Exchange Commission.

8 “(3) CUSTOMER.—The term ‘customer’ of a debtor
9 means any person (including any person with whom the
10 debtor deals as principal or agent) who has a claim on
11 account of securities received, acquired, or held by the
12 debtor in the ordinary course of its business as a broker
13 or dealer from or for the securities accounts of such per-
14 son (A) for safekeeping, (B) with a view to sale,
15 (C) to cover consummated sales, (D) pursuant to pur-
16 chases, (E) as collateral security, or (F) for purposes
17 of effecting transfer. The term ‘customer’ includes any
18 person who has a claim against the debtor arising out
19 of sales or conversions of such securities, and any person
20 who has deposited cash with the debtor for the purpose
21 of purchasing securities, but does not include any person
22 to the extent that such person has a claim for cash or
23 securities which by contract, agreement, or understand-
24 ing, or by operation of law, is part of the capital of the
25 debtor, or is subordinated to the claims of any or all

1 creditors of the debtor, notwithstanding that some ground
2 might have existed for declaring such contract, agree-
3 ment, or understanding void or voidable in a suit between
4 the claimant and the debtor.

5 “(4) CUSTOMER NAME SECURITIES.—The term
6 ‘customer name securities’ means securities which were
7 held for the account of a customer on the filing date by
8 or on behalf of the debtor and which on the filing date
9 were registered in the name of the customer, or were in
10 the process of being so registered pursuant to instruc-
11 tions from the debtor, but does not include securities
12 registered in the name of the customer which, by en-
13 dorsement or otherwise, were in negotiable form.

14 “(5) CUSTOMER PROPERTY.—The term ‘customer
15 property’ means cash and securities (except customer
16 name securities delivered to the customer) at any time
17 received, acquired, or held by or for the account of a
18 debtor from or for the securities accounts of a customer,
19 and the proceeds of any such property transferred by
20 the debtor, including property unlawfully converted.
21 The term ‘customer property’ includes—

22 “(A) securities held as property of the debtor
23 only to the extent that the inability of the debtor to
24 meet its obligations to customers for their net equity
25 claims based on securities of the same class and

1 series of an issuer is attributable to the debtor's non-
2 compliance with the requirements of section 15 (c)
3 (3) of the 1934 Act and the rules prescribed there-
4 under;

5 “(B) resources provided through the use or
6 realization of customers' debit cash balances and
7 the debit items includable in the 'Formula for Deter-
8 mination of Reserve Requirement for Brokers and
9 Dealers' under rule 15c3-3 under the 1934 Act, as
10 such rule is now in effect or as amended from time
11 to time;

12 “(C) any cash or securities apportioned to
13 customer property pursuant to section 6(d); and

14 “(D) any other property of the debtor which,
15 upon compliance with applicable laws, rules, and
16 regulations, would have been set aside or held for
17 the benefit of customers, unless the trustee deter-
18 mines that including such property within the mean-
19 ing of such term would not significantly increase
20 customer property.

21 “(6) DEBTOR.—The term 'debtor' means a mem-
22 ber of SIPC with respect to whom a protective decree
23 has been filed under section 5(a)(3).

24 “(7) EXAMINING AUTHORITY.—The term 'ex-
25 amining authority' means, with respect to any member

1 of SIPC (A) the self-regulatory organization which
2 inspects or examines such member of SIPC, or (B) the
3 Commission if such member of SIPC is not a member
4 or participant of any self-regulatory organization or if
5 the Commission has designated itself examining authority
6 for such member pursuant to section 13 (c).

7 “(8) FILING DATE.—The term ‘filing date’ means
8 the date on which an application for a protective decree
9 is filed under section 5 (a) (3), except that—

10 “(A) if a petition was filed before such date by
11 or against the debtor under the Bankruptcy Act,
12 or under chapter X or XI of such Act, as now in
13 effect or as amended from time to time, the term
14 ‘filing date’ means the date on which such petition
15 was filed;

16 “(B) if the debtor is the subject of a proceed-
17 ing pending in any court or before any agency of
18 the United States or any State in which a receiver,
19 trustee, or liquidator for such debtor was appointed
20 and such proceeding was commenced before the date
21 on which such application was filed, the term ‘filing
22 date’ means the date on which such proceeding was
23 commenced; or

24 “(C) if the debtor is or has been the subject
25 of a direct payment procedure discontinued by SIPC

1 pursuant to section 10 (f), the term 'filing date'
2 means the date on which notice of such direct
3 payment procedure was published under section
4 10 (b) .

5 “(9) GROSS REVENUES FROM THE SECURITIES
6 BUSINESS.—The term 'gross revenues from the securities
7 business' means the sum of (but without duplication) —

8 “(A) commissions earned in connection with
9 transactions in securities effected for customers as
10 agent (net of commissions paid to other brokers and
11 dealers in connection with such transactions) and
12 markups in respect of purchases or sales of securities
13 as principal;

14 “(B) charges for executing or clearing trans-
15 actions in securities for other brokers and dealers;

16 “(C) the net realized gain, if any, from princi-
17 pal transactions in securities in trading accounts;

18 “(D) the net profit, if any, from the manage-
19 ment of or participation in the underwriting or dis-
20 tribution of securities;

21 “(E) interest earned on customers' securities
22 accounts;

23 “(F) fees for investment advisory services or
24 account supervision with respect to securities;

1 “ (G) fees for the solicitation of proxies with
2 respect to, or tenders or exchanges of, securities;

3 “(H) income from service charges or other
4 surcharges in respect of securities;

5 “(I) except as otherwise provided by rule of
6 the Commission, dividends and interest received on
7 securities in investment accounts of the broker or
8 dealer;

9 “(J) fees in connection with put, call, and
10 other option transactions in securities;

11 “(K) commissions and fees in connection with
12 the distribution of shares in a registered open end
13 investment company or unit investment trust or
14 from the sale of variable annuities; and

15 “(L) fees and other income from such other
16 categories of the securities business as SIPC shall
17 provide by law.

18 “(10) LIQUIDATION PROCEEDING.—The term
19 ‘liquidation proceeding’ means any proceeding for the
20 liquidation of a debtor under this Act in which a trustee
21 has been appointed under section 5 (b) (3).

22 “(11) NET EQUITY.—The term ‘net equity’ means
23 the dollar amount of the account of a customer, to be
24 determined by—

1 “(A) calculating the sum which would have
2 been owed by the debtor to such customer if the
3 debtor had liquidated, by sale or purchase on the
4 filing date, all securities positions of such customer
5 (other than customer name securities reclaimed by
6 such customer) ; minus

7 “(B) any indebtedness of such customer to the
8 debtor on the filing date ; plus

9 “(C) any payment by such customer of such
10 indebtedness to the debtor which is made with the
11 approval of the trustee and within such period as
12 the trustee may determine (but in no event more
13 than sixty days after the publication of notice under
14 section 8 (a)) .

15 In determining net equity under this paragraph, accounts
16 held by a customer in separate capacities shall be deemed
17 to be accounts of separate customers.

18 “(12) PERSONS REGISTERED AS BROKERS OR
19 DEALERS.—The term ‘persons registered as brokers or
20 dealers’ includes any person who is a member of a
21 national securities exchange.

22 “(13) PROTECTIVE DECREE.—The term ‘protective
23 decree’ means a decree, issued by a court upon applica-
24 tion of SIPC under section 5 (b) (3) , that the customers

1 of a member of SIPC are in need of the protection pro-
2 vided under this Act.

3 “(14) SECURITY.—The term ‘security’ means any
4 note, stock, treasury stock, bond, debenture, evidence of
5 indebtedness, any collateral trust certificate, preorgani-
6 zation certificate or subscription transferable share, vot-
7 ing trust certificate, certificate of deposit, certificate of
8 deposit for a security, any investment contract or certifi-
9 cate of interest or participation in any profit-sharing
10 agreement or in any oil, gas, or mineral royalty or lease
11 (if such investment contract or interest is the subject of
12 a registration statement with the Commission pursuant
13 to the provisions of the Securities Act of 1933), any
14 certificate of interest or participation in, temporary or
15 interim certificate for, receipt for, guarantee of, or war-
16 rant or right to subscribe to or purchase or sell any of
17 the foregoing, and any other instrument commonly
18 known as a security. The term ‘security’ does not include
19 any currency, or any commodity or related contract or
20 futures contract, or any warrant or right to subscribe to
21 or purchase or sell any of the foregoing. SIPC may, by
22 rule, include within the meaning of the term ‘security’
23 any other investment contract or certificate of interest
24 or participation in any profit-sharing agreement or in

1 any oil, gas, or mineral royalty or lease if it determines
2 that their inclusion is within the purposes and policies of
3 this Act.”.

4 AMENDMENT TO THE SECURITIES EXCHANGE ACT OF 1934

5 SEC. 16. Section 3 (a) of the Securities Exchange Act
6 of 1934 (15 U.S.C. 78c (a)) is amended by adding at the
7 end thereof the following new paragraph:

8 “(40) The term ‘financial responsibility rules’
9 means the rules and regulations of the Commission or
10 the rules and regulations prescribed by any self-
11 regulatory organization relating to financial respon-
12 sibility and related practices which are designated by
13 the Commission, by rule or regulation, to be financial
14 responsibility rules.”.

15 TABLE OF CONTENTS

16 SEC. 17. The table of contents of the Securities Investor
17 Protection Act of 1970 (15 U.S.C. 78aaa et seq.) is
18 amended to read as follows:

 “TABLE OF CONTENTS

- “Sec. 1. Short title.
- “Sec. 2. Application of Securities Exchange Act of 1934.
- “Sec. 3. Securities Investor Protection Corporation.
- “Sec. 4. SIPC Fund.
- “Sec. 5. Protection of customers.
- “Sec. 6. General provisions of a liquidation proceeding.
- “Sec. 7. Powers and duties of trustee.
- “Sec. 8. Special provisions of a liquidation proceeding.
- “Sec. 9. SIPC advances.
- “Sec. 10. Direct payment procedure.
- “Sec. 11. SEC functions.
- “Sec. 12. Examining authority functions.
- “Sec. 13. Functions of self-regulatory organizations.
- “Sec. 14. Prohibited acts.
- “Sec. 15. Miscellaneous provisions.
- “Sec. 16. Definitions.”.

Mr. LUKEN. Our first witness, who is obviously ready to proceed, is the Honorable Hugh Owens, Chairman of SIPC.

We are pleased to have you with us, Chairman Owens.

Would you like to proceed?

I believe we have your written statement.

STATEMENT OF HON. HUGH F. OWENS, CHAIRMAN, SECURITIES INVESTOR PROTECTION CORPORATION (SIPC), ACCOMPANIED BY LLOYD McCHESNEY, VICE PRESIDENT, FINANCE; AND THEODORE H. FOCHT, GENERAL COUNSEL AND SECRETARY

Mr. OWENS. Yes, Mr. Chairman.

Mr. LUKEN. Without objection, it will be admitted into the record in these proceedings and you may proceed in any manner you see fit. You can either summarize, comment or go over your statement.

Mr. OWENS. Mr. Chairman, and members of the subcommittee.

It is a pleasure for me to appear before you this morning and present the views of the Securities Investor Protection Corporation on H.R. 8331; the Securities Investor Protection Act Amendments of 1977. A very similar bill, H.R. 8064, was the subject of hearings before this subcommittee in late 1975. The present bill incorporates many suggestions made by the Securities and Exchange Commission, SIPC, this subcommittee's own staff, and others in regard to H.R. 8064.

This morning, Mr. Chairman, I am accompanied by Mr. T. H. Focht, General Counsel and Secretary of our corporation who sits on my right; and Mr. Lloyd McChesney, Vice President, Finance of our corporation, who sits on my left.

We appreciate the interest which the subcommittee has evidenced in these important improvements in the SIPC program. I realize that the subcommittee is very pressed for time this morning. With your permission, I request, as has already been kindly acceded to by the chairman, that my complete statement be included in the record of these hearings, but, in an effort to save time, I will summarize it this morning and then answer any questions you may have.

As the subcommittee is aware, SIPC was created by the Securities Investor Protection Act of 1970. The 1970 act established a program whereby moneys from the SIPC fund would be available for the purpose of protecting customers of broker-dealer firms which encountered financial difficulty. As the act now stands, SIPC may advance a maximum of \$50,000 to protect the claim of any one customer of a failed broker or dealer, but no more than \$20,000 of that amount may be advanced to pay claims for cash as opposed to claims for securities. These payments supplement distributions of available securities and cash from the debtor's estate.

Since the enactment of the SIPC legislation, 123 of the over 8,700 broker-dealers which have been SIPC members over the past 6½ years have been placed in liquidation proceedings. As of June 30, 1977, SIPC had made net advances to trustees totaling \$53,411,014. In addition to these SIPC advances, significant amounts of securities and cash have been distributed to customers from assets which were acquired from the debtors' estates by the trustees at the time of their appointments.

We estimate that to date securities and cash having a value of approximately \$277 million have been distributed to approximately 105,000 customers in the course of liquidation proceedings under the 1970 act. I believe these figures demonstrate vividly the effect which the SIPC program has had on investors throughout this country and point up the wisdom of Congress in establishing SIPC and the SIPC program in 1970. It is especially noteworthy that this has been accomplished without any expenditure of Federal funds. Rather, the program has been financed completely from industry funds raised through statutorily imposed assessments on SIPC members.

As of June 30, 1977, SIPC had received assessments from members of SIPC which totaled approximately \$181 million. In addition to those assessments, SIPC had received approximately \$24 million in interest income on its investments, giving SIPC total revenues of \$205 million. SIPC's expenses from inception to this date totaled approximately \$62½ million. As noted above, \$53.4 million of that total represents advances made to trustees in SIPC liquidations and the balance represents administrative expenses for SIPC operations to date.

It may be noted that SIPC's administrative expenses for its internal operations have been approximately 37 percent of the interest income SIPC has earned on its investments. Currently, the SIPC fund totals approximately \$135 million.

Despite all of the good which has been accomplished by the SIPC program, there are serious limitations on SIPC's ability to satisfy customers' claims—limitations which were written into the act and which impair the restoration of investor confidence that the act was intended to achieve. Many of these limitations were apparent when I was appointed chairman of SIPC approximately 3½ years ago, and at my confirmation hearings, I pledged to move quickly to make recommendations for change.

One of my first official acts as chairman of SIPC was to appoint a task force to review the 1970 act and its operations, with a view toward achieving better, faster, and more efficient methods of investor protection. Although the membership of the task force represented diverse views and organizations, it was able to arrive at a consensus on all subjects, except one. Its recommendations represent an appropriate compromising and blending of views and positions in order to obtain the goal of all of us, namely, increased investor confidence through the existence of a viable and efficient SIPC program.

The task force report serves as the foundation for virtually all of the changes which the amendments being considered by you this morning would make in the 1970 act. Accordingly, Mr. Chairman, I request that a copy of the task force's July 1974 report "Report to the Board of Directors of the Securities Investor Protection Corporation of the Special Task Force to Consider Possible Amendments to the Securities Investor Protection Act of 1970" be included at this point in the record of these hearings [see p. 99.]

Mr. LUKEN. Without objection, it will be included in the record.

Mr. OWENS. Thank you, sir.

The board of directors of SIPC approved virtually all of the task force recommendations which were subsequently incorporated in

H.R. 8064. In addition to having the strong support of the board of directors of SIPC these proposals are generally supported by the Securities and Exchange Commission and the securities industry.

The proposed amendments carry out the task force recommendations and are designed to make the act more responsive to the reasonable expectations of investors.

The difficulties are not so much with the administration of the 1970 act, as with some of the specific liquidation procedures and limitations set forth therein. The trustees appointed by the court are, for the most part, doing a good job, but they—and SIPC—are handicapped by some inflexibilities in the law. In broad terms, there are three problems for which the present act does not provide adequate solutions.

The first is that customers generally expect to receive what is in their accounts when the member stops doing business. But in many instances that has not always been possible because securities have been lost, improperly hypothecated, misappropriated, never purchased, or even stolen. When there are valid claims for more stock than is on hand, under the present statute the claimant will receive only a pro rata portion of the securities he claims.

For the remainder of the shares due him, he will receive cash in lieu of stock based on the market price on the date the liquidation proceeding is initiated. Naturally, if the claimed stock goes up in price while he is waiting to have his claim settled, he will be decidedly unhappy with the check he receives from the trustee. On the other hand, if the stock declines in price, we may receive no complaints. But even in that situation, customers can suffer certain disadvantages, for example, tax consequences of what is, in effect, a forced sale of their stock.

The second major problem with the act is that the prescribed liquidation procedures are slower than they need be. This works a hardship on customers because, while they are waiting to receive their property, they are unable to effect transactions in their accounts. They stand at the risk of the market. Then, too, the normal flow of dividends and other distributions is disrupted and, in certain instances, tax problems can arise.

Third, the procedures are not only rigid and sometimes slow, they are expensive. There have been some cases where the trustee's administration expenses have exceeded the amounts advanced to satisfy customer claims. The framers of the act apparently had in mind the liquidation of large brokers such as Weis Securities, where there were 34,000 customer claims. They did not contemplate that the bulk of SIPC cases would turn out to be considerably smaller firms. Yet, under the present statute, whether a broker-dealer has 50 customers or 50,000, the same judicial procedures have to be followed. Virtually everything a trustee does has to be sanctioned by the court. Naturally, this is comparatively costly in a small liquidation proceeding.

The proposed amendments are designed to meet these shortcomings in the law. The amendments will, we believe, serve to maximize customer protection, add greater flexibility and speed to existing procedures, and reduce administration expenses where possible.

As I mentioned earlier, under the present statute the amount of money which SIPC can advance to satisfy any one customer claim

is limited to \$50,000 with a maximum of \$20,000 to satisfy a claim for cash. One important provision in the proposals we sent to Congress in December 1974 would raise these limits to \$100,000 with a maximum of \$40,000 to satisfy a claim for cash. This corresponds to changes in 1974 in the FDIC, FSLIC and FCUIC legislation increasing the coverage for bank and savings deposits from \$20,000 to \$40,000.

Out of the 105,000 claims satisfied in all liquidations to date, there have been 163 customers in 39 liquidations with claims for cash and/or securities which were over the limits of SIPC protection. That is about one-sixth of 1 percent of all claims received. In terms of dollars, the amount of these claims which could not be satisfied came to approximately \$3 million, representing approximately 1 percent of the value of all cash and securities distributed to customers. Had these proposed higher limits of protection been in effect as to claims satisfied to date in liquidation proceedings, the monetary impact on SIPC would have been relatively small—the total additional cost would have been approximately \$2 million and only 21 customers in 13 liquidations would not have had their entire claims satisfied.

Although H.R. 8331 incorporates our recommendation that the dollar limit of the advance which can be made by SIPC for the protection of a customer's account be increased to \$100,000, we are disappointed to note that the corresponding increase in the limit of SIPC advances to satisfy claims for cash as opposed to securities was not included in H.R. 8331. We strongly urge that the bill be changed in this regard, and that our initial proposal for \$40,000 to \$100,000 limits be reinstated.

The increase to \$100,000 is, of course, very important to the overall objective of public confidence in our nation's securities markets. We should not lose sight, however, of the importance of the proposed increase in cash protection to \$40,000. First, many customers have never been able to understand that their protection from SIPC is different if their claim is for cash as opposed to securities.

The distinction becomes especially dramatic when a customer who has had securities on deposit with his broker for many months—or years—sells those securities shortly before the filing date. This converts his claim against the broker from a claim for securities to a claim for cash. More important, perhaps, it converts the maximum advance he can get from the SIPC fund from \$100,000 to a much lower figure. There is an inequity in that situation which is unfortunate, and it is severely aggravated if the maximum advance for cash claims is kept at the existing \$20,000 instead of being raised to the recommended \$40,000.

Second, it should be noted that the experience we have had to date would seem to indicate that the costs of this proposal can easily be handled by the SIPC fund. Of the 163 claims to date which have been over the existing limits of SIPC protection, 106 were claims for cash over the \$20,000 limits. The total dollar amount of the claims over the \$20,000 limit was \$1.2 million. If the proposed \$40,000 limit had been in effect for cash, 91 of those claimants would have been fully protected at an additional cost to the SIPC fund of approximately \$900,000. We submit that that is a

sum which the industry, which is financing the SIPC program, is willing and able to bear.

Mr. LUKEN. But would the sum necessarily be the same if the limit were increased? Isn't it possible that brokers and customers would be aware of this amount of coverage, thereby limiting the amount of cash which is available, against which a claim might be made?

Mr. OWENS. I am not sure, Mr. Chairman, that I quite understand the thrust of your question.

May I have it again?

Mr. LUKEN. You propose to change the amount of coverage, right?

Mr. OWENS. Yes, sir.

Mr. LUKEN. From \$20,000 to \$40,000.

Mr. OWENS. Yes.

Mr. LUKEN. And if there is an awareness on the part of customers and of brokers of the increased limit, then there might be a tendency to have more cash on hand from which higher claims might result. In other words, you are changing the whole ecology of the situation.

Mr. OWENS. I think that that is possible, but after all, one of the major objectives of this legislation is to increase investor confidence. There is no reason why a person should be leaving \$20,000 with a bank or a savings and loan which could be left with his broker just as well. I can't see why there should be any difference in the protection afforded.

Mr. LUKEN. Isn't the protection principally to be for encouragement and additional protection of securities, not for cash?

Mr. OWENS. I think the original concept was to be protection for both.

Mr. LUKEN. This may encourage investors to leave securities with their brokers.

Mr. OWENS. As I pointed out here in my statement, there is no reason to penalize somebody who sells his securities and then gets caught with a failed broker-dealer. Whereas he would have had \$100,000 protection for his securities, he is caught maybe with a \$60,000 or even an \$80,000 loss, because he has decided to sell, and thus has a cash claim on the broker-dealer's books.

Mr. LUKEN. I recognize the application of that argument, but I am not sure that is the whole story.

Mr. OWENS. Bear in mind too, Mr. Chairman, that at the time of the passage of this original act, there was a desire on the part of Congress to keep this situation on a parity with the banks and the savings and loans. That was the reason the \$20,000 was left as it was, because at that time \$20,000 was the limit of the amount of protection at the banks and the savings and loans. Since that time, as you gentlemen are well aware, that amount has been raised to \$40,000 for those institutions.

Mr. LUKEN. FDIC is \$40,000?

Mr. OWENS. Yes, sir, and so are the savings and loans, and I might add that the broker-dealer community in the interim has been at a serious competitive disadvantage, and I don't see why it should be.

Mr. LUKEN. Mr. Oppen?

Mr. OPPER. Mr. Owens, I think as you know, there are some important national policy reasons for our encouraging depositors to keep their funds on deposit with federally insured banks, which are the financial intermediaries.

On the other hand, I question whether or not Congress would similarly want to encourage investors to keep large amounts of cash on deposit with broker-dealers. I think, as you are aware, one of the principal considerations during the deliberations at the 1975 act's amendments was whether or not it was appropriate at all to allow broker-dealers to custody the cash of the customers. This question of course has never been raised with respect to securities. As a matter of fact, the 1975 act's amendments encourage, it seems to me, investors to leave their securities with their broker in order to immobilize the stock certificate. I think the question can be raised as to whether just because we are increasing the coverage for securities, whether these proportions must be maintained by similarly increasing cash coverage to \$40,000. I wonder if you have any comment on that.

Mr. OWENS. I think the most effective comment I can make is to refer you to this list of people, 106 in number. If they had had the protections of \$40,000, they could have received full protection for their claims, and at a relatively small impact on the SIPC fund.

Now I don't see any reason, in fairness and equity, why these people should not be protected in the future, even though they haven't been in the past.

First of all, I guess we can argue this point because we don't have any statistics to support it on either side, but I highly doubt whether or not the raising of the limits to \$40,000, is going to serve as it were, as a magnet for additional cash funds on deposit with broker-dealers. I think that the people that are inclined to leave cash deposits are going to leave them where they can get the higher interest rates. By the same token, however, I think that it is highly desirable to have those protections available, if Mr. John Q is going to be subjected to the loss. I think that that far outweighs the possibility of any attraction of investor funds into the broker-dealer community, because I just don't think that is going to occur.

Mr. LUKEN. All right.

Mr. OWENS. Third, if our program is to achieve to the fullest the restoration of public confidence in our securities markets, there seems to be no compelling reason for failing to keep the limits of protection for cash of securities investors on a monetary par with protection to bank and savings depositors.

Proposed changes which have generated controversy relate to the distributors of mutual funds and variable annuities. Firms dealing exclusively in the sale of mutual funds or variable annuities are not now required to be SIPC members. Their exclusion is apparently based, at least in part, on the argument that since they are essentially sales organizations, not carrying customer accounts and generally not holding securities or funds, they present no risk to the SIPC fund.

The proposed amendments call for the elimination of this exclusion from SIPC membership. The reason for this is that, although those firms do not hold customers' securities or funds, they do

handle them. Accordingly, the possibility of loss or misappropriation exists.

In addition, the theory of inclusion in SIPC membership for many members has been that all who derive their livelihood from the securities industry should help to build the SIPC fund which is used to support a program designed to maintain investor confidence in our nation's securities markets. For example, floor members and specialists of stock exchanges—who have no public customers—are required to be members of SIPC.

A companion recommendation has to do with assessments. At the present time, SIPC members do not pay assessments on revenues from the distribution of mutual funds and variable annuities. To date, however, cash in lieu of missing mutual fund shares has been paid to 50 claimants in 8 different SIPC liquidations for a total of \$190,656. In addition, in 3 of those liquidations, mutual fund shares having an aggregate value of \$69,483 were distributed to 14 customer claimants. We believe that this experience establishes that:

(1) mutual fund transactions can give rise to claims in SIPC liquidations, and

(2) it is inequitable to be using SIPC funds to satisfy such claims if, at the same time, mutual fund transactions are not part of the assessment base for SIPC assessment purposes.

The SIPC board of directors recognizes that there is opposition to the inclusion of distributors of mutual funds and variable annuities in SIPC membership and to extending the assessment base to include revenues from the sale of these securities. With respect to variable annuities, we have not experienced losses to date. As noted above the same is not true with respect to mutual funds. We believe the public is entitled to protection in these transactions. Fairness, however, dictates that if the SIPC fund is to be used to protect these transactions, they should be assessed. That is what we proposed 3 years ago, and we are pleased to see that H.R. 8331 incorporates that proposal.

If, however, those who oppose paying assessments based on revenues from these transactions prevail, we would suggest that again fairness requires that the program be amended to provide clearly that SIPC funds should not be used to satisfy claims based on these transactions.

To the best of our knowledge, no foreign broker-dealer which is a member of SIPC has ever failed to meet its obligations to customers within the meaning of the present act, and therefore SIPC has never had to attempt a liquidation of such a SIPC member. The question, however, of how SIPC would go about obtaining jurisdiction over a foreign broker-dealer and effectuating its liquidation under the 1970 act has arisen in connection with questions about assessments on the securities business of foreign members of SIPC. Because of such jurisdictional and practical difficulties, the proposed amendments exclude from SIPC membership those broker-dealers whose principal business, as determined by SIPC, is conducted outside the United States, at the same time empowering SIPC to adopt rules admitting such broker-dealers to membership upon such terms as SIPC shall require.

Another proposed modification to the 1970 act which has generated some opposition is the proposed change in SIPC's authority with respect to a member's advertisements relating to its SIPC membership. Under the present statute, SIPC prescribes the manner in which a SIPC member may advertise the fact of its membership in SIPC. A few years ago, at the urging of the Securities Industry Association, SIPC reexamined its existing bylaws which permitted advertising of the fact of SIPC membership and proposed a bylaw which would have required SIPC members to identify themselves as members of SIPC. The Securities and Exchange Commission disapproved the proposed bylaw apparently on the basis that, in the commission's opinion, SIPC did not have authority to require members of SIPC to identify such membership.

H.R. 8331 would clarify SIPC's authority in this regard. We strongly support such clarification. One of the principal purposes of our program is public confidence in the securities markets. An important step towards reaching that goal is greater public awareness of the SIPC program. Based upon 6 years experience and observation we do not believe that investor knowledge of the protections afforded him even approaches the extent that it should.

We would urge, therefore, that mandatory identification of SIPC membership is a reasonable means of increasing public awareness of the SIPC program. The proposed SIPC bylaw was drafted carefully to minimize the impact which the requirement would have had on SIPC members, and any future action in this area will be carefully considered with that in mind. This desirable result can be achieved without imposing any great burden, financial or otherwise, on SIPC members, and we believe it is important that SIPC's authority in this area be made clear.

The proposed amendments also contain a definition of the term "securities." As the statute now reads, that term has the same meaning as it has under section 60e of the Bankruptcy Act. The Bankruptcy Act, however, contains no applicable definition of the term "securities." In liquidation proceedings to date, questions concerning the parameters of the term have arisen from time to time.

Accordingly, a definition of this term is set forth in proposed section 16(14). The starting point for this definition is the definition in the Securities Exchange Act of 1934. Recognizing, however, that the term is defined there for enforcement and regulatory purposes, and that a definition tailored to the purposes of the 1970 act is necessary, some modifications have been made.

For example, the proposed definition excludes investment contracts and oil and gas interests which are not registered with the commission under the Securities Act of 1933 since we have concluded that, while it is important to have them included in a definition for enforcement purposes, they are not the types of investments which should be protected by SIPC. On the other hand, we have added certificates of deposit and short-term instruments to the definition since we believe such interests should be included within the protections of the act.

One final aspect of the proposed amendments requires comment. Under the present statute, persons who make loans to a stockbroker on a subordinated basis are, to the extent of those loans, specifically excluded from the customer protection provision. In the

Weis Securities proceeding in New York persons who loaned millions of dollars to Weis on a subordinated basis are presently trying to rescind their subordination agreements on the ground that the agreements were fraudulently induced.

These rescission attempts are currently the subject of litigation in the Federal courts. One group of subordinated lenders, represented by Charles H. Morin, Esq., seeks not only to rescind the subordination agreements in question but also to be treated as customers of Weis entitled to all of the protections of the statute including advances from SIPC. The trustee for Weis Securities and SIPC, with the support of the New York Stock Exchange and the Securities and Exchange Commission, have resisted these attempts to rescind and to date have been successful.

Because of this litigation, and even though SIPC fully expects that its position will be upheld in the appellate courts, we propose that the definition of customer be modified to make clear beyond peradventure that subordinated lenders cannot be treated as customers even if they might have some ground for voiding the subordination agreement in a suit against the debtor.

The importance of subordinated capital to the securities industry cannot be overemphasized. Subordination agreements enable stockbrokers to comply with net capital rules and therefore to continue to deal with the public. The use of subordination agreements to increase a broker's net capital can, as happened with Weis, result in that firm being allowed to continue in business well beyond the time when it might otherwise have had to curtail its business for failure to comply with the applicable net capital rule.

The agreements are explicitly relied upon by the SEC and the self-regulatory organizations in determining whether or not a brokerage firm should be allowed to continue to do business. Reliance by customers and other creditors upon the existence and continued enforcement of subordination agreements is implicit and obvious. To allow rescission of subordination agreements which were instrumental in enabling a brokerage firm to continue to amass obligations to its customers, and then to allow the rescinding subordinated lenders to share *pari passu* with such customers, is contrary to the purposes of permitting the subordinated liabilities to be counted as part of the firm's capital. Indeed, it seems contrary to the purposes of net capital rules themselves, as well as to the desire of Congress, as expressed through the 1970 act, to enhance investor confidence in the securities markets.

In past hearings Mr. Morin has expressed the belief that the proposed amendment is "a shocking and unconscionable denial of a fundamental common law right. . . ." Obviously there is no common law right to the very special preferential treatment afforded to customers by the 1970 act. This, after all, is the only thing with which the proposed amendment deals. It provides that subordinated lenders cannot share with customers in the single and separate fund or receive protection from SIPC's funds.

I have taken time this morning only to highlight certain features of H.R. 8331. It should be noted that the bill makes many important changes to the 1970 act which I have not touched on this morning. I would like, therefore, to submit a section-by-section explanation which discusses some of the more important modifica-

tions made by H.R. 8331 and request that it be included in the record of these hearings [see p. 167.]

Mr. LUKEN. Without objection, it will be included.

Mr. OWENS. In conclusion, let me emphasize again the strong support the board of directors of SIPC gives to these proposed amendments and our hope that they will be enacted at the earliest practicable time. We believe this is advisable from the standpoint of the public's interest generally in our Nation's securities markets and particularly in the protections afforded to customers by the SIPC program.

Mr. Chairman, I will be happy to answer any questions, and my colleagues are also available in that regard.

[Testimony resumes on p. 196.]

[Mr. Owens' prepared statement and other documents submitted for the record follow:]

STATEMENT
BY HUGH F. OWENS, CHAIRMAN
SECURITIES INVESTOR PROTECTION CORPORATION
BEFORE THE
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
HOUSE OF REPRESENTATIVES
August 1, 1977

Mr. Chairman, and members of the Subcommittee, it is a pleasure for me to appear before you this morning and present the views of the Securities Investor Protection Corporation on H.R. 8331; the Securities Investor Protection Act amendments of 1977. A very similar Bill, H.R. 8064, was the subject of hearings before this Subcommittee in late 1975. The present Bill incorporates many suggestions made by the Securities and Exchange Commission, SIPC, this Subcommittee's own staff, and others in regard to H.R. 8064.

Before I review the many important improvements which H.R. 8331 would make in the Securities Investor Protection Act of 1970 (hereinafter referred to as the "1970 Act"), perhaps it would be useful if I summarized briefly the activities of SIPC since its creation in December, 1970. As many of you will recall, SIPC had its origins in the difficult years of 1968-1970 when the paper crunch brought on by an unexpectedly high trading volume in securities was followed by the most severe decline in stock prices since the Great Depression. Hundreds of broker/dealers were merged, acquired or simply went out of business. There were some which were unable to meet their obligations to customers and went bankrupt. Public confidence in our securities markets was in jeopardy.

In order to protect customers of failed broker/dealers against financial loss and, thereby, restore investor confidence in the securities markets, Congress passed the 1970 Act. That statute, which was signed into law on December 30, 1970, created SIPC and established a program whereby monies from the SIPC Fund would be available for the purpose of protecting customers of broker/dealer firms which encountered financial difficulty. As the Act now stands, SIPC may advance a maximum of \$50,000 to protect the claim of any one customer of a failed broker or dealer, but no more than \$20,000 of that amount may be advanced to pay claims for cash as opposed to claims for securities. These payments supplement distributions of available securities and cash from the debtor's estate.

Since the enactment of the SIPC legislation, 123 of the over 8,700 broker/dealers which have been SIPC members over the past 6 1/2 years have been placed in liquidation proceedings. As of June 30, 1977, SIPC had made net advances to trustees totaling \$53,411,014. In addition to these SIPC advances, significant amounts of securities and cash have been distributed to customers from assets which were acquired from the debtors' estates by the trustees at the time of their appointments. We estimate that to date securities and cash having a value of approximately \$277 million have been distributed to approximately 105,000 customers in the course of liquidation proceedings under the 1970 Act. I believe these figures demonstrate vividly the effect which the SIPC Program has had on investors throughout this country and point up the wisdom of Congress in establishing

SIPC and the SIPC Program in 1970. It is especially noteworthy that this has been accomplished without any expenditure of federal funds. Rather, the program has been financed completely from industry funds raised through statutorily imposed assessments on SIPC members.

As of June 30, 1977, SIPC had received assessments from members of SIPC which totaled approximately \$181 million. In addition to those assessments, SIPC had received approximately \$24 million in interest income on its investments, giving SIPC total revenues of \$205 million. SIPC's expenses from inception to this date totaled approximately \$62 1/2 million. As noted above, \$53.4 million of that total represents advances made to trustees in SIPC liquidations and the balance represents administrative expenses for SIPC operations to date. It may be noted that SIPC's administrative expenses for its internal operations have been approximately 37 percent of the interest income SIPC has earned on its investments. Currently, the SIPC Fund totals approximately \$135 million.

I mentioned earlier that 123 members have been or are being liquidated under the provisions of the 1970 Act. It is important to note the spread of those liquidations over the years of SIPC's operations.

1971	-	24
1972	-	40
1973	-	30
1974	-	15
1975	-	8
1976	-	4
1977 (6 months)		2

We are pleased with the declining number of liquidations. While we recognize that there is no single cause for the decline, I am confident that one of the factors is the positive actions taken by the regulatory and self-regulatory authorities over the past years. These actions are manifested not only in strengthened rules and regulations regarding entry qualifications and operating standards, but also in improved surveillance and inspection programs. These activities have had, and will continue to have, SIPC's full support and cooperation.

Despite all of the good which has been accomplished by the SIPC Program, there are serious limitations on SIPC's ability to satisfy customers' claims--limitations which were written into the Act and which impair the restoration of investor confidence that the Act was intended to achieve. Many of these limitations were apparent when I was appointed Chairman of SIPC approximately 3 1/2 years ago, and at my confirmation hearings, I pledged to move quickly to make recommendations for change. One of my first official acts as Chairman of SIPC was to appoint a Task Force to review the 1970 Act and its operations, with a view toward achieving better, faster, and more efficient methods of investor protection. That Task Force was headed by SIPC's General Counsel and was composed of representatives of organizations having a substantial interest in the effective operations of the Act. It conducted its study during the first half of 1974 and made its recommendations to the SIPC Board of Directors in July of that year. Although the membership of the Task Force represented diverse views and organizations, it was able to arrive at a consensus on all subjects, except one. Its

recommendations represent an appropriate compromising and blending of views and positions in order to obtain the goal of all of us, namely, increased investor confidence through the existence of a viable and efficient SIPC Program.

The Task Force Report serves as the foundation for virtually all of the changes which the amendments being considered by you this morning would make in the 1970 Act. Accordingly, Mr. Chairman, I request that a copy of the Task Force's July, 1974, Report [Report to the Board of Directors of the Securities Investor Protection Corporation of the Special Task Force to Consider Possible Amendments to the Securities Investor Protection Act of 1970] be included at this point in the record of these Hearings.

The Board of Directors of SIPC approved virtually all of the Task Force recommendations which were subsequently incorporated in H.R. 8064. In addition to having the strong support of the Board of Directors of SIPC these proposals are generally supported by the Securities and Exchange Commission and the securities industry.

The proposed amendments carry out the Task Force recommendations and are designed to make the Act more responsive to the reasonable expectations of investors. Even though the overall purpose of the Act is being met, that is to provide protection to customers of broker/dealers, some customers of failed members still believe that they are not receiving the protection they thought they were going to get and in the way they believe they should

get it. The proposed amendments will enhance investor confidence in our securities markets.

The difficulties are not so much with the administration of the 1970 Act, as with some of the specific liquidation procedures and limitations set forth therein. The trustees appointed by the Court are, for the most part, doing a good job, but they (and SIPC) are handicapped by some inflexibilities in the law. In broad terms, there are three problems for which the present Act does not provide adequate solutions.

The first is that customers generally expect to receive what is in their accounts when the member stops doing business. If John Q. Investor has 100 fully-paid shares of IBM and a credit balance of \$200 in his account, he expects to receive from the trustee a stock certificate for 100 shares of IBM and a check for \$200.

But in many instances that has not always been possible because securities have been lost, improperly hypothecated, misappropriated, never purchased, or even stolen. When there are valid claims for more IBM stock than is on hand, under the present statute John Q. will receive only a pro rata portion of his 100 shares. For the remainder of the shares due him, he will receive cash in lieu of stock based on the market price on the date the liquidation proceeding is initiated. Naturally, if IBM stock goes up in price while John Q. is waiting to have his claim settled, he will be decidedly unhappy with the check he receives from the trustee. On the other hand, if IBM declines in price, we may receive no complaints from John Q. But

even in that situation, customers can suffer certain disadvantages, for example, tax consequences of what is, in effect, a forced sale of their stock.

The second major problem with the Act is that the prescribed liquidation procedures are slower than they need be. This works a hardship on customers because, while they are waiting to receive their property, they are unable to effect transactions in their accounts. They stand at the risk of the market. Then, too, the normal flow of dividends and other distributions is disrupted and, in certain instances, tax problems can arise.

Thirdly, the procedures are not only rigid and sometimes slow, they are expensive. There have been some cases where the trustee's administration expenses have exceeded the amounts advanced to satisfy customer claims. The framers of the Act apparently had in mind the liquidation of large brokers such as Weis Securities, where there were 34,000 customer claims. They did not contemplate that the bulk of SIPC cases would turn out to be considerably smaller firms. Yet, under the present statute, whether a broker/dealer has 50 customers or 50,000, the same judicial procedures have to be followed. Virtually everything a trustee does has to be sanctioned by the court. Naturally, this is comparatively costly in a small liquidation proceeding. To date, we have had liquidations with under 50 customer claims in 22 percent of our cases.

The proposed amendments are designed to meet these shortcomings in the law (as well as to make numerous other improvements in the 1970 Act).

The amendments will, we believe, serve to maximize customer protection, add greater flexibility and speed to existing procedures, and reduce administration expenses where possible.

As I mentioned earlier, under the present statute the amount of money which SIPC can advance to satisfy any one customer claim is limited to \$50,000 with a maximum of \$20,000 to satisfy a claim for cash. One important provision in the proposals we sent to Congress in December, 1974 would raise these limits to \$100,000, with a maximum of \$40,000 to satisfy a claim for cash. This corresponds to changes in 1974 in the FDIC, FSLIC and FCUIC legislation increasing the coverage for bank and savings deposits from \$20,000 to \$40,000. Out of the 105,000 claims satisfied in all liquidations to date, there have been 163 customers in 39 liquidations with claims for cash and/or securities which were over the limits of SIPC protection. That is about 1/6 of one percent of all claims received. In terms of dollars, the amount of these claims which could not be satisfied came to approximately \$3 million, representing approximately one percent of the value of all cash and securities distributed to customers. Had these proposed higher limits of protection been in effect as to claims satisfied to date in liquidation proceedings, the monetary impact on SIPC would have been relatively small--the total additional cost would have been approximately \$2 million and only 21 customers in 13 liquidations would not have had their entire claims satisfied.

Although H.R. 8331 incorporates our recommendation that the dollar limit of the advance which can be made by SIPC for the protection of a

customer's account be increased to \$100,000, we are disappointed to note that the corresponding increase in the limit of SIPC advances to satisfy claims for cash as opposed to securities was not included in H.R. 8331. We strongly urge that the Bill be changed in this regard, and that our initial proposal for \$40,000/100,000 limits be reinstated.

The increase to \$100,000 is, of course, very important to the overall objective of public confidence in our nation's securities markets. We should not lose sight, however, of the importance of the proposed increase in cash protection to \$40,000. First, many customers have never been able to understand that their protection from SIPC is different if their claim is for cash as opposed to securities. The distinction becomes especially dramatic when a customer who has had securities on deposit with his broker for many months (or years) sells those securities shortly before the filing date. This converts his claim against the broker from a claim for securities to a claim for cash. More important, perhaps, it converts the maximum advance he can get from the SIPC Fund from \$100,000 to a much lower figure. There is an inequity in that situation which is unfortunate, and it is severely aggravated if the maximum advance for cash claims is kept at the existing \$20,000 instead of being raised to the recommended \$40,000.

Second, it should be noted that the experience we have had to date would seem to indicate that the costs of this proposal can easily be handled by the SIPC Fund. Of the 163 claims to date which have been over the existing limits of SIPC protection, 106 were claims for cash over the \$20,000 limits. The total dollar amount of the claims over the \$20,000 limit was

\$1.2 million. If the proposed \$40,000 limit had been in effect for cash, 91 of those claimants would have been fully protected at an additional cost to the SIPC Fund of approximately \$900,000. We submit that that is a sum which the industry, which is financing the SIPC Program, is willing and able to bear.

Finally, if our program is to achieve to the fullest the restoration of public confidence in our securities markets, there seems to be no compelling reason for failing to keep the limits of protection for cash of securities investors on a monetary par with protection to bank and savings depositors.

The proposed amendments call for changes in the Act which would enable the trustee, to a much greater extent than is now possible, to render accounts to customers in the same form as they stood when the member went out of business. Under Section 8(d)^{*/} of the proposed amendments, the trustee would be authorized to go into the market and purchase securities to make up for those which are missing, so long as this could be done in a fair and orderly market. The trustee would also be empowered under Section 7(b) to pay, subject to SIPC approval, bank loans collateralized by securities, including margin securities, thereby reclaiming those securities for distribution to customers. In appropriate cases, SIPC would be authorized to advance funds for this purpose. Margin customers would be permitted to pay their debit balances and receive the securities in their accounts. If these

^{*/} All Section references are to Sections of the 1970 Act as amended by H.R. 8331.

recommendations are implemented, the current practice of paying cash in lieu of missing securities would be eliminated for the most part. Customers would receive, instead, the securities in their accounts. Our expectation is that, in almost all cases, a customer's claim for securities would be satisfied by the delivery of securities, and, where necessary, to accomplish this the trustee would go into the open market and purchase securities. We believe, however, that it is advisable to provide that the trustee would not be required to purchase securities where that could not be done in a fair and orderly market. One chief concern is that the trustee not be required to make purchases in a market which is being improperly controlled or manipulated. This may be of particular significance where the member being liquidated was a market maker. Under those circumstances, the trustee would decline to purchase the needed securities and would instead satisfy the claim by paying cash in lieu of the securities based on the market value of the securities on the filing date.

As I have already mentioned, one of the principal goals of the proposed legislation is to make it possible for the trustee to render accounts to customers as they stood when the member failed. One way to accomplish this in very rapid order is to empower the trustee to transfer accounts in bulk to another broker/dealer. Section 8(f) of the proposed amendments authorizes such a transfer, in whole or in part, thereby eliminating the delays in distributing property to customers which are inherent in any liquidation proceeding. Under the terms set forth in the proposed amendment, SIPC

would guarantee that property available to the trustee will be delivered and that shortages in customers' accounts will be made good. The customer would not, of course, be obligated to leave his account with the broker/dealer to whom it was so transferred.

In this connection, I should point out that such bulk transfers are not always feasible. First of all, the failed firm would have to have kept complete and accurate customer records and, unfortunately, records in too many SIPC liquidation proceedings have ranged from poor to virtually non-existent. Second, the trustee has to be able to find another firm or firms willing to take on the accounts, which in many instances may not be possible. Third, SIPC would have to determine that the cost of a transfer in bulk would be no more than the cost of carrying out the liquidation in the usual fashion, that is account by account.

As I mentioned previously, administration expenses in liquidation proceedings can be disproportionately high, especially in the smaller cases. Fees paid to trustees and their counsel make up a substantial part of the expenses of administration of a liquidation proceeding. In order to cut down on such expenses and to provide experienced and competent trustees, Section 5(b)(3) of the proposed amendments gives SIPC discretion to specify itself or one of its employees as trustee where the failed firm's liabilities are less than \$750,000 and there are fewer than 500 customers. Local counsel would still be retained. We believe that the use of SIPC personnel as trustees will not only help to expedite the liquidation process, but will also result in

substantial savings of administration expenses. Some have questioned whether under the present statute SIPC may insist that a SIPC employee serve as trustee. In a number of cases, we have sought such appointments, but in only five cases have the Courts involved been willing to make the appointments. In those five cases, we have found a significant reduction in total administration expenses, and we believe the statute should be amended to authorize clearly such procedure.

Indeed, many of our cases have been so small (especially in terms of the number of customer claims filed), that we have come to the conclusion that the full judicial procedures are not essential in all liquidations. Section 10 of the proposed amendments would implement what is termed a direct payment procedure. Under that Section, SIPC is given discretion to make payments directly to customers without the necessity of a court-supervised liquidation proceeding, if certain conditions are met. Once SIPC has determined to utilize the direct payment procedure, Section 10(c) of the proposed amendments requires that distributions of cash and securities to customers be made in a manner substantially similar to the manner in which a trustee conducts a liquidation. The direct payment procedure has the advantages of speed of distributions, and a minimum of administration expenses (since there is no formal court proceeding) but without sacrificing the customers' rights to have court hearings as to disputes concerning their claims. Naturally, it is not contemplated that the broker/dealer would be allowed to go back into business once SIPC had paid off the claims of its customers. The

procedure would be utilized only in cases where the failed broker/dealer's registration as a broker/dealer had been terminated by the SEC or where the broker/dealer intends to go out of business and consents to the use of the direct payment procedure.

While it is not possible to determine with precision the dollar amount that would be saved in administration costs by these two proposed amendments (i.e., direct payment procedures and SIPC as trustee), we at SIPC are confident that the savings would be significant.

Another area of change is in the completion of open contractual commitments with other broker/dealers. The present Act's requirement for such completion in certain circumstances is eliminated under the proposed amendments as being unnecessary and cumbersome. In the industry, the practice is for such contracts to be closed out by the other broker/dealer by either purchasing or selling the securities in the market. A gain on a close-out is remitted to the trustee. The loss suffered on such a close-out is charged to the debtor's estate and in SIPC liquidations to date, it has been the practice of trustees to "complete" open contractual commitments by paying close-out losses. This practice has, in effect, been codified by Rule 56d-1, adopted by the Securities and Exchange Commission on July 25, 1973.

The effect of Section 8(e) of the proposed amendments is to continue what has been the practice in the industry and under the SEC Rule.

Where the closing broker/dealer was acting for his own customer, his loss would be paid by SIPC to a maximum of \$40,000^{*/} per customer account with respect to which the closing broker/dealer sustained a loss. There is no present or proposed authority for the advance of SIPC funds to trustees for the protection of the closing broker/dealer who was acting for his own account, rather than for the account of his customer.

Other proposed changes have to do with the distributors of mutual funds and variable annuities and with foreign broker/dealers. Firms dealing exclusively in the sale of mutual funds or variable annuities are not now required to be SIPC members. Their exclusion is apparently based, at least in part, on the argument that since they are essentially sales organizations, not carrying customer accounts and generally not holding securities or funds, they present no risk to the SIPC Fund. The proposed amendments call for the elimination of this exclusion from SIPC membership. The reason for this is that, although those firms do not hold customers' securities or funds, they do handle them. Accordingly, the possibility of loss or misappropriation exists. In addition, the theory of inclusion in SIPC membership for many members has been that all who derive their livelihood from the securities

^{*/} At the present time, pursuant to SEC Rule, the limit of the SIPC advance for satisfaction of such claims is \$20,000 (which compares to the limits of the SIPC advance for the protection of cash claims of a customer). For that reason SIPC proposed this limit be increased when it proposed an increase to \$40,000 for the limit of SIPC advances to protect customers' cash claims. As noted above, we hope the Subcommittee will amend H.R. 8331 to reinstate SIPC's proposed increase for the protection of cash claims of customers. If that is done, it would seem appropriate to keep the \$40,000 limit in this section.

Industry should help to build the SIPC Fund which is used to support a program designed to maintain investor confidence in our nation's securities markets. For example, floor members and specialists of stock exchanges (who have no public customers) are required to be members of SIPC.

A companion recommendation has to do with assessments. At the present time, SIPC members do not pay assessments on revenues from the distribution of mutual funds and variable annuities. To date, however, cash in lieu of missing mutual fund shares has been paid to 50 claimants in 8 different SIPC liquidations for a total of \$190,656. In addition, in 3 of those liquidations, mutual fund shares having an aggregate value of \$69,483 were distributed to 14 customer claimants. We believe that this experience establishes that (1) mutual fund transactions can give rise to claims in SIPC liquidations and (2) it is inequitable to be using SIPC funds to satisfy such claims if, at the same time, mutual fund transactions are not part of the assessment base for SIPC assessment purposes.

The SIPC Board of Directors recognizes that there is opposition to the inclusion of distributors of mutual funds and variable annuities in SIPC membership and to extending the assessment base to include revenues from the sale of these securities. With respect to variable annuities, we have not experienced losses to date. As noted above the same is not true with respect to mutual funds. We believe the public is entitled to protection in these transactions. Fairness, however, dictates that if the SIPC Fund is to be used to protect these transactions, they should be assessed. That is

what we proposed three years ago, and we are pleased to see that H.R. 8331 incorporates that proposal.

If, however, those who oppose paying assessments based on revenues from these transactions prevail, we would suggest that again fairness requires that the program be amended to provide clearly that SIPC funds should not be used to satisfy claims based on these transactions.

To the best of our knowledge, no foreign broker/dealer which is a member of SIPC has ever failed to meet its obligations to customers within the meaning of the present Act, and therefore SIPC has never had to attempt a liquidation of such a SIPC member. The question, however, of how SIPC would go about obtaining jurisdiction over a foreign broker/dealer and effectuating its liquidation under the 1970 Act has arisen in connection with questions about assessments on the securities business of foreign members of SIPC. Because of such jurisdictional and practical difficulties, the proposed amendments exclude from SIPC membership those broker/dealers whose principal business, as determined by SIPC, is conducted outside the United States, at the same time empowering SIPC to adopt rules admitting such broker/dealers to membership upon such terms as SIPC shall require.

Another proposed modification to the 1970 Act which has generated some opposition is the proposed change in SIPC's authority with respect to a member's advertisements relating to its SIPC membership. Under the present statute, SIPC prescribes the manner in which a SIPC member may advertise

the fact of its membership in SIPC. A few years ago, at the urging of the Securities Industry Association, SIPC re-examined its existing bylaws which permitted advertising of the fact of SIPC membership and proposed a bylaw which would have required SIPC members to identify themselves as members of SIPC. The Securities and Exchange Commission disapproved the proposed bylaw apparently on the basis that, in the Commission's opinion, SIPC did not have authority to require members of SIPC to identify such membership.

H.R. 8331 would clarify SIPC's authority in this regard. We strongly support such clarification. One of the principal purposes of our program is public confidence in the securities markets. An important step towards reaching that goal is greater public awareness of the SIPC program. Based upon six years experience and observation we do not believe that investor knowledge of the protections afforded him even approaches the extent that it should. We would urge, therefore, that mandatory identification of SIPC membership is a reasonable means of increasing public awareness of the SIPC program. The proposed SIPC bylaw was drafted carefully to minimize the impact which the requirement would have had on SIPC members, and any future action in this area will be carefully considered with that in mind. This desirable result can be achieved without imposing any great burden, financial or otherwise, on SIPC members, and we believe it is important that SIPC's authority in this area be made clear.

Another important portion of the proposed amendments deals with rule-making power. SIPC's experience in liquidations to date makes it clear

that many problems arise which are, understandably, not the subject of statutory determination. Additionally, it has become obvious that problems will continue to arise which could not have been foreseen at the time of legislative action. Therefore, proposed Section 3(b)(4) gives SIPC substantive rulemaking power, including power to make rules defining terms in the Act and relating to liquidation proceedings and direct payment procedures. Section 3(e) sets forth procedures for adoption of such rules and approval thereof by the Securities and Exchange Commission in such a manner as to give them the force and effect of law.

The proposed amendments also contain a definition of the term "Securities". As the statute now reads, that term has the same meaning as it has under Section 60e of the Bankruptcy Act. The Bankruptcy Act, however, contains no applicable definition of the term "securities". In liquidation proceedings to date, questions concerning the parameters of the term have arisen from time to time. Accordingly, a definition of this term is set forth in proposed Section 16(14). The starting point for this definition is the definition in the Securities Exchange Act of 1934. Recognizing, however, that the term is defined there for enforcement and regulatory purposes, and that a definition tailored to the purposes of the 1970 Act is necessary, some modifications have been made. For example, the proposed definition excludes investment contracts and oil and gas interests which are not registered with the Commission under the Securities Act of 1933 since we have concluded that, while it is important to have them included in a definition for enforcement purposes, they are not the types of investments which should be

protected by SIPC. On the other hand, we have added certificates of deposit and short-term instruments to the definition since we believe such interests should be included within the protections of the Act.

One final aspect of the proposed amendments requires comment. Under the present statute, persons who make loans to a stockbroker on a subordinated basis are, to the extent of those loans, specifically excluded from the customer protection provisions. In the Weis Securities proceeding in New York, persons who loaned millions of dollars to Weis on a subordinated basis are presently trying to rescind their subordination agreements on the ground that the agreements were fraudulently induced. These rescission attempts are currently the subject of litigation in the federal courts. One group of subordinated lenders, represented by Charles H. Morin, Esq., seeks not only to rescind the subordination agreements in question but also to be treated as customers of Weis entitled to all of the protections of the statute including advances from SIPC. The trustee for Weis Securities and SIPC, with the support of the New York Stock Exchange and the Securities and Exchange Commission, have resisted these attempts to rescind and to date have been successful. In the case of In re Weis Securities Inc., 425 F. Supp. 212 (S.D.N.Y. 1977), Judge Inzer B. Wyatt of the United States District Court for the Southern District of New York held that, even assuming that the subordination agreements were obtained by fraud (a proposition which has yet to be proven) considerations of public policy require that the subordinated lenders not be allowed to rescind. That decision is presently on appeal to the United States Court of Appeals for the Second Circuit.

Because of this litigation, and even though SIPC fully expects that its position will be upheld by the Second Circuit, we propose that the definition of customer be modified to make clear beyond peradventure that subordinated lenders cannot be treated as customers even if they might have some ground for voiding the subordination agreement in a suit against the debtor.

The importance of subordinated capital to the securities industry cannot be over-emphasized. Subordination agreements enable stockbrokers to comply with net capital rules and therefore to continue to deal with the public. The use of subordination agreements to increase a broker's net capital can, as happened with Weis, result in that firm's being allowed to continue in business well beyond the time when it might otherwise have had to curtail its business for failure to comply with the applicable net capital rule. The agreements are explicitly relied upon by the SEC and the self-regulatory organizations in determining whether or not a brokerage firm should be allowed to continue to do business. Reliance by customers and other creditors upon the existence and continued enforcement of subordination agreements is implicit and obvious. To allow rescission of subordination agreements which were instrumental in enabling a brokerage firm to continue to amass obligations to its customers, and then to allow the rescinding subordinated lenders to share pari passu with such customers, is contrary to the purposes of permitting the subordinated liabilities to be counted as part of the firm's capital. Indeed, it seems contrary to the purposes of net capital rules themselves, as well as to the desire of Congress, as expressed

through the 1970 Act, to enhance investor confidence in the securities markets.

In past hearings Mr. Morin has expressed the belief that the proposed amendment is "a shocking and unconscionable denial of a fundamental common law right" Obviously there is no common law right to the very special preferential treatment afforded to customers by the 1970 Act. This, after all, is the only thing with which the proposed amendment deals. It provides that subordinated lenders cannot share with customers in the single and separate fund or receive protection from SIPC's funds.

I have attempted to highlight the more important features of H.R. 8331. It should be noted, however, that the Bill makes numerous other technical and clarifying changes to the 1970 Act. I would like, therefore, to submit a Section by Section explanation which discusses some of the more important modifications made by H.R. 8331 and request that it be included in the record of these hearings.

In conclusion, let me emphasize again the strong support the Board of Directors of SIPC gives to these proposed amendments and our hope that they will be enacted at the earliest practicable time. We believe this is advisable from the standpoint of the public's interest generally in our nation's securities markets and particularly in the protections afforded to customers by the SIPC Program.

REPORT TO THE BOARD OF DIRECTORS OF THE SECURITIES
INVESTOR PROTECTION CORPORATION OF THE SPECIAL
TASK FORCE TO CONSIDER POSSIBLE AMENDMENTS TO
THE SECURITIES INVESTOR PROTECTION ACT OF 1970

July, 1974

LETTER OF TRANSMITTAL

SPECIAL TASK FORCE TO CONSIDER POSSIBLE
AMENDMENTS TO THE SECURITIES INVESTOR
PROTECTION ACT OF
1970

July 31, 1974

TO: The Honorable Hugh F. Owens, Chairman
Securities Investor Protection Corporation
900 Seventeenth Street, N. W.
Washington, D. C. 20006

Dear Mr. Chairman:

On behalf of the Special Task Force to consider possible amendments to the Securities Investor Protection Act of 1970, it gives me great pleasure to transmit herewith the Report of the Task Force.

The Report consists of a brief introduction followed by three principal parts and an appendix. Part I sets forth the basic policy determinations which guided the work of the Task Force and is followed by some commentary. Part II contains major policy recommendations which together comprise the improved methods of liquidation and customer satisfaction formulated by the Task Force. Part III contains recommendations designed to effect a number of important technical refinements to the 1970 Act pertaining generally to customer protection, SIPC's powers, and SIPC's relationship with its members. Each of the recommendations in Parts II and III is followed by a brief commentary which sets forth some of the considerations leading to the adoption of various recommendations and which, in certain instances, provides additional explanation as to the scope and purpose of the recommendations. Finally, the Appendix sets forth an illustrative example of the application of the proposed method of allocating customer property and providing SIPC protection in a simplified hypothetical case.

Since the Task Force had no staff of its own, all of its members were active ones. Starting with a meeting on January 3, 1974, the Task Force has held a total of twenty-one meetings in New York and Washington. In addition to these meetings, Task Force members have devoted considerable amounts of time attending numerous subcommittee meetings, studying problems, and drafting and refining proposals. I believe that this active participation is reflected in the quality of thought embodied in the recommendations of the Task Force. I should like to express my personal appreciation to the members of the Task Force, who served without compensation, for the many tireless hours of work which each of them devoted to this study, and for the important contribution which each made to the completion of our task. I should also like to thank the organizations which those members represented for the valuable logistical support which they provided.

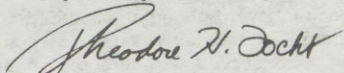
On behalf of the Task Force, I should like to express our appreciation to certain individuals who have met with and worked with the Task Force throughout its deliberations--namely, Roy C. Chapman of the Securities and Exchange Commission; James W. Giddens of Hughes Hubbard & Reed; and Harvey R. Miller of Weil, Gotshal & Manges. These men, each of whom had special expertise which he shared with the Task Force, have contributed greatly to our work. In addition, we wish to note the excellent contribution made to our work by Francis L. Carter of the SIPC staff who served as the secretary to the Task Force.

The Task Force is also deeply indebted to numerous other individuals who met with us from time to time, either on their own behalf or as representatives of organizations, interested in the work of the Task Force. These individuals, identified generally in the introduction to our Report, contributed their time, insight, and expertise, and our discussions with them have proved most beneficial to our study.

It should be noted that the recommendations contained in our Report are addressed primarily to the situation which arises when SIPC determines that it must act to liquidate a member which is unable to meet its obligations to its customers. It should be recognized that an improved SIPC program, standing alone, will not alleviate all of the problems which today beset the securities industry. The Task Force firmly believes, however, that prompt legislative implementation of its recommendations coupled with continuing vigorous surveillance and enforcement on the part of the regulatory and self-regulatory organizations will make an important contribution to the maintenance of investor confidence in securities firms and securities markets.

We, of course, anticipate that the Task Force's recommendations and Report will serve as a focal point as amendments to the 1970 Act are considered. We appreciate the opportunity which you have given to us, and we offer any further assistance which you believe may be useful.

Respectfully submitted,

A handwritten signature in dark ink, reading "Theodore H. Focht". The signature is fluid and cursive, with the first name being more prominent.

Theodore H. Focht, Chairman
SIPC Task Force on Amendments

TABLE OF CONTENTS

INTRODUCTION	1
THE SPECIAL TASK FORCE	4
CONTRIBUTIONS FROM OTHER INTERESTED PARTIES	5
SUMMARY OF FINDINGS	6
RECOMMENDATIONS OF THE TASK FORCE	7
I. Basic Policy Determinations	7
II. Major Policy Recommendations	9
III. Other Recommendations	42
CONCLUSION	57
SEPARATE STATEMENT OF FRANK J. WILSON IN OPPOSITION TO RECOMMENDATION III. B. 1.	59
APPENDIX	60

INTRODUCTION

On December 30, 1970, the President of the United States signed into law the Securities Investor Protection Act of 1970 ("1970 Act") "to provide greater protection for customers of registered brokers and dealers and members of national securities exchanges." The Act created the Securities Investor Protection Corporation ("SIPC"), a non-profit membership corporation of which (with certain limited exceptions) 1/ all registered brokers and dealers and all members of national securities exchanges became members by operation of law. The Act required SIPC to build a fund by levying assessments on its members based upon their gross revenues from the securities business. That fund was to be used for the protection of investors who were securities customers of members liquidated under the provisions of the Act.

In January, 1971, Byron D. Woodside was appointed SIPC's first Chairman. In April, 1971, the first trustee was appointed under the 1970 Act. Thereafter, SIPC applied for the appointment of trustees to liquidate a succession of relatively small broker-dealers. By the end of the first year, twenty-four trustees had been appointed; to date, a total of 105 trustees have been appointed.

1/ Exempt from SIPC membership pursuant to Section 3(a)(2) of the 1970 Act are:

. . . persons whose business as a broker or dealer consists exclusively of (i) the distribution of shares of registered open end investment companies or unit investment trusts, (ii) the sale of variable annuities, (iii) the business of insurance, or (iv) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts.

At first, the satisfaction of customers' claims proceeded slowly as SIPC and the appointed trustees became familiar with the 1970 Act and learned how to liquidate in accordance with its provisions. In many cases, prompt satisfaction was impeded by the debtors' lack of accurate books and records against which customers' claims might be readily verified. Gradually the SIPC staff grew in size, experience, and proficiency. Liquidation techniques and procedures were developed, refined, and disseminated to trustees and their counsel. As a result, the average time required to satisfy customers of broker-dealers in liquidation was shortened.

The experience of liquidating a large broker-dealer came in May, 1973, when SIPC applied to the United States District Court for the Southern District of New York for the appointment of a trustee for the liquidation of Weis Securities, Inc., a member of the New York Stock Exchange with some 32,000 active customers. The trustee and counsel designated by SIPC and appointed by the Court had served in several earlier liquidations under the Act. As Weis had maintained an apparently accurate system of computerized customer account records, the trustee was able to begin satisfying customer claims immediately upon his appointment. Within three months the trustee had processed and approved for payment some 92% of the customer claims filed. SIPC advanced necessary funds to the trustee quickly and provided assistance in resolving problems as they arose.

Yet it soon became evident that a substantial number of the Weis customers whose claims were satisfied by the trustee were "satisfied" only in the sense

that they had received the full protection afforded by the Act. Of some 32,000 customers who filed claims in the Weis liquidation, approximately five percent filed objections with the Court to the trustee's proposed distribution in satisfaction of their claims.^{2/} Approximately ten percent of the Weis customers corresponded from time to time with the trustee regarding settlement of their claims. An indeterminate additional percentage of Weis customers directed inquiries by telephone to the trustee and to SIPC. The principal complaint was the sale by banks of the hypothecated margin securities of customers. Another frequent complaint was the disruption which the customer experienced in the normal flow of dividends and other distributions.

Furthermore, SIPC's experience in Weis served to reenforce the conclusion, already well supported, that the liquidation procedures prescribed by the Act are in some respects inefficient, expensive, inflexible and not necessarily the speediest methods practicable. It appears that many Weis customers were in some measure dissatisfied with the protection afforded by the Act. It is believed that Weis was the first liquidation to make a large segment of the investing public aware of the liquidation procedures mandated by the 1970 Act.

The shortcomings of the Act are a matter of concern to SIPC members as well as to their customers. The more money expended from the SIPC fund for costs of administration, the less money there will be available to build the SIPC fund to its required statutory size, and the greater the resulting burden of assessments which will fall on members in order to maintain the fund. Moreover, it became clear that widespread dissatisfaction among customers of brokers in

^{2/} In virtually all cases, the trustee's position on these claims has been upheld by the court.

liquidation will tend to erode the very investor confidence which the Act was intended to foster.

THE SPECIAL TASK FORCE

In response to the challenge posed to SIPC and to the securities industry, SIPC Chairman Hugh F. Owens appointed this Task Force to consider possible amendments to the 1970 Act. The Task Force was directed to explore better, quicker, and more efficient methods of achieving the investor protection and concomitant investor confidence originally envisioned by the Congress. The Task Force was to meet as necessary to study the problems arising under the present Act, and then report its findings and recommendations to the SIPC Board of Directors.

Representatives of various organizations and groups having a substantial interest in the effective operation of the 1970 Act, were asked to serve on the Task Force--SIPC, the Securities and Exchange Commission, the American Midwest, and New York Stock Exchanges, the National Association of Securities Dealers, Inc., the securities industry, and trustees and counsel appointed under the Act. Since January 3, 1974, the Task Force has met on twenty-one separate occasions, all but two having been all-day sessions. In addition, there have been numerous subcommittee meetings to draft tentative recommendations for presentation to the full Task Force.

CONTRIBUTIONS FROM OTHER INTERESTED PARTIES

At its organizational meeting, the Task Force enumerated various problems for discussion and formulated tentative objectives. Given the magnitude of the task at hand, it determined that exposure to an even broader spectrum of opinion, expertise, and interest than that embodied in the Task Force would be helpful. Representatives of other interested parties were, therefore, invited to meet with the Task Force to discuss problems of mutual interest.

Initially, the Task Force met with selected attorneys and accountants who had served as trustees or counsel under the 1970 Act, to determine what problems they had encountered and to receive their suggestions as to how best to alleviate them. Thereafter, former SIPC Chairman Woodside presented his views and recommendations based upon his experience with the Act. His insight into the operation of the Act was of great assistance to the Task Force.

Officers of major New York banks attended a meeting to discuss liquidation problems posed by the hypothecation of securities of margin customers. Representatives of the Securities Industry Association met with the Task Force to express their views on the problems facing SIPC. Spokesmen for the major associations of transfer agents met with the Task Force to explore methods of expediting the registration and transfer of securities. A meeting was held with officials of the Federal Deposit Insurance Corporation to explore the liquidation techniques developed by that organization. From time to time staff personnel from the Securities and Exchange Commission attended meetings along with the Commission's regular delegate to aid the Task Force

in exploring the regulatory aspects of matters under discussion. A meeting was also held among selected members of the Task Force, representatives of SIPC and officials of selected clearing corporations to discuss common problems. In addition to meeting with interested parties, the Task Force invited written comments from all trustees and counsel appointed under the Act and from other parties having an interest in one or more aspects of its study.

SUMMARY OF FINDINGS

As a result of the aforementioned meetings and from studying written comments submitted, the Task Force was able to formulate general findings as to the deficiencies and limitations of the 1970 Act. The Task Force concludes that the 1970 Act is too narrow in scope and too rigid in application to allow efficient solutions to the broad range of problems which confront SIPC. There has been great diversity in the size, complexity of operation, and type of business of debtors liquidated under the Act. The problems incident to those liquidations have been similarly diverse. Furthermore, the wholesale incorporation of the Bankruptcy Act into the 1970 Act has created certain practical and conceptual difficulties. Customer satisfaction has been a slower and costlier process than it need have been.

Additionally, the protection afforded customers by the Act seems inadequate to maintain investor confidence. Notwithstanding that the Act has afforded protection to many customers who would previously have received none, it is clear that what the public customer wants is the speedy delivery of his account intact and not protection resembling insurance benefits.

Needed are flexible statutory guidelines designed to allow SIPC and trustees to exercise discretion to make customers whole quickly and with minimum expense. SIPC must be given such additional authority and discretion as are necessary to enable it to perform its role more effectively and efficiently and thereby to assist in maintaining investor confidence.

RECOMMENDATIONS OF THE TASK FORCE

At the conclusion of its meetings with interested parties, the Task Force formulated an agenda and conducted a series of meetings directed toward preparation of recommendations for amending the 1970 Act. The recommendations which follow were the result of study, deliberation, and debate. Commentary is included which sets forth briefly the rationale underlying the respective recommendations.

In accordance with the mandate of this Task Force, the foregoing findings and most of the recommendations which follow are applicable to those situations where SIPC must act to liquidate a member in financial distress. Clearly, the best protection for customers and the best source of investor confidence lies with the continuing efforts of the regulatory and self-regulatory organizations aimed at preventing practices which may result in injury to customers.

I. Basic Policy Determinations

The recommendations of the Task Force are based upon the following policy determinations which guided all of its deliberations:

- A. SIPC's role should remain that of a liquidator not a regulator.
- B. Broker-dealers in financial difficulty whose customers require

the protection of the Act should continue to be liquidated rather than rehabilitated.

- C. Once it becomes necessary for SIPC either to apply to a court for the appointment of a trustee or to satisfy customers administratively (see p. 27) the trustee or SIPC should have greater flexibility than is currently afforded by the 1970 Act in order to provide prompt satisfaction of customer claims, more adequate customer protection, and greater economy of administration.
- D. The protection afforded customers by the 1970 Act should be adequate, both quantitatively and qualitatively, to enable SIPC to fulfill its function in maintaining investor confidence in securities firms and securities markets.

The Task Force believes that the present regulatory structure of the securities industry, whereby regulatory responsibility is divided between government and self-regulators, has performed effectively and need not be modified to implement the amendments recommended for the 1970 Act. The Task Force recommends, therefore, that SIPC remain solely a liquidator and believes that SIPC can carry out that role effectively without becoming a regulator. The Task Force deems it inappropriate for SIPC to use its resources to rehabilitate a member in financial difficulty, as it favors neither premature SIPC intervention in the affairs of a financially troubled member nor granting to SIPC the regulatory power and staff capability consistent with such an undertaking.

The Task Force strongly recommends that SIPC be granted flexibility and discretion within its role as a liquidator. Once a member has reached a point where it has failed or is in danger of failing to meet its obligations to its customers, the expanded powers to be given SIPC would come into play.

The protection provided by SIPC to customers of brokers liquidated under the Act must be adequate to maintain the high level of investor confidence envisioned by the Congress and endorsed by the Task Force. Experience indicates that maintaining investor confidence is not solely a function of the dollar amount of protection available, but depends as well on the nature of the protection provided. The Task Force has, therefore, attempted to formulate its recommendations so that the protection provided by the Act will conform to the reasonable expectations of public investors. Maintenance of investor confidence is essential to the continued vitality of the American capital market and the securities industry which serves that market.

II. Major Policy Recommendations

A. The basic framework of the 1970 Act in regard to satisfaction of customers' claims should be modified to better meet the legitimate expectations of customers. The Task Force recommends the following:

1. A customer should receive securities to the maximum extent possible in satisfaction of a claim for securities. Customers whose claims fall within the limits of protection provided by the Act should receive their accounts as they stood on the filing date. ^{3/} In furtherance of this end, the trustee should be authorized to use customer-related assets or SIPC funds to:
 - a. Purchase securities in the open market or complete open contracts, as desired by the trustee, to obtain securities needed to restore customers' accounts.

^{3/} Section 5(b)(4)(B) of the Act defines "filing date" as follows:

Filing Date. -- The term "filing date" means the date on which an application with respect to any debtor is filed under subsection (a)(2); except that if --

- (i) a petition was filed before such date by or against the debtor under the Bankruptcy Act, or

- b. Pay or guarantee bank loans and thereby reclaim hypothecated securities.
- 2. All customer-related property available to the trustee for distribution should be allocated to customers ratably prior to the application of SIPC protection to the accounts of customers.
- 3. Margin customers should be included in such allocation, and should not be accorded a lower priority than cash customers.
- 4. Property in the possession or control of the debtor which should have been set aside for customers pursuant to applicable rules and regulations shall be deemed to have been so set aside. Specifically,
 - a. To the extent securities required to be in possession or control of the debtor pursuant to the requirements of Subsection (c)(3) of Section 15 of the Securities Exchange Act of 1934 and the rules and regulations thereunder, are not in possession or control in non-compliance with such rules and regulations, but securities of the same series and issue are
 - (i) in the possession or control of the debtor in a firm account, or
 - (ii) held as collateral together with securities purported to be proprietary securities of the debtor pursuant to a loan to the debtor and are or could be deemed in excess of the loan balance due the lender,

then such securities should be used to satisfy the claims (for cash or securities) of customers or SIPC as subrogee.

-
- 3/ continued (ii) the debtor is the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for such debtor was appointed which proceeding was commenced before the date on which such application was filed, then the term "filing date" means the date on which such petition was filed or such proceeding commenced.

- b. To the extent cash or qualified securities required under Subsection (c)(3) of Section 15 of the Securities Exchange Act of 1934 or the rules and regulations thereunder to be deposited and held in a special reserve bank account for exclusive benefit of customers or in a special account for the exclusive benefit of customers have not been so deposited and held, then cash otherwise held by the debtor should be used, to that extent, to satisfy claims (for cash or securities) of customers or SIPC as subrogee.
- 5. The resources provided through the use or realization of the debit items includable in the "Formula for Determination of Reserve Requirement for Brokers and Dealers" under Rule 15c3-3, should be used to satisfy the claims of customers or SIPC as subrogee and only the excess, if any, should be allocated to the general estate.
- 6. The trustee should be authorized, without the consent of customers, to sell or otherwise transfer customer accounts to another broker-dealer.
- 7. Where customer accounts cannot readily be so transferred, customers who have debit balances should be allowed to pay their debit balances promptly and receive securities to which they are entitled within the limitations prescribed by the Act.
- 8. The trustee should be authorized to indemnify the transferee or purchaser of customers' accounts against shortages in such accounts; provided, however, that the reasonably anticipated final cost to the SIPC fund arising from such indemnity may not exceed the amount which SIPC reasonably estimates would otherwise be required to satisfy the claims of customers, with respect to the accounts transferred, up to the limits provided by the Act and to pay necessary costs and expenses of liquidation.

9. Expenses of administration, that portion of a customer's claim in excess of the limits of protection, claims of persons other than customers, and claims of SIPC as subrogee (except as otherwise provided), should be allowable only as claims against the general estate.

These recommendations in conjunction with the plan of allocation discussed below form the core of the recommendations of the Task Force. They are designed to modify the 1970 Act to provide protection which better comports with the expectations of cash and margin customers alike without significantly increasing the burden on the SPIC fund. 4/

The recommendations embody a fundamental departure from the 1970 Act. The Task Force believes that customers' accounts should be reconstituted as they existed on the filing date with due regard for the limitations of protection provided in the Act. It also believes that this policy best meets the legitimate expectations of customers.

Moreover, the knowledge that his account will be returned in the form in which it existed on the filing date, allows the customer to continue to exercise investment prerogatives with respect to his portfolio with minimal disruption. If the account is promptly transferred to another broker-dealer, the customer may continue trading. If not, the customer may still exercise some control, for example, by executing offsetting transactions with another

4/ While the Task Force anticipates that certain recommendations will reduce administrative expenses, it does not believe it is possible to accurately predict the financial impact of each recommendation nor the impact of the recommendations of this report as a whole. Moreover, it should be noted that these recommendations are substantially integrated so that modification of one may affect others.

broker-dealer while awaiting the return of his funds and securities.

Returning accounts intact also relieves the customer of the expense involved in re-establishing positions. Adverse tax consequences to the customer will be avoided. Where accounts are transferred, adverse consequences which may arise under the margin regulations where a customer may have to meet higher initial margin requirements are avoided. Finally, such return or transfer is likely to achieve some reduction in SIPC's administrative expenses while expediting the satisfaction of customers' claims.

It is apparent that in order to reconstitute accounts, a trustee must be able to obtain securities either by open market purchases 5/ or by reclaiming securities in bank loan. 6/

Recommendation II. A. 2. is intended to deal with two provisions of the 1970 Act which the Task Force believes may no longer be consistent with the broad objective of customer protection expressed in the legislative history of the 1970 Act. These are Section 6(d) of the Act under which property in the single and separate fund may be used to complete open contractual commitments and Section 6(c)(2)(B) which permits payment of administrative expenses from the single and separate fund in priority to all other claims except those

5/ Recommendation II. A. 1. a.

6/ Recommendation II. A. 1. b. As discussed, infra pp.18-20, the Task Force suggests authorizing the transfer of accounts in certain circumstances. Accordingly, to facilitate such transfers, provision also has been made to allow the trustee to guarantee bank loans.

advances made pursuant to Section 6(d). The Task Force believes that property now includable in the single and separate fund should be distributed ratably to customers or used to benefit customers. The claims payable under Section 6(d) should be advanced from the SIPC fund and recouped by SIPC solely from the general estate in parity with claims of other creditors. Expenses payable pursuant to Section 6(c)(2)(B) should similarly be allowed only as a claim against the general estate. 7/

To some extent this objective has already been accomplished. Rule 15c3-3 under the Securities Exchange Act of 1934 was adopted in January, 1973, to meet the Congressional mandate expressed in Section 7(d) of the 1970 Act which amended Section 15(c)(3) of the Securities Exchange Act. Rule 15c3-3 establishes requirements regarding the segregation of customers' funds and securities. In conjunction with the Rule, acting pursuant to authority granted in Section 6(c)(2)(C)(iii) of the 1970 Act, the Commission defined as "specifically identifiable property" the funds and securities of customers segregated pursuant to the Rule. This action reduced the size and importance of the single and separate fund. The Task Force proposes in Recommendation II.A.2. to take additional steps necessary to meet the objectives fully. In effect, the concept of a "single and separate fund" would be eliminated and all property which can be identified to customers as a whole would be distributed ratably.

Recommendation II. A. 3. is based upon the Task Force's belief that

7/ This should be considered in connection with Recommendation II. A.9. infra pp. 20-21.

persons who are deemed customers under the SIPC Act should constitute a single class of claimants all of whom receive similar treatment in the allocation of property. The Task Force does not believe that distinctions based solely upon the fact that a customer deals as a margin customer should be maintained. A customer, in opening a margin account rather than a cash account, reasonably expects to assume a greater risk of loss due to market fluctuations in the value of the securities purchased on margin as a consequence of the leverage inherent in a margin account. The Task Force does not agree, however, that the margin customer should bear any greater proportion of the loss occasioned by the demise of a broker-dealer than a cash customer. This distinction was incorporated into the 1970 Act presumably on the theory that because margin securities are generally hypothecated by the debtor to finance margin debits, in liquidation this has the effect of reducing the pool of securities available for distribution. Consequently, margin customers were accorded a lesser share of such pool.

As proposed herein, the trustee would be empowered to redeem bank loans and to use customers' debit balances to benefit customers. In view of this, the Task Force believes the distinction in the allocation procedure between cash and margin customers has lost the validity it may have had and should be eliminated.

Recommendation II. A. 4. is designed to permit a trustee to act to bring the debtor into compliance with Rule 15c3-3. In effect, Recommendation

II. A.4.a. provides that if securities should have been in possession or control under Rule 15c3-3 but are not, and similar securities are found elsewhere in the debtor's estate, such securities are to be used to satisfy customers' claims. The Task Force takes the position that a debtor should be assumed to have sold or hypothecated proprietary securities rather than to have violated Rule 15c3-3.

It is specifically recognized that Rule 15c3-3 does not operate in a real time environment. Accordingly, there will arise situations where customers have claims for securities which are not in possession or control, but which Rule 15c3-3 does not require to be in possession or control, for example, a current fail to receive. In that instance, Rule 15c3-3 would not have been violated, and similar securities would not be taken from elsewhere in the debtor's estate under those circumstances.

Recommendation II. A. 4. b. would establish a procedure comparable to that recommended in II. A. 4. a. with regard to funds required under Rule 15c3-3 to be deposited in the special reserve bank account for the exclusive benefit of customers or in a special account for the exclusive benefit of customers of the debtor. 8/

Recommendation II.A.5. provides that resources generated from the use or realization of customers' debit balances should benefit customers. Under current procedures, the "Formula for the Determination of Reserve Requirement of Brokers and Dealers" under Rule 15c3-3 requires broker-dealers to account

8/ The latter account is used in conjunction with certain broker-dealers whose operations fall within the parameters of Paragraph (k) of Rule 15c3-3.

for customer-related credit balances and to segregate such credit balances in a special reserve account except to the extent that there exist offsetting customer debit balances. In general, the largest item among such debit balances is customer borrowings to finance margin purchases. Although customer debit balances are now allowed as an offset in the formula (which has the effect of reducing the amount segregated in the reserve bank account) resources realized from such debit balances do not directly benefit customers. The Task Force believes this is an anomalous situation and Recommendation II. A. 5. would serve to correct this. 9/

In the event that a broker-dealer becomes involved in a SIPC-initiated liquidation, resources derived from debit balances would go to satisfy customers' claims and claims of SIPC based on advances, and only the excess, if any, would go to the general estate.

In line with the provisions of Recommendation II. A. 5. regarding debit balances, Recommendation II. A. 7. suggests that customers be permitted to satisfy their debit balances. Under the 1970 Act, provision is not made for such payment. Rather, the value of a customer's account is computed on a "net equity" basis whereby the amount of any debit balance is deducted from

9/ In the most common situation, money paid in satisfaction of debit balances would be reallocated under the plan of allocation described below to benefit customers. Under some circumstances, debit balances may not be collected, but resources may be realized by selling or transferring customer accounts with debit balances to another broker-dealer. The recommendation takes this into account in its reference to resources provided through the "use" of customers' debit balances.

the value of funds or securities owing to the customer. Experience in the liquidation of Weis Securities, Inc., the first SIPC-liquidated firm which was involved on a large scale in margin lending, indicated that most customers would have been willing to, and indeed expected to, satisfy their debit balances in order to obtain the return of securities. This recommendation allows that expectation to be met. Where a customer's allocated portion of the shortfall of customer property^{10/} is less than the SIPC protection to which he is entitled, the customer could satisfy his debit balance and have his account restored. If he failed to do so, the debit balance would be deducted and securities equal to his net equity would be returned. For those customers who fail to satisfy their debit balances or whose pro rata share of the shortfall exceeds the SIPC limits, the trustee would determine at his discretion which securities are not to be returned.

Where accounts are transferred, in most instances the debit balances would be assumed and financed by the receiving broker-dealer. Provision has been made elsewhere which would enable SIPC to provide or arrange for interim financing if that were necessary.

Recommendations II. A. 6. and II. A. 8. empower the trustee to transfer or sell customers' accounts to another broker-dealer without the consent of the

^{10/} This is more fully described *infra* pp. 22-26. In effect, it means the amount needed to restore the customer's account after returning to him specifically identifiable property, if any, and allocating his ratable share of other customer property.

customers and to indemnify the receiving broker-dealer against loss within certain limits.

Transferring accounts without consent is an obvious prerequisite if the transfer is to occur within a reasonable time frame. Prompt transfer minimizes disruption and permits customers to continue to exercise investment discretion. Customers would not be bound to leave their accounts with the receiving broker-dealer.

The trustee or SIPC would determine whether a transfer is an appropriate alternative based upon the anticipated exposure to the SIPC fund. If it is reasonably estimated that the cost to the SIPC fund to deliver out the accounts (or any part of them) would be less than would be incurred otherwise to satisfy such customers' accounts (including related administrative expenses), then transfer should be allowed. The Task Force is aware that it frequently will not be possible to make this initial determination with precision, but the experience heretofore acquired by SIPC in liquidating firms should prove helpful. The Task Force has been advised that a similar test is used by the Federal Deposit Insurance Corporation and has proved workable.

If it is determined, based on the foregoing estimate, that a transfer can be effected, SIPC or the trustee would be authorized to negotiate such a transfer, including terms for indemnifying the receiving broker-dealer against losses arising from any shortfall in customer property or errors in the accounts trans-

ferred. It is likely that in some circumstances the amount of loss against which the receiving broker is initially indemnified will be significantly greater than the amount arrived at above as the acceptable exposure to the SIPC fund. For example, a trustee may have securities in transfer which he anticipates will be returned and delivered to the receiving broker-dealer. The trustee should be authorized to guarantee receipt of such securities to the receiving broker-dealer in the interim. In this instance, there would be no anticipated exposure to the SIPC fund, although there would be an indemnification. Accordingly, the Task Force recommends that the total indemnification provided to the receiving broker-dealer be left to the discretion of SIPC as long as SIPC has reasonably estimated that the probable final cost to the SIPC fund will be within the recommended guidelines.

The Task Force is of the opinion that prompt transfer of accounts coupled with appropriately limited indemnification will prove to be the most practicable procedure in terms of satisfaction of customers' claims. It should be considered as an alternative in all SIPC liquidations, except where inadequate or non-existent books and records prevent reconstruction of customers' accounts within acceptable time frames.

Recommendation II. A. 9. conforms SIPC's claim against the debtor's estate with the Recommendations II. A. 1. through II. A. 8. Since all customer-related property will be distributed to customers or used to benefit customers, the concept of the single and separate fund is vestigial and should

be eliminated. Accordingly, SIPC, which heretofore claimed against the single and separate fund for administrative expenses, to complete open contractual commitments, 11/ and for claims as subrogee of customers, will make such claims only against the general estate with certain limited exceptions. In addition, the Task Force recommends that SIPC relinquish its priority claim on the general estate for administrative expenses.

The objective of the Task Force is to structure a SIPC liquidation in such a way that there are only two classes of claimants, customers 12/ and general creditors. (There will, of course, be subordinated lenders and equity holders.) In accordance with this objective, when SIPC foregoes its priority claim, all lesser priority claims should likewise be yielded, e. g., wages, taxes, rent. While this at first appears to affect adversely the rights of certain priority creditors, in many instances it may increase their recovery. Frequently, SIPC's priority claim for administrative expenses depletes the general estate and other creditors have no recovery. SIPC's claim will now stand on a parity with all other claims, and general creditors will be assured a pro rata share of the general estate.

It is apparent that the foregoing recommendations involve some fundamental departures from the liquidation procedures set forth in the 1970 Act. SIPC and the trustee will be required to make a number of complex decisions

11/ Advances to broker-dealers regarding open contractual commitments under Section 6(d) of the 1970 Act would be made from the SIPC fund and recouped from the general estate.

12/ Customers are a separate class to the extent their claims fall within the limits of SIPC protection. Any excess claim would be allowed against the general estate.

within constrained time frames. This is particularly so if transfer of accounts is to be a viable alternative.

The Task Force believes that to carry out this program effectively, it will be necessary to develop a computer program designed to accept input regarding a debtor's estate without dependence on the accounting system of the particular debtor. The Task Force has been advised that such a computer program is feasible and recommends that SIPC undertake its development. It is hoped that this computer program, combined with other innovations herein proposed, will result in a reduction of the time required to return funds and securities to customers which the Task Force believes is at present unacceptable.

In conjunction with the foregoing general recommendations, the Task Force has considered the specific application of these concepts as they affect the allocation of property to customers. The Task Force believes the following plan of allocation comports with, and carries out the intent of, these recommendations: 13/

- (1) Moneys in customer segregated bank accounts should be allocated pro rata to customers with free credit balances.
- (2) Securities in the possession or control of the debtor should be allocated pro rata to customers, issue by issue on the basis of each customer's ownership interest in each issue, without distinguishing between cash and margin customers. Securities registered in the names of individual customers, however, should be returned to customers entitled thereto, as is currently done.

13/ An example demonstrating the allocation procedure in a hypothetical situation is attached as an appendix to this report.

- (3) Each customer's claim for cash and/or securities remaining unsatisfied after application of (1) and (2) above would be valued, using filing date prices. The resultant dollar values would be aggregated to determine the total dollar value of remaining unsatisfied claims.
- (4) The expenditure required to restore each account to its filing date status would be determined by adding to unsatisfied cash claims the amount of funds necessary to purchase in the open market the shortfall in securities claimed by customers beyond those recoverable from bank loan.
- (5) The resources available to the trustee, before consideration of any SIPC advances, for the purposes of restoring accounts would be determined. Such resources would primarily consist of customers' debit balances, the market value on the filing date of customer short security positions and the market value on the filing date of securities on hand which relate to open contracts such as customer-related fails to deliver, stock borrowed, C.O.D. contracts, and securities due to CNS systems, which are not to be completed and which were not allocated as possession or control securities.
- (6) If the aggregate dollar value of the resources available to the trustee in (5) above equals or exceeds the aggregate dollar value of the claims in (4) above, each customer's account would be restored to its filing date status without the use of SIPC funds, other than for any net losses due to market fluctuations which would be borne by SIPC.
- (7) To the extent that the resources available are less than the funds needed to restore the accounts to their filing date status, such shortfall will be allocated to customers based upon the proportion that each customer's claim in (3) above bears to the total dollar value of all remaining claims in (3) above.
- (8) Any customer whose pro rata share of the shortfall is within the limits of protection provided by the Act will

have his account restored to its filing date status. For those customers whose pro rata share of the shortfall exceeds the SIPC limits, the trustee will determine at his discretion which securities are not to be returned.

(Note: Each customer's pro rata share of the shortfall would first be applied against his unsatisfied claim for securities, if he has claims for both securities and cash.)

It is important to understand that the steps outlined do not result in any distribution to customers. Rather they constitute a method of ascertaining the aggregate shortfall in customer property and the resources needed to reconstitute customers' accounts. The procedure involves first equitably allocating available or obtainable customer property then computing and allocating ratably the aggregate shortfall in property needed to reconstitute customer accounts. In every instance 14/ where a customer's pro rata share of the shortfall is less than the protection provided by SIPC, the customer would receive his account intact.

Steps 1 and 2 provide for the allocation of property segregated pursuant to Rule 15c3-3. In accordance with Recommendation II.A.4.a. above, if there were a shortfall in such property and securities of the same type or issue as the shortfall securities were located elsewhere in the debtor's estate, such securities would be used to reduce the shortfall. 15/

14/ Except where securities which are not available cannot for some reason be reclaimed from bank loan or purchased in a fair and orderly market.

15/ Under Recommendation II.A.4.b. the same situation would prevail with regard to cash.

In Step 3, the value of all customers' claims remaining unsatisfied after Steps 1 and 2, is computed. In Step 4, the expenditure necessary to restore customers' accounts is computed. ^{16/} This may be less than the value of the claims computed in Step 3 since, for example, the trustee may be able to reclaim securities from a bank loan valued in excess of the loan balance.

Having computed the expenditure necessary to restore customers' accounts, in Step 5 the trustee evaluates the resources available to him. Assuming such resources are less than those required to restore customers' accounts, the shortfall is allocated to each customer in the proportion that his unsatisfied claim computed in Step 3 bears to the aggregate value of all unsatisfied claims in Step 3. ^{17/}

If a customer's proportionate share of the shortfall is less than or equal to the limits of SIPC protection, the customer would be fully protected and his account would be restored. Where the customer's claim is beyond the limits, the trustee would determine what property would not be returned to the customer.

The Task Force believes this allocation procedure results in the most equitable division of the debtor's estate among customers and between customers and creditors of the general estate. The procedure gives recognition to the

^{16/} This does not include administrative expenses or transaction costs where securities are to be purchased.

^{17/} If there is no net shortfall, all customers would be fully satisfied.

fiduciary relationship between broker-dealers and customers and to the treatment accorded customers' funds and securities under Rule 15c3-3.

The Task Force is cognizant that the recommendations in this area are broad in scope and will have a significant impact on the manner in which SIPC liquidations are carried out. The Task Force believes, however, such changes are essential to meet the expectations of customers by expeditiously restoring accounts.

- B. The trustee should have broader authority to operate the business of the debtor:
1. For a limited period of time in order to preserve the salability of certain assets of the debtor, such as branch offices;
 2. To arrange interim financing to facilitate the transfer of accounts from a debtor to a transferee or purchaser of assets; and
 3. To margin and maintain accounts in accordance with prescribed standards.

The foregoing recommendation assumes that a court will stay banks from liquidating securities held as collateral and that a trustee will be able to hold the debtor's sales and back-office personnel together for a short period of time while he determines the aggregate shortage of customer property and negotiates with potential purchasers of the debtor's assets or other transferees. This recommendation is not intended to facilitate or lead to the rehabilitation of a debtor, but rather recognizes that the "going concern" value of a brokerage firm or its branch office may be an economically transferable unit or even a

salable asset. Potential economies cannot be realized if productive units are dismembered. It is also anticipated that the trustee may need to retain employees of the debtor to assist in accomplishing the speedy delivery of accounts to a purchaser or other transferee. The power to arrange interim financing may be necessary to the implementation of those procedures relating to purchase or other transfer of assets. If the trustee is to be successful in transferring accounts, he must be able to protect those accounts against impairment due to market fluctuations. This may include the transmission of maintenance margin calls as well as the liquidation of accounts in appropriate circumstances.

- C. In appropriate cases, SIPC should have the authority to make payments directly to customers. This authority would permit SIPC to make settlement of the claims directly with the customer without a judicial proceeding. The authority would be solely discretionary and would be used in cases where:
- (1) The total known claims of all customers is less than \$250,000, and
 - (2) SIPC reasonably determines that the total cost to the SIPC fund would be less by direct settlement with customers than by a judicial liquidation.
- In these situations SIPC, of course, would be subrogated to the rights of the customers satisfied and could then determine whether it is feasible to pursue the principals, seek to put the firm into bankruptcy, or follow some other course.

Administrative expenses incurred in small liquidations to date have been disproportionately large both in relation to the size of the estates liquidated and in terms of the number of customers satisfied in such proceedings. It appears that such expenses result from the requirement that even the smallest

liquidation proceeding observe all of the formalities of a judicial proceeding under the Bankruptcy Act. Although such procedures are intended to protect the rights of all parties with an interest in a liquidation proceeding, in a no-asset or minimal-asset liquidation, the need for such protection may be lacking. It is recognized that parties aggrieved by acts or omissions on the part of SIPC must have ready access to judicial review of SIPC's determinations, but such a consideration should not preclude the possibility of a streamlined administrative procedure.

It is anticipated that SIPC staff personnel, operating without court supervision, can satisfy customers more quickly and economically than can outside professionals liquidating within the framework of a judicial proceeding. To implement this recommendation, criteria for setting in motion administrative settlement procedures will need to be developed, as well as procedures to assure that a member is effectively out of business prior to SIPC's satisfying any of its customers.

The limit upon aggregate customer claims for the use of administrative settlement procedures is set at \$250,000 in order to afford SIPC maximum flexibility. Had this recommendation been in effect from the inception of the 1970 Act, SIPC would have had discretion to use such procedures in fifty-four of its first ninety-four liquidations. It is doubtful, however, that SIPC would have elected to utilize administrative settlement procedures in all cases within the recommended dollar limit. Cases involving large numbers of customers

or more than a few disputed claims would probably not be appropriate for the use of such procedures.

- D. Upon the entry of an adjudication that SIPC assistance is required [Section 5(b)(1) of the 1970 Act] the court should be required forthwith to appoint SIPC as trustee for the liquidation of the business of the broker or dealer unless (a) SIPC in its discretion declines to accept the appointment within a specified time period or (b) the liabilities of the broker or dealer to unsecured general creditors (other than customers) and subordinated lenders appear to be \$750,000 or more, or there appear to be 500 or more customers who have either open securities positions or cash balances in their accounts. The disinterestedness standard 18/ for a trustee should not apply where SIPC is to serve as trustee. If SIPC is ineligible to serve as trustee or otherwise declines such appointment, then SIPC should have the power to designate who shall be appointed by the court as trustee and as counsel for the trustee. Where SIPC designates a trustee other than itself, the trustee and his counsel should be persons who are "disinterested" within the meaning of the Bankruptcy Act.

Expenses of administration may be substantially reduced by appointing SIPC trustee in those cases where a judicial liquidation proceeding is appropriate. The obvious difficulty inherent in appointing SIPC trustee is that of potential conflict of interest. This problem, however, is more apparent

18/ Section 5(b)(3) of the 1970 Act provides in pertinent part that "No person shall be appointed as . . . trustee or attorney if such person is not 'disinterested' within the meaning of Section 158 of the Bankruptcy Act." Section 158 provides that a person shall not be deemed disinterested, for the purposes of Section 156 and Section 157 of this Act, if --

- (i) he is a creditor or stockholder of the debtor; or
- (ii) he is or was an underwriter of any of the outstanding securities of the debtor or within five years prior to the date of the filing of the petition was the under-

than real in the no-asset or minimal-asset case. Where the estate of a debtor contains substantial assets, SIPC would have the option to retain independent local counsel, or designate an independent trustee, as appropriate in a given case. The procedure recommended is not without precedent. The Federal Deposit Insurance Corporation, for example, generally acts as receiver for banks which must be liquidated, notwithstanding any conflict of interest. Eliminating SIPC's priority claims and placing SIPC's claims on a parity with claims of other creditors against the estate of the debtor may also tend to diminish SIPC's potential conflict with other creditors. The criteria recommended for appointing SIPC trustee are based upon SIPC's experience to date and require the appointment of an independent trustee only where it is likely there are substantial assets to be administered.

It is anticipated that substantial administrative economies may be realized through SIPC's serving as trustee in appropriate cases. SIPC staff personnel can perform many liquidating functions more quickly and economically than less experienced local professionals. The SIPC fund will benefit from

18 / continued

writer of any securities of the debtor; or

- (iii) he is, or was within two years prior to the date of the filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter; or
- (iv) it appears that he has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason an interest materially adverse to the interests of any class of creditors or stockholders.

SIPC's experience by saving the costs incident to having local personnel familiarize themselves with liquidation procedures.

- E. SIPC should be authorized to join or otherwise enter into agreements to use the facilities of clearing corporations and depositories.

No amendment to the Act is deemed necessary to enable SIPC to implement this recommendation. Such arrangements by SIPC may be necessary or desirable to facilitate the prompt delivery or transfer of branch offices and individual customer accounts.

F. Open contractual commitments should be satisfied as follows:

1. All open contractual commitments should continue to be closed-out through buy-in or sell-out procedures.
2. Claims based on close-out losses suffered by broker-dealers may be filed with the trustee. Claims based on transactions in which a customer of another broker-dealer had an interest should continue to be satisfied with SIPC funds up to the limits which would apply had each customer of the claiming broker filed a claim for cash. Broker-dealer claims based on transactions in which a customer did not have an interest should be allowed as claims of unsecured general creditors against the estate of the debtor.
3. SIPC should be subrogated to the claims of broker-dealers satisfied with SIPC funds. SIPC's priority right to recoup advances to satisfy claims filed by broker-dealers should be eliminated. SIPC should, however, assert a claim based on such advances against the general estate of the debtor and share on a parity with other creditors.
4. Each clearing corporation should be allowed to file a single claim for a net loss, if any, attributable to transactions with the debtor, and such claim should

be treated as that of a general creditor against the estate of the debtor.

The effect of the foregoing recommendations is to continue the present practice whereby trustees use SIPC funds to pay close-out losses to broker-dealers who are able to demonstrate to the satisfaction of the trustee that their claims are based on transactions in which a customer had an interest, and to add to the statute the same limit of protection imposed on customer claims for cash. The recommendations specify that such claims should be closed-out promptly and that SIPC's claim based on advances to satisfy open contractual commitments and other broker-dealer claims should be filed as the claim of a general creditor against the estate of the debtor.

Consideration was given to requiring the trustee to complete all open contractual commitments as if in the ordinary course of business. After ^{19/}deliberation, the Task Force concluded that this was not a viable alternative. There are situations where completion is not desirable, such as where no orderly market exists. This frequently occurs where the debtor is the principal market-maker for the issue in question. For the trustee to complete all transactions promptly would entail a significant administrative burden during the critical first days of a liquidation; to delay completion would subject SIPC to prolonged market risk. Also, complex problems would have to be resolved con-

^{19/} Completion of particular transactions solely at the discretion of the trustee for the purpose of expediting the satisfaction of customer claims is provided for in Recommendation II. A. 1. a.

cerning the status of clearing corporations and concerning institutions which deal on a C.O.D. basis. Finally, completion of all open contractual commitments without regard to whether a customer had an interest in the transactions would result in direct protection of broker-dealers with SIPC funds in some situations. The legislative history of the 1970 Act indicates that Congress did not favor extending SIPC protection in such situations, and the Task Force did not find compelling reasons to suggest modification of that position.

The foregoing recommendations also define the status of clearing corporations. It is the decision of the Task Force that clearing corporations should be permitted to follow their internal rules and procedures relating to the settlement of open transactions with an insolvent broker.^{20/} The clearing corporations are in a position analogous to that of a secured creditor in that they usually will have recourse to the clearing deposits of an insolvent member, proceeds of the sales of exchange seats, securities, dividends and other assets of a debtor.

A broker filing claims for losses on "close-outs" with a SIPC trustee and with a clearing corporation may be subject to an inconsistent requirement to pay "profits" on certain close-outs either to the trustee or to the clearing corporation. The Task Force has determined that it is reasonable to allow a broker to pay profits on trades within a clearing corporation's system to the clearing corporation. Since the debtor's estate would lose the benefit of these profits as off-sets, such claims should not be satisfied with SIPC funds pursuant to

^{20/} e.g., Rule 281 of the New York Stock Exchange and Rule 16 of the Stock Clearing Corporation.

Section 6(d). If a clearing corporation sustains a net loss, it should only have a claim as an unsecured general creditor against the debtor's general estate because it has the "profits" of its members as well as certain assets of the debtor.

The Task Force notes that as continuous net settlement clearing systems become universal, certain problems are likely to surface with respect to the interface and integration of these systems. Those problems are considered beyond the purview of this study. The Task Force recommends, however, that problems resulting from related trades in two or more systems be studied by those in a position to respond to such problems.

- G. The wholesale incorporation of the Bankruptcy Act into the 1970 Act should be eliminated. Those points of substantive bankruptcy law and procedure which are necessary or useful to the conduct of a liquidation proceeding should either be set forth expressly in the Act or incorporated by reference to specific provisions of the Bankruptcy Act.

The 1970 Act incorporates by reference the great bulk of both Chapter X and Chapters I through VII of the Federal Bankruptcy Act. Provisions of those chapters are applicable to a liquidation proceeding unless inconsistent with the 1970 Act. Many bankruptcy provisions have been necessary and useful to the conduct of a liquidation proceeding. Others are not useful but are not clearly inconsistent with the 1970 Act, leaving the trustee and his counsel in some doubt as to which provisions must be observed and which may be disregarded. For example, Chapter X of the Bankruptcy Act is designed to facilitate

reorganization, which is expressly prohibited by the 1970 Act. Chapters I through VII, on the other hand, are designed to facilitate liquidation, but, their underlying concept is the equitable division of assets of a debtor which are insufficient to satisfy in full competing claims. That concept should only be applicable to those parts of the liquidation proceeding which deal with creditors other than customers whose claims are fully protected by the Act. Experience to date has indicated a need for statutory clarification.

It should also be noted that a new Federal Bankruptcy Act drafted by the Commission on the Bankruptcy Laws of the United States is now before the Congress. If enacted, that legislation may substantially change bankruptcy procedure and administration as well as certain substantive rights. It is as yet premature to assess the impact of the proposed new Bankruptcy Act on the 1970 Act. The Task Force is concerned, however, that so long as the Bankruptcy Act is engrafted wholesale onto the 1970 Act, any and all revisions of the Bankruptcy Act (which are not inconsistent with the 1970 Act) automatically become part of the 1970 Act, whether beneficial or detrimental to the conduct of a liquidation proceeding.

It is the foregoing considerations which have led the Task Force to recommend that selected provisions of the Bankruptcy Act which are necessary or useful to the conduct of a liquidation proceeding be specifically incorporated into the 1970 Act and that wholesale incorporation of the Bankruptcy Act be eliminated. This recommendation should obviate the need for a trustee to

determine which bankruptcy provisions are applicable, streamline procedures in a liquidation proceeding, and further clarify the respective powers of the trustee and of the bankruptcy court.

The Task Force has no desire to remove liquidation proceedings from the bankruptcy court. Once a trustee is appointed by the District Judge a proceeding under the 1970 Act should be immediately referred to a Bankruptcy Judge for all further proceedings in order to benefit from the experience of the bankruptcy court in handling liquidations generally. To date, the Bankruptcy Judges have cooperated with trustees and their counsel in solving liquidation problems and in interpreting the 1970 Act in order to make the Act work as well as it has.

It is recommended, therefore, that the 1970 Act dispense with wholesale incorporation of the Bankruptcy Act and set forth the following powers either expressly or, where applicable, by incorporation of specific provisions of the Bankruptcy Act the following:

1. Once the Federal District Court has adjudicated the need for SIPC protection and appointed a trustee, provide for a liquidation proceeding to be generally referred to the Bankruptcy Court in the territorial district in which the broker or dealer maintains its principal place of business, and that Bankruptcy Court shall have exclusive jurisdiction over the broker or dealer and its property wherever situated.
2. Provide for the appointment of SIPC as trustee in appropriate cases as provided in Recommendation II. D., p. 29; provide for the designation by SIPC of a trustee where SIPC is ineligible or otherwise declines to serve as trustee; and provide that SIPC may retain local counsel

when it serves as trustee or designate who should be appointed counsel when a trustee other than SIPC is appointed, and that such counsel or outside trustee may be paid by SIPC in accordance with Recommendation III. B. 11., p. 52 .

3. Vest in SIPC the functions, to the extent appropriate, which the Commission on the bankruptcy laws proposes to vest in the United States Bankruptcy Administration. This will give SIPC control over all of the assets and properties of defunct brokers or dealers and allow SIPC to invest moneys generated thereby as an aggregate, eliminate appraisers and other functionaries where possible, as well as obviate the necessity of continually applying to the court for the approval of administrative matters such as sale of assets, the allowance of claims where there is no dispute, the authorization for distributions and other functions which do not require judicial decisions.
4. State the powers and duties of a trustee, including, without limitation, the authority to continue temporarily the operation of the business of a debtor with the approval of SIPC and subject to such restrictions as SIPC may impose; transfer accounts in bulk; purchase or sell securities; satisfy bank loans and do all things necessary to effectuate the provisions, legislative purpose and policy of the Act.
5. Vest the trustee with the same avoidance powers as a trustee may have under any bankruptcy act then in effect.
6. Vest the trustee with appropriate investigatory powers.
7. Set forth the method of distribution of customer property and the purposes for which SIPC funds may be used in accordance with Recommendation II. A., pp. 9-12.
8. Establish that all claims provable against the general estate of the debtor shall share in the assets of the debtor on a parity basis, except those claims which are by contract, agreement, or understanding, or by operation of law, subordinated to claims of other creditors of the debtor or based upon property which is part of the capital of the debtor. SIPC's claims based on advances to protect customers, compensate liquidation personnel, and pay other administrative

expenses would share in the general estate on a parity with claims of other creditors.

9. Empower SIPC to adopt, amend and repeal rules and regulations in accordance with Recommendation II. J., p. 40.
 10. Provide for appropriate appellate procedures affording the opportunity to any person who claims to be aggrieved by an action of SIPC to have that action reviewed by the Bankruptcy Court. In connection herewith, it is suggested that where SIPC or a trustee makes any determination affecting a substantive right of a claimant or customer who requests that the same be reviewed by the court, it should be the burden of SIPC or the trustee to cause that matter to be placed upon the calendar of the court for review and hearing at the earliest practicable date.
 11. Establish standards for the filing of claims and the periods of limitation in connection therewith in accordance with Recommendation III. A. 3., p. 43.
 12. Include such other bankruptcy provisions, with modifications as appropriate, as are necessary or desirable for the conduct of a liquidation proceeding.
- H. Persons who lend securities to a broker-dealer should not be deemed customers within the meaning of the Act with respect to claims for securities so loaned; provided, however, that persons whose securities are held by a broker-dealer as collateral for a margin loan should be deemed customers within the meaning of the Act, regardless of whether the broker thereafter hypothecates or loans those securities.

A recent inquiry by the New York Stock Exchange into the practice of individuals and institutions lending securities to brokers indicates that the great majority of such loans are made against cash collateral and marked to the market. The lender holds the cash collateral outside of the brokerage

house. Such lenders may look to their collateral for protection and consequently should require no further protection under the Act. The small number of persons who loan securities to brokers without collateral or who leave such collateral on deposit with the broker, typically receive consideration for such loans. The debtor-creditor relationship so established should be distinguished from the more nearly fiduciary character of the broker's obligation to his ordinary customer. It is noted that the Congress rejected the idea of protecting banks, subordinated lenders, and other creditors who might reasonably be expected to bear the risk of loss in a brokerage insolvency as an ordinary business risk.

A customer who leaves fully-paid securities with his broker-dealer for safekeeping is clearly protected by the Act against the possibility that the broker-dealer might loan those securities without the consent of the customer. The exception for margin customers gives effect to the inherent nature of the margin transaction as well as to the intent of the customer and his broker.

- I. The limits of SIPC protection should be raised to \$125,000 per separate customer with no more than \$50,000 to be paid with respect to a claim for cash.

This recommendation is designed to provide greater protection to customers and to maintain parity of SIPC protection of credit balances with that provided depositors by the Federal Deposit Insurance Corporation and the Federal Savings & Loan Insurance Corporation. Both those organizations are expected to have their depositor protection limits raised to \$50,000 in the near future. The recommended increased protection with respect to securities merely maintains

the 2-1/2 to 1 securities to cash ratio originally enacted. The higher limits are deemed necessary to bolster investor confidence and to maintain the high degree of protection intended by the Congress.

The proposed higher limit of protection with respect to claims for cash will further protect customers who do not normally leave large cash balances with their broker, but who sell securities immediately prior to the filing date and receive in payment a check from their broker which is subsequently dishonored. To the extent that the proposed increase in protection with respect to claims for securities will encourage customers to leave additional securities with broker-dealers, and those securities are in turn placed in depositories, this recommendation should improve the securities transaction processing system. It is also anticipated that SIPC can provide protection up to the recommended higher limits more economically than commercial insurance carriers are at present willing to do. Based on data available from the ninety-four liquidations commenced prior to January 1, 1974, a total of 107 out of 110 accounts over the present limits would have fallen within the proposed limits for a total additional payout of approximately \$1 million from the SIPC fund. Therefore, through a relatively small additional expenditure from the SIPC fund, a great many investors with accounts in excess of the present limits might have greater confidence in their broker-dealers.

- J. The authority to promulgate rules under the Act should be granted to SIPC, subject to oversight and non-disapproval by the Securities and Exchange Commission. Similarly, authority to define by bylaw or rule terms used in the Act,

insofar as such definitions are not inconsistent with the provisions of the Act, should be given to SIPC, and such definitions adopted by SIPC should control the interpretations of the terms so defined as used in the Act, notwithstanding that such definitions might be inconsistent with or otherwise at variance from the definitions of the same terms as used in the Securities Exchange Act of 1934 or any rules promulgated thereunder.

It is clear that amendment of the 1970 Act whenever new or unforeseen problems arise in liquidation proceedings is not feasible. SIPC has demonstrable need for a means to devise equitable and efficient solutions to such problems on a continuing basis. It is the view of the Task Force that the Act should provide broad guidelines as a framework within which SIPC may exercise sound discretion in order to benefit fully from its experience. The power to promulgate rules and define terms in a manner not inconsistent with the provisions of the Act is deemed essential to achieving the flexibility for SIPC envisioned by the Task Force. Such rules and definitions are, of course, subject to scrutiny by the Securities and Exchange Commission before they may become effective.

The Task Force believes that it may at times be necessary for SIPC to promulgate definitions at variance with those same terms as defined in the 1934 Act and rules thereunder. It seems entirely appropriate for a given term to have a broader or narrower definition for purposes of a liquidation proceeding than the same term might require within the context of regulation of an on-going entity.

III. Other Recommendations

A. Customer Protection.

1. The term "controlling person" (defined in accordance with SEC Form BD) should be added to the enumeration in Section 6(f)(1)(C) of the Act of persons excluded from SIPC protection.

Section 6(f)(1)(C) of the Act currently excludes from protection with SIPC funds any officer, director, or general partner of a debtor, as well as anyone having an equity interest in the debtor of five percent or more. As those who actually control a broker-dealer may eschew titles and offices normally incident to the position of principal, in some cases an evasion of the statutory exclusion from SIPC protection may result. This recommendation is designed to foreclose the possibility of evasion by expressly excluding from SIPC protection any "controlling person," defined as:

Any person who directly or indirectly through agreement or otherwise exercises or has the power to exercise a controlling influence over the management or policies of the debtor.

It is also recommended that SIPC use its power to define terms, recommended above, to define the term "officer" in such a way as to avoid the inequity of excluding from protection those who were corporate officers in name only and had no real part in the management of the debtor.

2. Claims based upon valid customer transactions with a debtor effected after the filing date, but prior to the appointment of a trustee, should be satisfied with SIPC funds.

It appears that those who drafted the 1970 Act failed to foresee that a debtor might do business, legally or illegally, after the "filing date" (generally, the date when SIPC applies to a court for the appointment of a trustee; see definition, p. 9, n. 3). Although there is no reason for failing to protect bona fide customers with respect to post filing date transactions, the provisions of the Act requiring computation of net equities as of the filing date create a conceptual impediment to the satisfaction of claims based on such transactions. This recommendation merely seeks to amend the Act to reflect what probably would have been done originally had the problem been foreseen. Where securities could not be distributed in kind to customers claiming securities, such customers (who will be relatively few in number) would be paid the trade date value of such securities up to the limits of protection provided by the Act.

3. The customer claim period in a liquidation proceeding under the Act should be set at sixty (60) days from the publication of notice or such shorter time as the court may order for customers who are to receive a prorated share of customer property and initial SIPC advances. Claims received from customers within six (6) months from the date of publication of notice will receive protection up to the limits provided by the Act, but will not necessarily receive any prorated distributions of customer property in the debtor's estate.

This procedure is recommended for those situations in which bulk transfer is not feasible. This recommendation recognizes that the sooner the trustee can allocate customer property on hand, the sooner he can distribute such

property in satisfaction of customers' claims. Where the books and records of the debtor are adequate, the trustee should be able to allocate customer property before the initial customer claim period expires and then satisfy individual claims as they are received. Where the books and records do not permit preliminary allocation, this recommendation allows the trustee to make an allocation as soon as the initial customer claim period set by the court expires.

Those who do not file claims within the prescribed time limit should not be deprived of SIPC protection, but their tardiness should not be allowed to delay the allocation of customer property and the transfer or distribution of that property. Those who fail to file timely claims will receive cash in lieu of securities up to the limits provided by the Act, unless the trustee in his discretion decides otherwise.

The foregoing is SIPC's current practice and appears to be in accord with Sections 6(e) and 6(g) of the Act. In at least one case, however, a judge has refused to allow customers' claims filed after the sixty (60) day claim period but within the six (6) month limit, notwithstanding SIPC's professed willingness to honor such claims. The Act therefore needs clarification as to SIPC's right to protect customers who file claims prior to the absolute bar date for all claims and as to satisfying these untimely claims somewhat differently from timely ones, where expeditious administration so requires.

4. Where SIPC has taken no action with respect to a member, SIPC should be able to take action under the 1970 Act for a period of six (6) months

after the termination of the registration of that member as a broker or dealer. The Securities and Exchange Commission should develop procedures to provide for appropriate notice to the public of the termination of registrations.

Section 5(a)(2) of the 1970 Act authorizes SIPC to act with respect to a "member" which has failed or is in danger of failing to meet its obligations to its customers. SIPC members are in turn defined as persons registered as brokers and dealers under the 1934 Act or who are members of national securities exchanges. Should a situation arise where it is not apparent that a broker-dealer has failed to meet its obligations to one or more customers until after its registration as a broker-dealer has been revoked or withdrawn, a question arises as to whether SIPC may act to protect customers of an entity which is technically no longer a "member" of SIPC. The foregoing recommendation is designed to clarify SIPC's ability to act and also to provide a reasonable cut-off date as to SIPC's obligation with respect to customers of a former member.

5. Where a customer maintains accounts with two or more introducing broker-dealers, all of whom introduce accounts to the same broker-dealer on a fully disclosed basis, or the customer maintains an account with the carrying broker and with one or more of the introducing brokers, the customer should be deemed to have separate accounts with each for purposes of liquidation of the carrying broker-dealer under the 1970 Act.

This recommendation is intended to clarify a situation which might arise. In conformity with other recommendations with respect to the treatment of

customers, it is designed to give effect to the reasonable expectations of the customer. The number of separate accounts 21/ which a customer has with the carrying broker should be the sum of the number of separate accounts which the customer had with each introducing broker and with the carrying broker.

B. SIPC and SIPC members.

1. All current exclusions from SIPC membership should be eliminated.
2. Current exclusions from assessable gross revenues should be eliminated except for revenues from the conduct of the business of insurance and other non-securities business.

The current exclusions from SIPC membership 22/ and from assessable gross revenues 23/ tend to work inequities in the assessment process. Apparently, those exclusions are based, at least in part, on the theory that the firms and types of business excluded present no danger of loss to public customers, hence it would be inequitable to assess those firms and types of business expressly excluded, as they would neither require nor derive benefit

21/ Section 6(c)(2)(A)(iv) of the 1970 Act provides in pertinent part that "[A]ccounts held by a customer in separate capacities shall be deemed to be accounts of separate customers." In October, 1971, SIPC promulgated "Series 100 Rules" identifying accounts of separate customers of SIPC members.

22/ Listed on p. 1, n.1.

23/ Section 4(i)(1) of the 1970 Act provides in pertinent part that the term "Gross Revenues" "[D]oes not include revenues received by a broker or dealer in connection with the distribution of shares of a registered open end investment company or unit investment trust or revenues derived by a broker or dealer from the sale of variable annuities or from the conduct of the business of insurance.

from SIPC protection. This theory overlooks the very real danger that any broker who accepts funds from public customers for the purchase of securities may commingle or misappropriate those funds. Revenues from the sale of mutual fund shares, for example, are at present excluded from assessable gross revenues. Notwithstanding the theory that such purchases present no risk to the customer other than market risk, SIPC has to date satisfied some forty claims filed in liquidation proceedings with respect to shares of mutual funds at a cost to SIPC of approximately \$170,000. The inclusion of broker-dealers who have no customers to be protected under the 1970 Act is not novel. Under the Act, some brokers (for example, specialists, floor brokers, and firms doing exclusively institutional C.O.D. business) were consciously included as members of SIPC, even though they have no customers protected by the Act. This was based in part on the philosophy that those who earn their livelihood from the securities market should contribute to the building of the SIPC fund. Eliminating all exclusions from membership and from assessable revenues is consistent with this philosophy.

The original congressional objective to build the SIPC fund rapidly to \$150-million for the benefit of the entire industry and the investing public remains valid. Moreover, Section 4(c)(2) of the Act expressly authorizes SIPC to establish variable assessment rates for different classes of members at such time as the fund reaches the required level.

The representative of the National Association of Securities Dealers, Inc. on the Task Force has requested that the opposition of his organization to these two recommendations be noted. The Association's statement is set forth at the end of this report.

3. The SIPC Board should have the authority to enter into agreements for confirmed lines of credit in addition to those currently counted as part of the fund, which the Act now requires be phased out, and such additional confirmed lines of credit should not be counted as part of the SIPC fund.

It would be unfortunate for SIPC to have to borrow from the United States Treasury unless a catastrophe makes such borrowing absolutely necessary. SIPC might, however, need a relatively small amount of money either for a short period of time as a "cushion" against unforeseen contingencies or to demonstrate the ability to meet an indemnity or guaranty. The SIPC Board should have discretion to maintain additional confirmed lines of credit separate from those now being serially phased out, as required by the Act. At present, the Act is unclear as to whether all confirmed lines of credit maintained by SIPC must be permanently eliminated, or whether such lines of credit must merely be phased out of the SIPC fund. The foregoing recommendation is intended to clarify the Act in accordance with the latter interpretation.

4. SIPC members should be subject to a minimum assessment of \$25.00 per year for the next three (3) years with the minimum assessment thereafter to be set by SIPC by rule or bylaw.

The assessment paid by a SIPC member must at a minimum exceed the

administrative cost of maintaining his membership and payment records. SIPC needs flexibility to raise the minimum assessment from time to time as its costs increase.

5. SIPC should be authorized to levy by rule or bylaw a penalty in addition to interest charges for late payment of assessments and to waive such penalty in appropriate circumstances.

At present, SIPC is unable to levy interest charges at a rate high enough to make late payment of assessments uneconomical. It is feared that a large enough interest charge to discourage late payments might violate local usury laws resulting in protracted litigation. Express statutory authority for SIPC to levy a penalty in addition to an interest charge should aid in deterring late payment of assessments.

6. The Task Force suggests that the SIPC Board recommend that the Securities Exchange Act of 1934 be amended to grant the Securities and Exchange Commission the authority to designate, with respect to a member who is a member of more than one self-regulatory organization, the examining authority for any or all purposes including financial responsibility; and that such recommendation be coupled with a recommendation for an appropriate limitation of liability in connection therewith.
7. The self-regulatory organizations should continue to collect SIPC assessments from their members, and SIPC should continue to designate which self-regulatory organization shall collect from a member who is a member of more than one self-regulatory organization.

The question of designation of the examining authority with respect to

financial responsibility for a SIPC member is but a small part of the much larger problem of distributing responsibility efficiently among the self-regulatory organizations. Comprehensive solution of that larger problem, however, lies beyond the mandate of the Task Force. The foregoing resolution is in furtherance of what appears to be a partial solution. It recognizes that where one self-regulatory organization is made responsible for examining a member of another, the latter might nevertheless be concerned lest it be held liable for its failure to examine its member. There are also difficulties inherent in designating one self-regulatory organization to examine and enforce compliance with the rules of another.

Collection of assessments, however, remains the primary concern of SIPC, and SIPC should continue to designate which self-regulatory organization shall collect from a SIPC member who is a member of more than one self-regulatory organization. SIPC should have greater flexibility, however, and not necessarily be required to designate the examining authority as the collection agent, as it now must, if it would be more efficient to do otherwise.

8. All broker-dealers who are members of SIPC should be made subject to certain minimum financial responsibility rules, including municipal bond dealers, who are at present exempt from such rules.

For historical reasons, certain firms dealing exclusively in municipal securities and registered as broker-dealers (and therefore members of SIPC) are exempt from most financial responsibility rules. The public interest and

SIPC's interest in those firms whose customers it may have to protect demand that all SIPC members be made subject to at least minimum standards of financial responsibility. An amendment to the 1970 Act, however, may not be the appropriate statutory vehicle for implementing this recommendation.

9. Voluntary membership in SIPC, pursuant to Section 3(f) of the Act, should be restricted to those broker-dealers who are either registered with the Securities and Exchange Commission or are members of a national securities exchange or association.

The primary reason for this recommendation is much the same as for the one immediately preceding it. To the maximum extent possible it is desirable that all SIPC members be effectively regulated to assure compliance with applicable financial responsibility rules as well as other rules and regulations promulgated by the Commission and the self-regulators to protect the public interest.

10. Section 12 of the Act should be amended to read as follows:

(2) FINANCIAL RESPONSIBILITY RULES - Notwithstanding any other provision of this Act, the term "Financial Responsibility Rules" shall have the same meaning as under the 1934 Act.

There would then be added to the Securities Exchange Act a new Section 3(a)22 as follows:

The term "Financial Responsibility Rules" means the rules and regulations of the Commission or the rules and regulations prescribed by any national securities exchange or

registered national securities association pertaining to financial responsibility and related practices which are designated by the Commission by rule or regulation to be "Financial Responsibility Rules."

While SIPC needs the power to define terms in order to discharge effectively its statutory responsibilities, it is the Commission and the self-regulatory organizations who are charged with setting standards of financial responsibility for SIPC members. As originally enacted, Section 12 defined the term "financial responsibility rules" narrowly by relating it to Section 15(c)(3) of the 1934 Act or to the rules of a national securities exchange. The Task Force believes that a much broader definition of that term is warranted. Rules not specifically adopted pursuant to that section also establish standards of financial responsibility as do numerous rules of the National Association of Securities Dealers, Inc.

11. SIPC should have the power to fix compensation by agreement with trustees, counsel, and accountants without court approval.

In order to satisfy customers promptly and efficiently, SIPC may require the assistance of a trustee, counsel and accountants located in the community where a debtor is located. It is important that SIPC be able to employ competent local professionals. It will be easier to induce highly qualified professionals to serve if prompt payment of fair compensation can be assured, especially in no asset or minimal asset cases. SIPC, which will serve as trustee in most cases, will be in a position to ascertain what rate of compensation is appropriate in a given case and whether services billed have been

competently performed.

At present, the Act contains an anomaly in that accountants may be compensated without court approval, while trustees and their counsel must seek court approval for their compensation and must carry time on their books for long periods without compensation. Compensation was formerly a priority charge against the estate of the debtor. The Task Force has recommended that compensation of professionals be paid directly by SIPC and that SIPC then file its own claim as a general creditor based on all of its expenditures in a liquidation proceeding. ^{24/}

C. Miscellaneous Recommendations

1. A trustee should be exempt from the obligation to file any income tax return for periods prior to and subsequent to the filing date.

This recommendation is in accord with the proposed new Bankruptcy Act drafted by the Commission on the Bankruptcy Laws of the United States. SIPC and other creditors would benefit therefrom in that more assets would be available to satisfy their claims and the time and expense of preparing returns (which in some cases has been considerable) would be saved.

2. Section 10(c) of the Act (Criminal Offenses Against SIPC) should be broadened to make it clear that it includes attempts to defraud SIPC or a trustee by the willful filing of a false claim in a liquidation proceeding.

^{24/} See Recommendation II. A. 9., p. 12, and commentary on pp. 20-21.

As criminal statutes are strictly construed and must define precisely the conduct prohibited, Section 10(c) of the Act must be clarified if it is to serve as an effective deterrent to the filing of fraudulent claims by customers and broker-dealers. Any attempt to file a fraudulent claim in a liquidation proceeding should be expressly proscribed by the Act and made subject to criminal penalties.

3. SIPC should explore avenues available to ease problems which trustees have encountered in dealing with transfer agents, including alternatives such as guaranteeing signatures or purchasing an insurance policy.

The Task Force believes that no legislative action is necessary to implement this recommendation because SIPC probably has the power to act in this regard pursuant to Section 3(b)(7) of the Act. Transfer problems have heretofore been a major cause of delay in satisfying customers in liquidation proceedings. It is believed that bulk transfers of customer accounts where feasible will serve to reduce transfer problems, because the services of transfer agents will not be necessary to facilitate bulk transfer of street name securities. Nevertheless, the problem remains one of sufficient importance to warrant appropriate action by SIPC.

4. It is recommended that the following sentence be added to the end of Section 10(b) of the Act:

Provided, however, that any self-regulatory organization may establish qualification standards prohibiting membership therein or association with members of any person who is a controlling person, the owner of ten (10)

percent or more of the voting securities or ten (10) percent or more of the general partnership interest of any broker or dealer for whom a trustee has been appointed pursuant to this Act, or which was the subject of a SIPC liquidation proceeding, whether judicial or administrative, unless it is determined after appropriate notice and opportunity for hearing that it would not be contrary to the public interest or the protection of investors to permit membership or association with a member.

The self-regulatory organizations should have clear-cut authority to take whatever steps, consistent with the requirements of due process, are necessary to prevent the speedy reentry into the securities business of persons in control capacities of firms whose customers have required SIPC protection. The law should be clear on this important subject, since the public interest demands that such persons be barred from assuming positions where they may again subject their customers and the SIPC fund to unwarranted risk.

5. Section 5(a)(2) of the 1970 Act should be amended to read as follows:

Action by Self-Regulatory Organization - If a self-regulatory organization is aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or may be approaching financial difficulty and has notified SIPC of the same pursuant to Section 5(a)(1) and the broker or dealer undertakes to liquidate or reduce its business either pursuant to the direction of the self-regulatory organization or voluntarily, the self-regulatory organization may render such assistance or oversight to the broker or dealer as it deems appropriate to protect the interests of customers of the broker or dealer. The assistance or oversight by the self-regulatory organization shall not be deemed the assumption or adoption by the self-

regulatory organization of any obligation or liability to customers, other creditors, shareholders, or partners, of the broker or dealer or prevent or act as a bar to any action by SIPC pursuant to Section 5(a)(3).

6. Current sections 5(a)(2) and 5(a)(3) of the 1970 Act should be redesignated as Sections 5(a)(3) and 5(a)(4) respectively.
7. Section 9(b) of the 1970 Act should be amended to read as follows:

Immunity - No self-regulatory organization shall have any liability to any person for any action taken or omitted in good faith pursuant to Section 5(a)(1) and (2).

The foregoing recommendations recognize the importance of the work of the self-regulatory organizations in acting to obviate the need for SIPC to protect customers of their members. Prompt action by the self-regulatory organizations, taken with respect to members in financial difficulty before such financial difficulty becomes irreversible or before such members reach the point where they cannot meet obligations to their customers, has on a number of occasions precluded the need for a liquidation proceeding under the 1970 Act. Both customer confidence and the SIPC fund have been benefited by these actions by the self-regulatory organizations. The decision as to whether or not such action is warranted, however, should remain within the sole discretion of the self-regulatory organizations, and they should not be held liable for good faith acts or omissions in this regard.

CONCLUSION

The Task Force believes that the foregoing recommendations will meet the reasonable needs and expectations of the investing public and at the same time result in faster and more efficient liquidations of broker-dealers. The Task Force expects that such improved SIPC protection, coupled with continuing vigilance by the regulatory and self-regulatory bodies will help to maintain investor confidence. The Task Force has attempted to streamline the administration of a liquidation proceeding. Its recommendations should provide both SIPC and court appointed trustees with a more flexible procedure to achieve the investor protection envisioned by the Congress.

In the course of its study, the Task Force has been mindful of the need to maintain the fiscal integrity of the SIPC program. Those recommendations which increase the dollar limits of protection and which diminish SIPC's rights of recovery from assets of the debtor will perforce result in added cost to the SIPC fund. This added cost should be offset, at least in part, by administrative economies likely to result from more flexible liquidating procedures in all cases, and from allowing SIPC to serve as liquidator in small cases. The net additional cost to the SIPC fund cannot be accurately projected. It would seem that any additional cost can be financed by SIPC out of current revenues and that an increase in assessment on members is not indicated at this time. Should the net cost prove greater than anticipated, the Task Force is confident that

adequate funding can be obtained because of the importance of the SIPC program to the industry and to the capital markets of the country.

The Task Force transmits these recommendations and comments to the SIPC Board of Directors and urges the Board to act favorably and with dispatch in forwarding them to the Congress in appropriate form for legislative action.

Respectfully submitted,

Theodore H. Focht
Chairman of the Special Task Force
General Counsel
Securities Investor Protection Corporation
Washington, D. C.

Edward S. Redington, Esquire
Hughes Hubbard & Reed
New York, New York

Robert M. Bishop
Senior Vice President, Regulation
and Surveillance Group
New York Stock Exchange, Inc.
New York, New York

Kenneth I. Rosenblum
Vice President and Counsel
Midwest Stock Exchange
Chicago, Illinois

Benjamin L. Lubin
Managing Partner
Bruns, Nordeman, Rea & Company
New York, New York

James W. Walker, Jr.
Executive Vice President
American Stock Exchange, Inc.
New York, New York

Robert J. Millstone
Special Counsel
Division of Market Regulation
Securities and Exchange Commission
Washington, D. C.

Frank J. Wilson
Senior Vice President, Regulation
National Association of Securities
Dealers, Inc.
Washington, D. C.

SEPARATE STATEMENT OF FRANK J. WILSON

IN OPPOSITION TO

RECOMMENDATION III. B. 1.

The Task Force has recommended at page forty-six of its report that the existing exemption from membership in SIPC contained in Section 3(a) of the 1970 Act be eliminated. I am opposed to that recommendation.

My opposition is primarily based on the view that mutual fund/variable annuity underwriters and dealers, as well as those dealers who sell tax shelters and other securities on a subscription basis, do not present the risk the Act is designed to protect against. In addition to the fact that there is no evidence whatsoever that any such dealer has ever failed under circumstances which resulted in customer loss, the extremely low-risk nature of such limited function broker-dealers is well recognized and codified in various exemptions from SEC Rules, including Rules 15c3-1 (the net capital rule) and 15c3-3 (the customer protection rule) under the Securities Exchange Act of 1934. These types of broker-dealers do not, by definition, place customers' funds or securities at risk in the financing of other areas of business and, to a large degree, would not have funds or securities available to them in any event because a large proportion of their business involves the direct payment by customers to agents for the issuers. Some such broker-dealers handle no customers' funds or securities at all.

It is estimated that the elimination of the current exemption from SIPC membership would require at least 720 broker-dealer members of the National Association of Securities Dealers, Inc., to join SIPC, most of whom would have to bear the not insignificant expense of obtaining a fidelity bond in addition to the payment of other fees attendant to SIPC membership. Without clear and convincing evidence that such is necessary (and in my opinion none has been presented), the impact of the elimination of the exemptions from SIPC membership is unfair and the recommendation is unwarranted. While some of the broker-dealers who would be affected by the recommendation are large, well capitalized insurance companies, the large majority of them are small mutual fund retailers; thus, the recommendation would appear to be contrary to the intent of Senate Resolution 173 regarding the continued participation of small broker-dealers in the securities markets without unnecessary administrative burdens.

APPENDIXIllustration of Proposed Method of Allocating Assets to Customers

(Under present limits of SIPC customer protection; i.e.
\$50,000 per customer of which not more than \$20,000
may be advanced to satisfy a claim for cash, as distinct
from a claim for securities.)

ASSUMPTIONS:

A.	Aggregate customer debits	\$ 1,000,000	
	Aggregate customer credits		\$ 200,000
	Fail to deliver not offset by proprietary position at con- tract price	100,000	
	Fail to receive not offset by proprietary position at con- tract price		200,000
	Proceeds from bank loan collateralized by other than proprietary securities		800,000
		<u>1,100,000</u>	<u>1,200,000</u>
			<u>1,100,000</u>
	Required Reserve Balance		<u>\$ 100,000</u>
	Actual Reserve Balance		<u>\$ 50,000</u>

B. Individual customer account positions:

Customer	Money Balance	Security	Shares	Filing Date Price	Value
1	\$ 550,000 Dr.	ABC	40,000	\$ 5	\$ 200,000
		XYZ	80,000	10	800,000
2	50,000 Dr.	XYZ	9,000	10	90,000
3	400,000 Dr.	ABC	20,000	5	100,000
		XYZ	81,000	10	810,000
4	75,000 Cr.	XYZ	10,000	10	100,000
5	20,000 Cr.	XYZ	3,000	10	500,000
6	105,000 Cr.	XYZ	50,000	10	30,000
7	0	XYZ	37,000	10	370,000
	\$1,000,000 Debits				<u>\$3,000,000</u>
	<u>200,000 Credits (all free credits)</u>				

C. Location of securities:

Security		
ABC	In possession or control	22,000 shares
	Stock record difference	38,000 shares
		<u>60,000 shares</u>

XYZ	In possession or control	140,000 shares
	In fail to receive	20,000 shares
	In bank loan (loan amount \$800,000)	<u>110,000 shares</u>
		<u>270,000</u>

GHI	In box (only long position is fail to deliver), filing date price \$9.00	<u>10,000 shares</u>
-----	--	----------------------

PROCEDURE: (Steps which follow correspond to allocation steps 1-8 in commentary on Recommendation II on pp. 22-24.

Step 1. Allocate cash to customers with free credit claims:

Customer	Free Credits	Allocation	Remaining Claims for Free Credits
4	\$ 75,000	\$ 18,750	\$ 56,250
5	20,000	5,000	15,000
6	<u>105,000</u>	<u>26,250</u>	<u>78,750</u>
	<u>\$ 200,000</u>	<u>\$ 50,000</u>	<u>\$ 150,000</u>

Step 2. Allocate possession or control stock by issue:

Security	Customer	Shares Owned	Allocation	Remaining Shares	Value
ABC	1	40,000	14,677	25,333	126,665
ABC	3	<u>20,000</u>	<u>7,333</u>	<u>12,667</u>	<u>63,335</u>
		<u>60,000</u>	<u>22,000</u>	<u>38,000</u>	<u>190,000</u>
XYZ	1	80,000	41,482	38,518	385,180
	2	9,000	4,667	4,333	43,330
	3	81,000	42,000	39,000	390,000
	4	10,000	5,185	4,815	48,150
	5	3,000	1,555	1,445	14,450
	6	50,000	25,926	24,074	240,740
	7	<u>37,000</u>	<u>19,185</u>	<u>17,815</u>	<u>178,150</u>
		<u>270,000</u>	<u>140,000</u>	<u>130,000</u>	<u>1,300,000</u>
Aggregate Value of Remaining Securities Claims					<u>\$1,490,000</u>

3. Remaining unsatisfied claims for cash and or securities:

<u>Customer</u>	<u>Securities Value</u>	<u>Cash</u>	<u>Total</u>
1	\$ 511,845	-	\$ 511,845
2	43,330	-	43,330
3	453,335	-	453,335
4	48,150	\$ 56,250	104,400
5	14,450	15,000	29,450
6	240,740	78,750	319,490
7	178,150		178,150
	<u>\$1,490,000</u>	<u>\$150,000</u>	<u>\$1,640,000</u>

Step 4. Expenditure required to satisfy claims in 3 above

<u>Claim</u>	<u>Expenditure</u>	<u>Value of</u>
	<u>Type</u>	<u>Assets Acquired</u>
Cash	-	\$ 150,000
ABC Securities	Open market purchases	190,000
XYZ Securities	Open market purchases	200,000
	Redeem sec. in bank loan	800,000
		<u>1,100,000</u>
		1,340,000
		<u>1,640,000</u>

Step 5. Determine Amount of resources available before consideration of SIPC advances:

<u>Resource</u>	<u>Amount</u>
Customers' debits	\$1,000,000
GHI stock in box which can be sold by trustee since related fail to deliver will not be completed, at filing date value	90,000
	<u>\$1,090,000</u>

Step 6. Not applicable as there is a net shortfall of \$250,000
(\$1,340,000 - \$1,090,000)

Step 7. Allocate shortfall to customers based on remaining unsatisfied claims in 3 above

<u>Customer</u>	<u>Remaining Claim</u>	<u>Allocated Shortfall</u>	<u>SIPC Advance</u>	<u>Final net Shortfall</u>
1	\$ 511,845	\$ 78,025	\$ 50,000	\$ 28,025
2	43,330	6,605	6,605	-
3	453,335	69,106	50,000	19,106
4	104,400	15,915	15,915	-
5	29,450	4,489	4,489	-
6	319,490	48,703	48,703	-
7	178,150	27,157	27,157	-
	<u>\$1,640,000</u>	<u>\$ 250,000</u>	<u>\$ 202,869</u>	<u>\$ 47,131</u>

Step 8. Conclusion:

Customers #2,4,5,6, and 7 would have accounts returned or transferred as they stood on the filing date.

Customers #1 and 3 would not receive shares of securities which had a filing date value of \$28,025 and \$19,106 respectively.

Comment:

Actual SIPC expenditure may exceed or be less than the \$202,869 noted above as it may require more or less than the \$390,000 noted in Step 4 as being expenditure necessary to purchase 38,000 and 20,000 shares of ABC and XYZ, respectively. Moreover, the actual realized value of the 10,000 shares of GHI may similarly differ from the filing date value of \$90,000 shown in Step 5.

August, 1977

SECTION BY SECTION EXPLANATION OF H.R. 8331
AMENDMENTS TO SECURITIES INVESTOR PROTECTION ACT

The following is a section by section analysis of H.R. 8331, proposed amendments of the Securities Investor Protection Act of 1970 ("SIPA"). The italicized captions at the left hand margin refer to sections of the Bill. The explanation which follows each caption discusses the relevant sections of SIPA as amended by the Bill. Where appropriate, reference is made to the Report of the Special Task Force dated July 31, 1974 ("TFR").

Section 1

Self-explanatory.

Section 2

§3(a)(2) of the Act--All existing exemptions from SIPC membership for persons in the securities business are eliminated to cure inequities in the existing membership scheme and to reflect the philosophy that those who earn their livelihood from the securities market should contribute to the building of the SIPC fund. (See TFR p. 46) Particularly anomalous is the fact that SIPC is presently required to satisfy customer claims based on transactions in mutual funds while deriving no assessments from such transactions. Persons whose principal business is conducted outside the United States are excluded from SIPC membership, except upon such terms as SIPC shall require by rule, thus solving the existing problem of obtaining jurisdiction to liquidate such persons under SIPA. Accordingly, subsection 11(b) of the present SIPA is deleted (see section 14(c) of H.R. 8331).

Existing §3(f) is deleted. The need for a provision allowing voluntary SIPC membership, other than for foreign broker/dealers, is obviated by the proposed amendment to subsection 3(a)(2) which, by eliminating former membership exemptions, extends the mandatory membership requirement to all brokers and dealers registered under the 1934 Act except for certain foreign organizations.

Section 3

This section makes certain minor technical and clarifying changes, in addition to the substantive changes discussed below.

§3(b)(3) of the Act--A specific reference to SIPC's power to indemnify its directors, officers, and employees for acts done within the scope of their employment is added to present subsection (b)(3) concerning SIPC Bylaws. In view of the many new situations in which SIPC officials and employees will be called upon to exercise discretion, and particularly in view of the possibility of a SIPC employee serving as trustee, it was thought desirable to grant protection against whatever increase in exposure to suit may result from these new responsibilities.

§3(b)(4) of the Act--This new subsection permits SIPC to adopt substantive rules including rules defining terms used in SIPA and rules relating to liquidation proceedings and direct payment procedures.

Section 4

§3(c)(2)(C)(ii) of the Act--This amendment makes a technical change to conform to changes in the 1934 Act.

§3(c)(5) of the Act--Reference to the determination of dollar volume of trading on exchanges is deleted. Its inclusion in the present SIPA is the result of an unintended carry-over from earlier SIPA bills which used the concept.

Section 5

§3(e) of the Act--Provisions regarding initial bylaws are deleted. In addition, procedures are established for the adoption, amendment and repeal of bylaws and rules. Bylaws generally remain subject to the procedure described in the present Act, unless the Commission finds that a matter relating to a bylaw is of such significant public interest that it should be handled according to the procedures used for rules. With respect to rules, new procedures are adopted which are appropriate to legislative, rather than interpretative, rules, since it is intended that SIPC's rules will have the force and effect of law. Power to develop rules which will clearly control the myriad problems and disputes which arise in the course of liquidations will substantially aid in the administration of the statute.

Section 6

This section makes various technical and clarifying changes in addition to the substantive changes discussed below.

§4(a)(2)(C) of the Act--This amendment provides that confirmed lines of credit maintained by SIPC pursuant to subsection 4(a)(4) are not to be included in calculating the balance of the fund. (See TFR p. 48)

Existing §4(c)(3)(C) is deleted. The effect of the deletion of this subsection and the corresponding amendment of subsection 4(i) is that SIPC assessments will be based on all aspects of members' activities in the securities business including, for example, transactions in mutual funds and variable annuities. Present exemptions for certain activities are eliminated because many of these activities have in fact led to customers' claims. A parallel amendment to subsection 3(a)(2) eliminates current exemptions for SIPC membership. (See TFR p. 46) The deletion of the reference to revenues from the business of insurance is not intended to change the liability of any person for SIPC assessments. Rather, it is a recognition that the only revenues upon which SIPC assessments may be based are revenues from the securities business.

§4(d)(1)(C) of the Act--This new provision imposes a minimum assessment of \$25 per year through 1979, with the minimum assessment thereafter to be set by SIPC, but not to exceed \$150 per year. The purpose is to insure that a member's assessment covers the resulting administrative cost incurred by SIPC. (See TFR p. 48)

§4(a)(4) of the Act--The amendment clarifies SIPC's authority to maintain confirmed lines of credit separate from the fund (see §4(a)(2)(C) above), thereby diminishing the possibility that SIPC will be forced to borrow from the United States Treasury. (See TFR p. 48)

§4(e)(3) of the Act--By this provision SIPC is empowered to levy a penalty for late payment of assessments in addition to the interest charges currently permitted by the Act. (See TFR p. 49)

Section 7

§5(a)(2) of the Act--This section would clarify the authority of self-regulatory organizations to assist in or take such action with respect to a member in financial difficulty as may be appropriate to protect customers of the member. Timely action by a self-regulatory organization under this subparagraph may obviate the need for a SIPC liquidation. (See TFR p. 55)

§5(a)(3) of the Act--As under the present Act, the subsection entitled "Action by SIPC" empowers SIPC, on the basis of certain factual determinations, to apply for a court decree which sets in motion the customer protection and liquidation procedures. Amendments to this subsection would codify existing rules whereby only persons who are or have been members within the past 180 days are potential subjects of SIPC action [see 17 C.F.R. §§240.15b5-1; 240.15b6-1] and would make it clear that SIPC has no obligation to act where no customer interests of the kind protected by SIPC are involved. (See TFR p. 44) For convenience of reference, the decree for which SIPC is empowered to apply under this paragraph is termed a "protective decree," and is defined in §16(13) of the Act (see §15 of the Bill).

§5(b)(1) of the Act--A new subsection, consolidating present subsections (A) and (B), is intended to eliminate whatever ambiguity may have existed concerning the action to be taken by a court when presented with a SIPC application. The substance of existing subsection (B) is unchanged except that an application to which the debtor gives its consent will be granted without delay.

§5(b)(2) of the Act--This subsection, relating to the jurisdiction of a court, does not make significant substantive changes from SIPA as now in effect.

This and subsequent sections, however, reflect the approach taken to the conceptual and drafting problems involved defining the precise relationship between SIPA and the Bankruptcy Act. The aim of these revisions is to make a liquidation proceeding subject to the provisions in the Bankruptcy Act relating to ordinary bankruptcy, except for those provisions relating exclusively to stockbrokerage liquidations. Incorporation of chapter X (relating to reorganizations) is eliminated, since many of its provisions are inappropriate in the context of a liquidation. Those chapter X provisions considered particularly desirable in a liquidation proceeding have been selectively incorporated. Complicating the task of drafting language to carry out these intentions is the expectation that the Bankruptcy Act may be amended and renumbered in the near future. (See TFR p. 34)

Accordingly, the "Bankruptcy Act" is defined in subsection 16(1) to mean the statute and rules relating to ordinary bankruptcy. Chapters I-VII are mentioned only parenthetically with a view to the possibility that the comparable provisions of an amended Bankruptcy Act will be differently designated.

Added here, as well, are jurisdictional provisions which reflect case law developed under chapter X. Although the proposed amendment retains the language of the present Act (which was drawn from chapter X), it is thought prudent to include also the precedents developed under that section, lest a court be tempted to interpret the language differently now that it is divorced from chapter X of the Bankruptcy Act. Accordingly, it is provided in §5(b)(2)(A)(i) that the court may issue orders protecting property in the

actual or constructive possession of the debtor located outside the territorial limits of the court. See, e.g., Continental Illinois National Bank & Trust Co. v. Chicago Rock Island & Pacific Ry., 294 U.S. 648 (1935). This protection is not available in ordinary bankruptcy. §5(b)(2)(A)(i) also incorporates the rule that a chapter X court has jurisdiction over property in the possession of a secured creditor who does not challenge the debtor's title but maintains a right to retain the property as security or subject to a lien. See, e.g., 6 Collier on Bankruptcy ¶ 3.05 (14th ed. 1976); Continental Illinois National Bank & Trust Co., *supra*; In re Prudence Bonds, 77 F.2d 328 (2d Cir. 1935).

§5(b)(2)(B) of the Act--This subsection incorporates the provisions of §§113, 116(4) and 148 of chapter X relating to stays.

§5(b)(3) of the Act--Three objectives are accomplished by amendments to this subsection. First, because of the numerous times courts have questioned the authority of SIPC to designate the trustee and his counsel, the existing provision that such designations are within the discretion of SIPC is sharpened. Second, it is made clear that the trustee and his counsel may be with the same firm. Finally, it is provided that SIPC has discretion to designate itself or one of its employees as trustee in certain cases, thus achieving, in the appropriate case, a substantial saving in expenses of administration. (See TFR p. 29)

§5(b)(4) of the Act--This provision clarifies the existing practice of referring any or all aspects of a liquidation proceeding to a referee in bankruptcy. See, e.g., Exchange National Bank v. Wyatt, 517 F.2d 453 (2d Cir. 1975). In many cases such a reference has speeded liquidation proceedings.

§5(b)(5) of the Act--Compensation of trustees and their attorneys is to be based on services rendered and costs incurred, the basis used in SIPC liquidations to date, rather than on the amount of assets marshalled. While both measures of compensation have support in the Bankruptcy Act, the primary purpose of the SIPC liquidation is to return property to customers of the debtor, regardless of whether that property comes from the debtor, from SIPC advances or from other sources. This subsection expressly provides for interim compensation. The subsection also requires SIPC to file a recommendation with respect to compensation, which recommendation is binding in "no-asset" cases unless the amount of compensation is disputed by the applicant. Cf. SIPC v. Charisma Securities Corp., 506 F.2d 1191 (2d Cir. 1974). In other cases, the recommendations of SIPC are to be given great weight.

§5(b)(6) of the Act--Incorporated here are the requirements of disinterestedness which now appear in SIPA only by reference to chapter X of the Bankruptcy Act. Since chapter X is not generally incorporated, it is now necessary to make express the provisions of §§157, 158 and 161 of chapter X. SIPC, however, is deemed disinterested in all cases, even though by subrogation or otherwise it may have a claim on the debtor's estate and even though the debtor may owe assessments as a member of SIPC. An employee of SIPC is considered disinterested unless his interest arises from a source other than his association with SIPC. The notice provisions for a hearing on disinterestedness conform with other notice provisions in these amendments.

§5(d) of the Act--This section is designed to make clear that SIPC, as the agency charged with the administration of SIPA, as advisor to the court, as

the party initiating a liquidation proceeding, and as the party which, to a large extent, funds a liquidation proceeding, is entitled to participate fully in all matters arising in a liquidation proceeding. In at least one case a party asserting a right to reclaim property in the possession of the trustee objected to SIPC's participation. This section confirms SIPC's right to participate, whether a particular matter is deemed part of a proceeding in bankruptcy or a controversy arising in a proceeding in bankruptcy. The language is drawn from section 208 of chapter X. See, SEC v. Krentzman, 397 F.2d 55 (5th Cir. 1968).

Section 8

§6(a)(1)(A) and (B) of the Act--Language changes here are consistent with the substantive changes to the concepts of "specifically identifiable property" (now termed "customer name securities" in subsection 16(4) below) and "single and separate fund" (now termed "customer property" in subsection 16(5) below).

§6(a)(2) of the Act--Present subsection 6(a)(2) is deleted pursuant to the decision of the Task Force that open contractual commitments of the debtor should not ordinarily be completed. (See TFR p. 31 and subsection 8(e) of the Act discussed below) An added purpose of a liquidation proceeding is to sell or transfer productive units of the debtor. (See TFR p. 26)

§6(b) of the Act--The paragraph entitled "Application of the Bankruptcy Act" in SIPA as now in effect is changed with a view toward making a liquidation proceeding, except as to those aspects (principally relating to the satisfaction of customer claims) which are unique to stockbrokerage liquidations, subject to the Bankruptcy Act provisions relating to liquidations under ordinary bank-

ruptcy. (See subsection 5(b)(2) of the Act discussed above and subsequent discussion). Accordingly, a liquidation proceeding is to be conducted in accordance with, and as though it were being conducted under, specified provisions of the Bankruptcy Act. As is made clear in §16(1) of the Act, a simple reference to the Bankruptcy Act has the effect of incorporating the currently effective provisions relating to ordinary bankruptcy. Reference to chapter X is deleted as inappropriate, since the aim of a SIPA proceeding is the liquidation, not reorganization, of a member.

Existing §6(c)(2)(A)(1), defining the term "property", is deleted.

Since treatment of cash and securities is not always the same, it is considered preferable to indicate in the substantive provisions themselves whether they apply to cash or securities or both. "Property," therefore, is no longer a useful term. The reference to "property of a similar character" has caused confusion, and has been deleted in favor of an inclusive definition of the term "security" in subsection 16(14) of the Act.

§6(c) of the Act--This amendment reflects the view that a customer who has entered into transactions in good faith after the filing date should not be barred from certain protections. (See TFR pp. 10 and 42) SIPC advances for the protection of such late transactions, however, are subject to the discretion of SIPC under subsection 9(a)(4) of the Act.

§6(e) of the Act--It is made clear in this subsection that certain advances by SIPC will be deemed to be costs and expenses of administration, and will be recouped as such. Other claims against the general estate have the same priority they would have under the Bankruptcy Act.

Section 9

§7(a) of the Act--Pursuant to the decision to delete the general incorporation of chapter X of the Bankruptcy Act (see §5(b)(2) of the Act above and accompanying discussion), the powers with which the trustee is vested by this section are described simply as those of a trustee under the Bankruptcy Act, together with those powers specifically granted in subsections (1), (2) and (3), which may be exercised only with SIPC approval.

§7(a)(1) of the Act--The powers granted here are the same as those granted by §6(b)(1)(A) of the existing Act.

§7(a)(2) of the Act--The trustee is specifically authorized to use SIPC employees in connection with a liquidation proceeding, thus making their experience in handling such proceedings available directly to the trustee. It is anticipated that this will increase both the speed and efficiency of liquidation proceedings.

§7(a)(3) of the Act--The trustee is authorized to maintain customer accounts to facilitate their transfer under subsection 8(f) of the Act. As in the amendment to subsection 6(a) above, reference to completion of open contractual commitments is deleted.

§7(b) of the Act--As elsewhere, incorporation of a particular section of the Bankruptcy Act has been deleted in favor of a general reference which will not be disturbed by amendment and renumbering. In addition to the duties incumbent on a bankruptcy trustee, the SIPA trustee is charged with the following duties: to deliver securities to customers to the maximum extent possible, and, under appropriate circumstances, to guarantee the debtor's indebtedness

to a bank to obtain the securities pledged as collateral therefor. (See TFR pp. 9 and 10)

§7(c) of the Act--This subsection, expanded from current section 6(i), is intended to incorporate the reporting requirements of Bankruptcy Rule 218 and adds certain requirements peculiar to a SIPA liquidation.

§7(d) of the Act--This new subsection is based on Bankruptcy Act §167 from chapter X, which is somewhat broader in scope than the comparable provision relating to ordinary bankruptcy. It may be particularly useful in investigating the causes of a stockbrokerage liquidation with a view to marshalling assets for the estate.

§8(a)(1) of the Act--Here again, specific incorporation of the Bankruptcy Act is deleted (see discussion in connection with §5(b)(2) above). To eliminate any ambiguity in the use of the term "customer", the trustee's duty to give notice is made applicable only to those customers who appear to have had an open account with the debtor within the 12 months preceding the filing date. Notice to creditors is the same as under the Bankruptcy Act, except that it is given by the trustee rather than by the court.

§§8(a)(2) and (3) of the Act--The limitations of time in SIPA as now in effect are altered to fit the contours of the new distribution scheme. It is provided that claims for customer property must be filed promptly, reflecting the trustee's need for certainty in regard to allocation of customer property at an early date. SIPA protection, however, may be extended to claims filed within six months. Important in this connection is the provision that the trustee may

satisfy claims filed between 60 days and 6 months after the date of publication of notice in the most economical way. This is necessary to protect SIPC against market risk arising from customers' withholding their claims for the purpose of speculation. It was considered appropriate in the subsection concerning notice and claims to include the provisions of present §§6(g) and (h) relating to the appropriate form of response by customers to the notice. Accordingly, the provisions allowing informal claims by customers except customers associated with the debtor are included here. It is made clear, however, that this does not dispense with the need to file a written claim. (See TFR p. 43)

The claims of creditors other than customers are governed by a provision that tracks the current Bankruptcy Act, except that the time period runs from the date of publication rather than from the first date set for the first meeting of creditors. This is to anticipate the possibility that first meetings may be eliminated when the Bankruptcy Act is revised. To eliminate ambiguity, it is stated that claims must actually be received by the trustee within the six-month period. As under the present statute, neither customer nor other creditor claims may be allowed if received after that period.

§8(a)(4) of the Act--The substance of existing subsection 6(j) is preserved in this subsection.

§8(b) of the Act--The subsection entitled "Payments to Customers" is retained without major change even though the manner in which the trustee effects "payment" will, in most instances, be substantially different. The trustee's power to satisfy claims in either cash or securities must be preserved, however, to enable him to deal properly with the situation in which there is not a "fair and orderly market" available within the meaning of §8(d) and the situation in which a customer makes a late claim that is nevertheless entitled to protection under §8(a). In addition, it is made clear that securities are valued as of the filing date for the purpose of determining what securities a customer is entitled to receive.

§8(c) (1) of the Act--This, the operative provision with respect to customer property, provides that each customer will be allocated a ratable share of customer property based upon his net equity. This allocation is fundamental to the process of determining the extent to which SIPC protection will be available to a customer, because SIPC advances are applied to the difference between a customer's ratable share of customer property and his net equity claim. Customer property remaining after the satisfaction of SIPC claims based on certain advances and all customer claims against it becomes part of the general estate. Any excess of a customer's net equity over his allocated share of customer property plus the protection available from SIPC is a claim against the general estate.

§8(c) (2) of the Act--The trustee is required by this subsection to return customer name securities to the customers in whose names they are registered or to deliver them on such customer's behalf.

§8(c)(3) of the Act--The substance of existing subsection 6(c)(2)(D) is preserved in this subsection which describes those transactions in customer property deemed to be voidable under SIPA. In addition to transactions void or voidable under the Bankruptcy Act, this subsection reaches transactions which have the effect of granting preferential treatment to individual customers.

§8(d) of the Act--This subsection, carrying out one of the central recommendations of the Task Force, authorizes the trustee to purchase securities for the purpose of restoring customers, as far as possible, to their positions as of the filing date (see TFR p. 9). To the extent he can do so in a fair and orderly market, the trustee would be expected to purchase securities to cover the deficiency remaining in a customer's account after allocating to such customer his share of customer property as provided in subsection 8(c)(1) of the Act. This would carry out a key objective of the Task Force which is the satisfaction of a customer's claim for securities by the delivery of securities wherever that is possible. The only time it is envisioned that a trustee would not deliver securities to satisfy a claim for securities would be in those situations where the market for the securities is so thin or so closely controlled by insiders that it would seem inappropriate and unwise for the trustee to be required to purchase securities for the satisfaction of claims. The trustee may use SIPC funds to purchase securities to replace that part of a customer's deficiency in securities whose value on the filing date did not exceed the limits of SIPC protection provided in subsection 9(a) of the Act.

§8(e) of the Act--The decision of the Task Force, the present policy of SIPC as expressed in the Commission's rule S6d-1, and the prevailing practice of trustees with respect to contracts of the debtor open on the filing date, are all reflected in this paragraph. In most instances, such contracts will be closed out. That is, the other contracting broker or dealer will complete the contract in the best available market, and account to the trustee for his profits or file a claim for his losses. If the closing-out broker or dealer was acting for a customer (as defined in subsection 8(e)(4) of the Act) with respect to contracts, he will be entitled to SIPC protection up to \$40,000 for losses sustained for that customer. Where the closing-out broker or dealer was not acting for a customer, any loss he suffers will be a claim against the general estate, not payable from SIPC advances. (See TFR p. 31)

§8(e)(3) of the Act--The provisions of §8(e) will not apply to a clearing corporation which has its own rules on close outs for its members. Losses by clearing corporations are claims against the general estate only, and not payable from SIPC advances. (See TFR p. 31)

§8(f) of the Act--This important new subsection gives the trustee the right to transfer in whole or in part the account of a customer. In view of the benefits to customers and the saving to SIPC that may result in an appropriate case, SIPC funds may be used to facilitate such transfer of accounts. (See TFR p. 11)

§9(a) of the Act--The provisions of SIPA as now in effect setting limits to SIPC advances are affected in three important respects, relating both to the dollar limits of advances and the manner in which they are applied to claims. First, the dollar figure for securities claims is raised to \$100,000. Second, it is made clear that the limits are applied, not to the net value of a customer's account, but to the shortage remaining after the allocation of customer property, thus making the benefit of SIPC advances cumulative with whatever bankruptcy-type remedy the customer may have had. Finally, it is provided that the dollar limits do not apply, strictly speaking, to the SIPC advance itself, but, rather, to the filing date value of the securities in respect of which the advance is made.

§9(a) (4) of the Act--To guard against abuse of the provision giving protection to trades made in good faith after the filing date (subsection 6(c) of the Act), SIPC is given discretion not to advance money with respect to such trades.

§9(a) (5) of the Act--It is made clear in this subsection that persons with power of control over the debtor will not be protected by SIPC advances under any circumstances. (See TFR p. 42)

§9(a) (6) of the Act--Consistent with current practice the provision making brokers, dealers or banks ineligible to receive SIPC advances unless acting for a customer have been clarified by stating that a broker, dealer or bank is not considered to be acting for a customer where the customer is itself a broker, dealer or bank, or a person associated with the debtor.

§9(b) of the Act--Advances for customer-related losses on closed out contracts and expenses of administration where the debtor's estate is not sufficient to pay them are made mandatory.

§9(c) of the Act--This new subsection is added to permit SIPC to make discretionary advances to aid in reclaiming pledged securities under §7(b)(2), in transferring accounts under §8(f) and in purchasing securities under §8(d).

§10 of the Act--Administrative expenses incurred in small liquidations to date have been disproportionately large, both in relation to the size of the estates liquidated and the number of customers satisfied. The Task Force recommended, therefore that SIPC should have the authority to make payments directly to customers without judicial proceedings in appropriate circumstances. (See TFR p. 27) This new section is designed to permit such payments. It is important to note, however, that the direct payment procedures set forth in this section would only be used where the member's registration as a broker/dealer has been terminated or where the member planned to terminate its business and consented to the use of the direct payment procedure.

§10(a) of the Act--Guidelines are provided for the determination by SIPC that direct payment is appropriate. For SIPC to initiate direct payments in preference to a liquidation proceeding, it must appear to SIPC that (i) all customer claims are within the §9(a) limits, (ii) the sum of customer claims is less than \$250,000, and (iii) direct payments will result

in a saving to the SIPC fund. SIPC must bring its discretion and experience to bear on this determination, and the decision to proceed by direct payment is not a purely mechanical one based on the existence of the enumerated conditions.

§10(b) of the Act--SIPC is to give notice by publication and mailing to the customers of the debtor as they appear from the member's books and records. Claims must be received within six months in order to be paid.

§10(c) of the Act--Payments are to be made and securities are to be delivered by SIPC in a manner similar to that in which the trustee is obligated to make payments and deliver securities in a liquidation proceeding.

§10(d) of the Act--Direct payment proceedings by SIPC are not to prejudice any right to pursue any other remedy a person may have had against the member.

§10(e) of the Act--The district court where the head office of the member is located is to have original jurisdiction of controversies relating to a person's right to direct payment. This preserves the right of a claimant to have his disputed claim adjudicated.

§10(f) of the Act--This subsection provides a safety valve in case changed circumstances make direct payments inappropriate or SIPC discovers that the situation is not what it appeared to be at the time of the determination under subsection (a). Prior payments or denials of a claim are nonetheless binding in subsequent proceedings.

Section 10

§11(a) of the Act--This section of the Act is section 7 of the existing Act. The Commission's rule-making power refers to subsection 3(e)(4) and to amended section 10(f). Conforming changes only are made in this subsection.

Section 11

§12 of the Act--Certain changes are made to conform to changes in section 13(a) of the Act.

Section 12

§13(a) of the Act--Where it would be more efficient to do so, SIPC is given the flexibility to designate a self-regulatory organization other than the examining authority to collect assessments from a SIPC member who is a member of more than one self-regulatory organization. (See TFR p. 49)

§13(b) of the Act--The immunity granted by this section is extended to cover self-regulatory organizations which act to assist their members in accordance with new section 5(a)(2). If self-regulatory organizations are to be encouraged to take prompt action to assist members in financial difficulty, they should not be held liable for good faith acts or omissions in connection with such action. (See TFR p. 56)

§13(c) of the Act--The existing provision with respect to the designation of the examining authority for brokers and dealers who are members of more than one self-regulatory organization is changed to provide that

designation shall be made by the Commission rather than by SIPC and that the Commission may designate itself as responsible for the examination. In addition, if the self-regulatory organization of which a member of SIPC is a member or participant is a registered clearing agent, the Commission is given authority to designate itself as responsible for the examination of such member. (See TFR p. 49)

§13(f) of the Act--This section is amended to delete from section 9(f) of the existing Act certain powers of the Commission which are now granted to the Commission under the Securities Exchange Act of 1934.

Section 13

§14(a) of the Act--To conform to the amendment in subsection 4(e)(3), this subsection will refer to penalties as well as to other payments and interest.

§14(c) of the Act--Any attempt to defraud SIPC or a SIPC trustee by any means, and any act which, if taken in relation to a proceeding under the Bankruptcy Act, would be criminal, is made a criminal offense. (See TFR p. 53) The language of this section is drawn from 18 U.S.C. §152.

Section 14

§15(d) of the Act--Officers and employees are to be included in that class of persons not liable for action taken or omitted in good faith. The probability of SIPC employees acting as trustees in liquidation proceedings is a major, but not the only, reason for this inclusion.

§15(e) of the Act--This is to clarify SIPC's power to require notice of SIPC membership at members' places of business and in their advertisements.

§15(b) of the Act--Existing subsection 11(b) of the Act regarding foreign members is deleted because the substance of the subsection is made a qualification to the description of a member of SIPC in subsection 3(a)(2).

Section 15

§16 of the Act--This section collects various definitions which were scattered throughout the existing Act.

§16(1) of the Act--See discussion under §5(b)(2) of the Act.

§16(2) of the Act--Self explanatory.

§16(3) of the Act--The definition of "customer" should include only a person who enjoys the type of fiduciary relationship with the debtor that characterizes customers in general. Recent decisional law is codified in the definition to provide that only securities received "in the ordinary course of [the debtor's] business as a broker or dealer" may form the basis of a customer claim. See, e.g., SIPC v. Executive Securities Corp., [current] Fed. Sec. L. Rep. (CCH) ¶96,062 (2d Cir. 1977); SEC v. F.O. Baroff Co., 497 F. 2d 280 (2d Cir. 1974). Also, the Task Force agreed that customer status should not be extended to lenders of securities to the debtor where such lenders have received either collateral or consideration for their loans. Lenders of securities in such circumstances can reasonably

be expected to bear the risk of the failure of the debtor's business. (See TFR p. 38; SIPC v. Executive Securities Corp., supra) Accordingly, some language from the current definition was dropped since it has been used by some lenders in an attempt to gain for themselves the preferred position of customers. The deletion of the language is not intended to change the rights of cash or margin customers who lend securities from their trading accounts to their broker (without taking back collateral or receiving additional consideration). It is further provided that contributors to capital cannot become customers by avoiding the contracts pursuant to which they have contributed capital, e.g., on the grounds of fraud. Whatever their rights may be, it is not appropriate to treat such persons as customers. This is in line with recent decisional law. See In re Weis Securities, Inc., 425 F. Supp. 212 (S.D.N.Y. 1977).

Existing section 6(c)(2)(A)(iii), defining "cash customer", is deleted. That concept, closely related to the concept of "specifically identifiable property," is no longer useful. (See §§6(a)(1)(A) and (B) above) Further, the Task Force indicated that the distinction made by SIPA as now in effect between margin and cash customers is not in keeping with the goal of returning securities wherever practicable, or with the justifiable expectation of margin customers and others that they will be entitled to their accounts upon payment of debit balances. (See TFR pp. 10 and 11)

§16(4) of the Act--"Customer name securities" takes the place of "specifically identifiable property" as the category of securities which will

be returned to individual customers outside the normal procedure for allocating and distributing customer property. Securities registered in the names of customers or in the process of being so registered on the filing date will be treated, in short, as though they are not part of the debtor's estate, but merely held by the debtor as bailee. Excluded from this definition are securities in negotiable form, for example, securities registered in customer name but for which the customer has signed stock powers.

§16(5) of the Act--This section defines "customer property," the concept which takes the place of the "single and separate fund" of SIPA as now in effect. Customer property, briefly explained, consists of all cash and securities (other than SIPC advances and customer name securities) available to the trustee for the satisfaction of customer claims. It includes all cash and securities held from or for the accounts of customers, including the proceeds of any such property transferred or unlawfully converted. Also included is property generated from the use of debit items in customers' accounts and property of the debtor which, upon compliance with applicable laws, rules and regulations would have been set aside or held for the benefit of customers.

§16(6) of the Act--The definition of "debtor" is changed to make it conform to amended subsection 5(a)(3).

§16(7) of the Act--The definition of "examining authority" is changed to make it conform to amended section 13.

§16(8) of the Act--The definition of "filing date" is changed to make it conform to amended subsection 5(a)(3) and new section 10 of the Act.

§16(9) of the Act--Changes in the definition of "gross revenues" are necessitated by the amendments to existing subsections 3(a)(2) and 4(c)(3) discussed above, which eliminate the current exclusions from membership and assessable revenues. The change in existing subsection (K) (new subsection (L)) is designed to be a "catch all" category allowing SIPC by bylaw to pick up any revenues from the securities business not covered in the earlier subsections.

§16(10) of the Act--Self explanatory.

§16(11) of the Act--Changes to the definition of "net equity" reflect the views that margin and cash customers should be treated on an equal basis and that customers who have entered into transactions in good faith after the filing date should not be barred from certain protections. (See TFR pp. 10 and 42) SIPC advances for the protection of such late transactions, however, are subject to the discretion of SIPC under subsection 9(a)(4) of the Act. Amendments to this subsection are also made necessary by the modification of the concept of "specifically identifiable property" and by the new provisions covering close outs of open contractual commitments.

§§16(12) and (13) of the Act--Self explanatory.

§16(14) of the Act--The new definition of "security" is essentially patterned after the definition in the Securities Exchange Act of 1934. However, in recognition of the fact that the definition in the 1934 Act is for the purpose of enforcement and regulation and that the purposes of SIPA are different, certain alterations in the definition are made. Certificates of deposit and short term instruments are included in the definition of securities for SIPC purposes; investment contracts, profit sharing plans, and oil and gas leases are excluded unless registered with the Commission under the provisions of the Securities Act of 1933 or unless SIPC by rule determines that their inclusion in the definition of "security" is within the purposes or policies of SIPA. Commodity contracts and options relating thereto are also excluded.

§16(15) of the Act--Self explanatory. .

Section 16

This section of the Bill amends section 3(a) of the Securities Exchange Act of 1934 by adding thereto a definition of the term "financial responsibility rules". That definition will then be applicable to SIPA by reason of section 2 of the Act, which makes applicable to SIPA those provisions of the 1934 Act which are not in conflict with SIPA.

Section 17

SIPA's table of contents is amended to conform to the changes made by the Bill.

Namy

SECURITIES INVESTOR PROTECTION CORPORATION
FARRAGUT BUILDING
900 SEVENTEENTH STREET, N.W.
WASHINGTON, D.C. 20006

HUGH F. OWENS
CHAIRMAN

August 26, 1977

The Honorable James T. Broyhill
Congress of the United States
House of Representatives
Washington, D.C. 20515

Re: H.R. 8331

Dear Congressman Broyhill:

This is in response to your letter of August 19, 1977, concerning information you desire in connection with your consideration of H.R. 8331. Your inquiries were:

1. "To what extent has SIPC paid out on customer claims involving money market instruments?"

Until recently we had not been maintaining our data in a way which permits a precise answer to this question; however, we have been able to identify claims in some liquidation proceedings which resulted from transactions in such instruments. Although we expect that there were some claims based on transactions in these instruments in our largest liquidation to date, namely, Weis Securities, Inc., we are unable to provide any figures on this subject for that case. This is so because there were approximately 34,000 claims in that liquidation proceeding, and it would take quite some time and be very expensive to review all of those claims in order to obtain figures. I can report to you, however, that, in liquidation proceedings under the 1970 Act (other than the liquidation of

Weis Securities, Inc.) SIPC has advanced to trustees \$1,758,781 to pay customer claims which arose from transactions in U.S. Treasury securities and bank certificates of deposit, as follows:

Orin Dudley & Co.	\$ 51,935
C. H. Wagner & Co., Inc.	891,169
Dow Financial Inc.	39,400
R. L. Whitney Securities Inc.	650,000
Horvat, Maniscalco & Co.	<u>126,277</u>
	\$1,758,781

2. Concerning payments made to mutual fund customers:

(a) "Did any of the broker-dealers involved have fidelity bonds?"

To date we have encountered claims based on mutual fund transactions in eight liquidations. Four of the eight broker-dealers involved had broker blanket bond policies in effect. Another one had a security deposit with a state securities commission.

(b) "Did SIPC attempt to recover under any bonds which these broker-dealers may have had? If not, why not?"

Under the 1970 Act, it is the trustee that has the standing to seek such recoveries. The \$5,000 deposit with the state agency involved with the one case referred to above was recovered by the trustee.

Of the four cases where there were broker blanket bond policies in effect, one trustee was able to recover \$8,800. In two of the cases, the trustee was not able to seek a recovery on the bond, a major reason being that such bonds do not protect the principal of the firm from his or her own misconduct, and the losses in those cases were caused by the misconduct of the principals. Indeed, this fact alone points up the great inadequacy of suggestions that the solution to this problem lies in requiring and universally relying on the existence of broker blanket bonds. Too often the misconduct which results in losses to customers is misconduct which is not and cannot be covered by such bonds.

Finally, one of the liquidations referred to above is still open, and the question of recovery under the bond has not yet been finally resolved by the trustee.

We appreciate the opportunity to clarify these matters for you. Should you have any additional questions on this or other matters related to our work, please do not hesitate to contact me.

Sincerely yours,

Henry J. Owens

Mr. LUKEN. Thank you, Mr. Owens, for a very complete, thorough explanation of this matter.

The gentleman from North Carolina.

Mr. BROYHILL. Thank you, Mr. Chairman.

As I understand it, you want to assess any dealer who deals in mutual funds even though he may not be dealing in other securities.

Is that the effect of these amendments?

Mr. OWENS. Yes, sir.

Mr. BROYHILL. It is my understanding your argument is that you are satisfying customer claims with regard to mutual funds, and that you are not assessing the transactions in mutual funds, even though the mutual funds may not be held in a customer account.

Now let me understand what the magnitude of this problem is.

How much was paid out in the last couple of years or so to satisfy customer claims in mutual funds?

Mr. OWENS. Mr. Broyhill, I have the precise figures right here in my statement. It is a little under \$200,000. It is \$190,656.

Mr. BROYHILL. In the last year?

Mr. OWENS. That is since our beginning.

Mr. BROYHILL. From 1970.

Mr. OWENS. Yes, sir.

Mr. BROYHILL. For the total amount.

Mr. OWENS. That is correct, sir.

Mr. BROYHILL. How many firms were involved? Is this a few firms or a great number?

Mr. OWENS. There were 50 claimants in 8 liquidations.

Mr. BROYHILL. What type of firms were these? Were these firms that were holding other securities in customer accounts?

Mr. OWENS. Yes, sir.

Mr. BROYHILL. As well as mutual funds?

Mr. OWENS. They were, sir. We have never had an exclusive dealer in mutual funds liquidated under the provisions of our statute because they are not members of SIPC.

Mr. BROYHILL. But these amendments would make them members of SIPC.

Mr. OWENS. That is correct.

Mr. BROYHILL. How many members would be brought under the SIPC umbrella if your amendment were adopted? What is going to be the impact of this request?

Mr. OWENS. Do you have that figure, Mr. McChesney?

Mr. MCCHESENEY. I don't know that I have the exact number of firms.

Mr. BROYHILL. How much revenue do you anticipate?

Mr. OWENS. That is a hard question to answer right now, because we have underway a task force which is considering and reappraising the whole assessment program. As you will recall, Mr. Broyhill, the statute contemplates that at the time the fund reaches \$150 million, we can change the assessment base.

Mr. BROYHILL. Right.

Mr. OWENS. Right now the statute imposes an assessment on all SIPC members of one-half of 1 percent of gross revenues. A task force, headed by Mr. McChesney is now taking a look at a possible different basis for assessment, because we are pretty close to the

\$150 million figure. We could be there by the end of the year. In light of that, it is kind of hard to project.

Mr. BROYHILL. I just wonder if you could give us, give me at least, and furnish it for the record, some idea of the magnitude of revenues that we are contemplating here. I think we should have some idea of what you project as the potential loss in the next few years.

Is there not some relationship to the potential loss to the revenues that would be brought in from an assessment of this kind, or should there be a relationship?

Mr. OWENS. I don't see how we can make that comparison. We just don't have any figures to go on.

Mr. MCCHESENEY. Sir, I do have some estimates which are very rough in which we compared the then available data for the 1971 to 1974 period. Based on those categories of firms that are excluded and would be brought in, we would increase SIPC's annual revenues somewhere between \$1.4 million and \$2 million.

Mr. BROYHILL. Annual revenues would?

Mr. MCCHESENEY. Would increase them.

Mr. BROYHILL. Increase them.

Mr. MCCHESENEY. Yes, sir.

Mr. OWENS. That is on the basis of present assessments.

Mr. MCCHESENEY. That was based on the one-half of 1 percent assessment.

Mr. OWENS. We are very likely coming to a much lower assessment base in the future. I think that that is likely. I am not trying to prejudge the task force recommendations. It is hard to project.

Mr. BROYHILL. By bringing these people in as members, and assessing their revenues, do they get any extra protection? Do they get any extra benefits from this membership, over and above what they get today?

Mr. OWENS. I don't think that there would be any increased protections over what they get today. The only thing is that there would not be a free ride, so to speak, on the assessment feature. The protections are there right now, Mr. Broyhill.

Mr. BROYHILL. Right.

Mr. OWENS. We give them the protection. The only thing that is missing is the concomitant payment for that protection by the mutual fund people.

Mr. BROYHILL. The problem, as I see it, and I am no expert in this field at all, is these firms that have held funds for customers, and then as you have had to liquidate the firms, you have had to determine how much is in those customer accounts, whereas what we are talking about here is assessing people who don't do this. They are merely in the business, or many of them that will be affected at least by your recommendation, are not holding funds for customer accounts.

Mr. OWENS. You are right in this respect. It would catch the dealer who comes within the purview of the statute which says dealing exclusively in mutual funds. I don't have the figure. I don't think there are very many of those.

Mr. BROYHILL. How many of these have been liquidated, that fall in that category?

Mr. OWENS. How many we are talking about?

Mr. BROYHILL. You indicated of eight firms liquidated that involved mutual funds. Were those firms that exclusively dealt in mutual funds?

Mr. OWENS. No, sir, they were not. This type of claim probably arises when Mrs. Jones comes into a broker-dealer and deposits \$5,000 for the purchase of a mutual fund. Before that fund is purchased, it is a cash item on the books. If the broker-dealer fails, that amount is then protected by us. It is frequently a cash claim.

Mr. BROYHILL. Let me turn to another subject.

As I understand it, you want to assess money market instruments. What are the revenue projections on that proposal? How much do you estimate that that will increase revenue?

Mr. OWENS. May I give you a little background on the inclusion of that?

Mr. BROYHILL. Fine.

Mr. OWENS. When we started considering amendments to the 1970 act, it became apparent at the outset that a definition of the term securities for the 1970 act was desirable. For example, the question of whether or not investment contracts are included within the meaning of the term security for SIPC purposes is a troublesome one. It was our feeling that investment contracts were included under the 1934 act because that act is a regulatory and enforcement tool.

In addition it must be kept in mind that the determination of the existence of an investment contract is sometimes a very difficult question of law and fact, which may not be decided by a court until some 2 or 3 years hence. We concluded it was not the type of instrument that should come within the purview of protection under the SIPC program.

The SEC had some difficulty with this. We finally worked out a compromise with them to the effect that those investment contracts which were registered with the SEC under the 1933 act should be covered.

By the same token the 1934 act excludes, from the definition of security, money market instruments, which include commercial paper.

We believe that SIPC should protect transactions in these instruments. So the point I would make at the outset is that the inclusion of these instruments was not looked at with the idea that they would be assessed. Rather it was motivated by the belief that they should be within the protective provisions of the act.

Based upon the present assessment base, Mr. Broyhill, I would anticipate that for probably as many as 10 firms that deal largely in this type of paper, it would increase their assessment into the SIPC fund. For example, I have in mind one large firm who paid into the SIPC fund last year about \$600,000 on the basis of one-half of 1 percent of its revenue. Including commercial paper within its assessment base would amount to an additional, I believe, \$65,000 assessment for them. That is about the only figure that I have, but it is generally illustrative.

Mr. BROYHILL. Are these firms not now members of SIPC?

Mr. OWENS. Oh, yes, they are; but they are not paying on commercial paper because of the exclusion.

Mr. BROYHILL. There again will the customers receive extra protection as a result of this including it? I am not sure if I understand.

Mr. OWENS. Actually we are doing with that right now what we are doing on mutual funds. We are protecting transactions in them, but we are not getting assessments based on those transactions. I have the figure here as to how much we paid. In the 6½ years of our existence we have paid out in money market instruments approximately \$1,861,100.

Mr. LUKEN. Will the gentleman yield?

Mr. BROYHILL. Yes.

Mr. LUKEN. Are you saying that you are not necessarily required to pay on the mutual funds? You say you are paying on them.

Mr. OWENS. Yes; we are paying on them because they are a security.

Mr. LUKEN. They are covered.

Mr. OWENS. They are a security.

Mr. LUKEN. Is there any question about whether you have the obligation to pay?

Mr. OWENS. No, sir, there is not.

Mr. LUKEN. Thank you.

Mr. BROYHILL. No other questions at this time.

Mr. OWENS. Mr. Chairman, may I give a little history? In the original bill, as I recall, mutual funds were included in the assessment scheme. In the 11th hour of consideration, strong objection was raised, principally by the Investment Company Institute to the inclusion of mutual funds. I believe it was concluded at that late date that the objections may have jeopardized the passage of the bill. I think the feeling of the Congress was that mutual funds would be left out, and we would take a look at the experience of SIPC under the provisions.

Mr. LUKEN. Let me try to understand this or simplify it. You are running an insurance operation, right?

Mr. OWENS. No, sir, we are not running an insurance operation.

Mr. LUKEN. Indemnification. It sounds like an insurance operation to me. You are indemnifying third parties against loss.

Mr. OWENS. Yes; but we don't have any fixed premium rate.

Mr. LUKEN. You may not be doing it in accordance with all of the rules and that is why you are coming in for a change and that is why the question has been raised.

Mr. OWENS. I automatically react to that word insurance because we try to stay away from it, but we—

Mr. LUKEN. For those of us with limited understanding, we have some familiarity with insurance and we are trying to make an analogy with it. You are indemnifying the customers against loss.

Mr. OWENS. Yes, sir.

Mr. LUKEN. Your insured are the brokers, and what you want to do now in these—

Mr. BROYHILL. The brokers are not the insured.

Mr. LUKEN. Yes; they are.

Mr. BROYHILL. It is the customer.

Mr. LUKEN. The broker is the insured. The beneficiary who is covered, the one who will take advantage of it, is the third party, the customer, who may indirectly pay it, the fees of the broker, but

the broker is insured. You are indemnifying the third party. You don't have any contract with the customer, right?

Mr. OWENS. That is right.

Mr. LUKEN. You have an insurance contract with the broker, correct, and you now need these amendments, in order to enlarge the coverage? No, I take that back. It is not to enlarge the coverage. The coverage is already there.

Mr. OWENS. That is correct, sir.

Mr. LUKEN. You are changing the underwriting rules as to your charges. What I want to get to is you have been paying on losses.

Mr. OWENS. Yes, sir.

Mr. LUKEN. And you are required to pay on losses.

Mr. OWENS. Correct.

Mr. LUKEN. Even though you have not been charging any fee for that exposure in certain instances.

Mr. OWENS. Correct.

Mr. LUKEN. In that case it is not insurance.

Mr. OWENS. That is right.

Mr. LUKEN. No self respecting insurance company would do that.

Mr. OWENS. The philosophy behind the exclusion was that there would be—and we can't argue with the fact as I have given you the figures this morning—very limited exposure, but by the same token the philosophy of the law was——

Mr. LUKEN. There is very limited exposure.

Mr. OWENS. Yes, sir.

Mr. LUKEN. Therefore, to bring it back to the insurance analogy, you admit to a different loss ratio for what you want to include now in the assessment basis, than for what has already been included in the assessment basis, correct? Yet you are not going to charge any different premium, any different rate, for the different exposures, are you?

Mr. OWENS. No, sir.

Mr. LUKEN. And that is the problem.

Mr. OWENS. Yes.

Mr. LUKEN. That is the problem I think Mr. Broyhill was trying to get to in his questions or was addressing, and the real problem we are facing here, because you really aren't sophisticated enough to set up those premiums on the basis of risk.

Mr. OWENS. No, sir, we are not, and the task force——

Mr. LUKEN. And you don't think you can do that.

Mr. OWENS. No, sir, I don't think we can, at least not on an overall basis. As a matter of fact, the task force is looking at that feature right now. Even the FDIC and the FSLIC have had difficulties in that area, but let me explain the situation. The philosophy of the 1970 act originally was that everyone in the securities industry would benefit appreciably from the passage of the 1970 act. Why? Because of that intangible, but very real product known as investor confidence.

Mr. LUKEN. But that doesn't affect the question. The question here is whether you are charging the fees equitably?

Mr. OWENS. If I may just continue.

Mr. LUKEN. There may be general confidence restored.

Mr. OWENS. Correct.

Mr. LUKEN. And there may be a general benefit but you still have to have an equitable method of taxation or fee charge.

Mr. OWENS. If I may just continue, in light of that concept, the floor brokers and the specialists on the exchanges, with whom we have even less exposure than we are talking about here this morning, have been paying into the SIPC fund one-half of 1 percent of their gross revenues for 6½ years because they are the beneficiaries of this so-called commodity known as investor confidence. It was for that reason that mutual funds were included originally in the bill, but they were excluded due to the reason that I reviewed here 1 minute ago.

Mr. LUKEN. I have just one other question.

What about advertising? Why are so many firms reluctant to advertise their membership?

Mr. OWENS. I think you will have to address that question, Mr. Chairman, to the people that are going to testify next here.

Mr. LUKEN. Couldn't we ask you to speculate?

Mr. OWENS. Yes, sir. I don't know because there is a strong segment of the securities industry that strongly supports—

Mr. LUKEN. Doesn't want to contemplate that any loss could occur.

Mr. OWENS. A strong segment of the industry supports this measure as drafted, and the NASD, as they will tell you in their testimony coming up next, have opposed it.

Mr. LUKEN. The advertising?

Mr. OWENS. The requirement for advertising. This is a compulsory feature.

Mr. LUKEN. It is in the amendment.

Mr. OWENS. We propose it in the amendment, yes, sir, and as I said in my statement, I do not think that, based upon our observation and our experience of 6½ years, that the average investor knows that this protection exists and is available to him.

Mr. LUKEN. And you think it is important that they should know.

Mr. OWENS. I think it is important they should know.

Mr. LUKEN. Whether they want to know it or not.

Mr. OWENS. I think that it is important and the only way that I think we can get that done. I don't think that it is wise for us to embark on a public relations program or hire moviemakers and all that to get the job done. I think the way to do it is to require every broker-dealer that is going to advertise on TV or radio and so forth to say that he is a member of this corporation and that this protection is available to his customers. If he objects to that, then I think their objection is based upon primarily—

Mr. LUKEN. Are banks required to do it?

Mr. OWENS. Yes, sir, the FDIC requires it and so does the FSLIC.

Mr. LUKEN. On television they have a little block over there saying FDIC.

Mr. OWENS. Yes, sir, as the Securities Industry Association will tell you in their testimony, they strongly support this provision. This is one of the controversial areas of the bill, I am happy to say one of the few.

Mr. LUKEN. Thank you.

Mr. OPPER?

Mr. OPPER. I would like to go back very briefly to the question of coverage for the broker-dealer. As I understand it, approximately 99 percent of all accounts that have been involved in liquidation proceedings have fallen within the \$20,000 figure. In other words, we are talking about a very small increment of the accounts which were not covered.

Mr. OWENS. Yes, sir.

Mr. OPPER. And even if we increased the cash coverage to \$40,000, there still would be some accounts which would not be covered based upon prior experience. In other words, there are a number of accounts where the cash on deposit exceeded \$40,000 in prior liquidations.

Mr. OWENS. Yes, there have been.

Mr. OPPER. What is to preclude SIPC from coming back some time in the future and saying, "Look, we still have more accounts that haven't been covered, and we want to raise the coverage to \$80,000 or \$100,000?" The point I am getting at is that no matter at what figure we place the cash insurance coverage at, there will always be some accounts which will not be covered.

Mr. OWENS. I think it is fair to state, Mr. Oppen, that we would never seek to increase it above what is provided for the banks and savings and loans. I can make that statement flatly for the record.

Mr. OPPER. It is also the suggestion if we fail to increase the cash coverage commensurate with the increase in securities there will be a disincentive on the part of investors to sell their securities and leave the resultant cash with the broker-dealer no matter how short that period of time may be. Is there anything in your experience which has demonstrated this disincentive with respect to the present coverage of 50 to 20?

Mr. OWENS. Not in our experience. The broker-dealer community may give you that testimony, and I think in more tangible form, but so far as our experience is concerned I do not think we can give you an answer to that.

Mr. OPPER. You do feel the problem might be exacerbated if we increase the securities coverage to \$100,000 and not commensurately increase the cash coverage?

Mr. OWENS. Yes. I just do not think that the broker-dealer customer is getting a fair shake in this kind of arrangement.

Mr. OPPER. In your statement you discuss the question of the customer who has subordinated his securities and whether or not he should be treated as a customer if he had been fraudulently induced to subordinate those securities. I understand that in the present litigation in which SIPC is involved concerns fairly sophisticated investors who are claiming they were fraudulently induced. In the past the commission has had some experience, particularly with smaller firms where the small customer, the unsophisticated little old lady, if you will, has been persuaded by her broker to become a subordinated lender even though she had very little understanding of the difference between a customer and a subordinated lender and the difference in protections.

Is there anything we can do to protect this person who does not understand the difference between the two categories and yet has been fraudulently induced to give up his customer rights?

Mr. OWENS. Whether there is some way to do that or not I cannot answer, but I strongly suggest that you not do it in this context, because you are talking about literally apples and oranges. You are talking about a debt on the one hand, and on the other hand we are talking about customer protection that is a fiduciary relationship that exists between the customer and the broker-dealer. The two are entirely different. Maybe Mr. Focht can speak to this further. He has lived with this and the litigation in connection therewith. Maybe he has an observation.

Mr. FOCHT. The only observation I would make is that even in the Weis litigation, Mr. Oppenheimer, there is a variety of persons who are involved in that and a substantial difference in the amount of sophistication which they have. I think I echo what the chairman said. If these people have protection, that is an open question, but I do not see it as part of the customer-oriented protection of this program.

Mr. OPPENHEIMER. Perhaps we could get a subordination agreement which would spell it out.

Mr. FOCHT. I think the SEC now requires that a number of provisions be included in those subordination agreements. Just how much there is in the way of pointing out this particular problem I do not know, but that certainly could be dealt with by way of disclosure, I would think. I suppose the problem is that, sad to say, many people sign those agreements without reading them.

Mr. DARROW. I would like to ask one question.

Mr. Chairman, it appears that you believe that the mere possibility of loss, notwithstanding any risk involved in some of these transactions, should operate as controlling consideration for the purpose of assessment. Just as a matter of record I want to understand you properly. Evidently you believe that some of these dealers, especially those in mutual funds and variable annuities, should pay as a cost of doing business some assessment for the benefit of the tangible or intangible investor confidence that you believe they evidently benefit from. Is that right?

Mr. OWENS. That is correct.

Mr. DARROW. That argument also applies in a similar fashion to transactions involving money market instruments?

Mr. OWENS. That argument would hold in that area too.

Mr. DARROW. That tends to ignore some of the equities involved, and rely on a principle not dissimilar from taxation, in the sense that the rich pay the most in taxes but often receive the fewest benefits in our welfare state. This is considered a cost of living in a welfare state. Presumably in the same sense in the securities industry, where individuals or firms benefit from overall investor protection, we are really assessing certain transactions for the purpose of protecting the smaller firms because the larger firm is the least likely to suffer insolvency. Is that correct?

Mr. OWENS. That is correct.

Mr. DARROW. That is all.

Mr. LUKEN. Anything further?

Mr. OPPENHEIMER. I have an additional question. My understanding is that with respect to section 14(e), the advertising provision of this bill, SIPC's interpretation is that any bylaw adopted by SIPC to proscribe the manner in which members may or shall display signs

or other advertising with respect to SIPC is not reviewable by the Securities and Exchange Commission; is that right?

Mr. OWENS. You mean in present law?

Mr. OPPER. No, as proposed in this bill.

Mr. OWENS. Any bylaw that we would propose would have to be, under the statute, subject to review by the SEC.

Mr. OPPER. I think there was some misunderstanding of this point.

Mr. OWENS. This would not be self-executing. It would be subject to nondisapproval by the SEC, as are all our bylaws.

Mr. LUKEN. Is there anything further?

Thank you, Mr. Owens.

Mr. LUKEN. Mr. Macklin, we have your statement of some six pages with attachments, and it will be entered into the record without objection. You may proceed in any way you see fit. Thank you for coming.

STATEMENT OF GORDON MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., ACCOMPANIED BY FRANK J. WILSON, SENIOR VICE PRESIDENT FOR REGULATORY POLICY AND GENERAL COUNSEL

Mr. MACKLIN. Thank you, Mr. Chairman.

Recognizing the time deadline you have this morning, we appreciate your accepting our written statement for the record and we will attempt to go through and paraphrase what we have said to highlight the key points of our statement.

Mr. LUKEN. You have been present for Mr. Owens' testimony and if you want to clarify or comment on any questions raised, go ahead.

Mr. MACKLIN. I think you will find our written statement addresses many of the questions that have come up.

With me today is Frank Wilson, who is Senior Vice President and General Counsel of the association. He served as a member of the task force whose recommendations led to the current proposed legislation.

Last year when this bill was up we submitted a statement which supported the bill in its entirety with two exceptions which we feel are major, which we feel can be set aside in the interest of fairness and would leave a bill that is very constructive. We think the bulk of the bill is most helpful in dealing with the complex legal and financial problems with which SIPC is faced. In addition, at that time we stated, and still state, that our opportunity to work with SIPC management and directors leads us to the conclusion that they are doing a very good job.

In spite of that, we object strongly to the elimination of the exclusion for those broker-dealers engaged exclusively in the distribution of mutual funds and variable annuities as well as those engaged in the business of rendering investment advisory services.

At the time of our last statement, our figures showed there would be over 500 firms not currently covered by SIPC which would be included in the SIPC program and would be subject to the SIPC financial and paperwork burdens.

As we said at that time, we know of no failure by these limited risk firms, and we think it is a hardship to include them in SIPC,

particularly since our data showed the overwhelming majority of these were relatively small firms.

We also object to the elimination of the exclusion of assessable gross income as SIPC members for that income which is derived from the distribution of mutual funds and variable annuities as well as the investment income related to them. We noticed at the time we testified last that out of some \$41 million SIPC claims, only \$170,000, less than one-half of 1 percent, were paid to customers in losses relating to mutual fund transactions. These figures have since been updated so that now from total SIPC disbursements of \$53.4 million, total claims of this type are \$190,656.

At the time of our last statement we had noticed that compared to the \$170,000 losses, had that income been assessable, \$5,395,209 would have been collected. That figure was up through 1974. Add to that three additional years at Mr. McChesney's minimum estimate of \$1.4 million per year, and you can see that the SIPC assessment on these types of products would be somewhere in the neighborhood of \$9.5 million to address \$190,000 of losses. We do not feel that assessment is particularly appropriate or necessary.

As to the matter of investor confidence, there is no record in the sale figures of mutual funds since 1970 that expanded investor confidence has rubbed off on that segment of the business.

Our second objection to the bill relates to the matter of SIPC advertising. We feel that if it is indeed beneficial to advertise SIPC membership, SIPC members should most certainly be allowed to do that. Our objection is somewhat philosophical and yet somewhat recognizing the burden our board members can see in this. Our objection is to making it mandatory. We cannot see any reason whatsoever why a rule should come out of Washington to address the specific details of the advertising program of the many thousands of members.

Mr. LUKEN. Does that philosophical objection apply to any regulation coming out of Washington or particularly to this one?

Mr. MACKLIN. Particularly to this one. We feel there must be overall restrictions to misleading advertising, we see some merit in consumer protection, and we can see some merit in regulatory oversight which prevents misleading advertising. However, we do not see any merit to requiring the display of the SIPC symbol, particularly when it is available if the member wants it.

Mr. LUKEN. You think there is a distinction between this requirement and that of the banks being required to advertise their protection, FDIC?

Mr. MACKLIN. We think the banks are wrong. The idea of requiring every bank in the country to include that advertising is silly, but that is their problem, not ours.

Mr. LUKEN. We are trying to reason out your conclusion and analysis, but I think the public generally appreciates the opportunity to ascertain, through the advertising, whether that bank is covered because the public is very much concerned about that protection. Whether they should be or not, they are. I think I would be reluctant if it were proposed to eliminate that requirement to jump in and approve such elimination with regard to the banks. I am just wondering about the comparison.

Mr. MACKLIN. Our people feel that the free forces of economics tend to work, and if broker-dealers found it advantageous to include this in their advertising, if it helped them attract business and addressed a customer's need, they would do it. Many of our members do not immediately perceive that the public is interested in this type of advertising.

Mr. LUKEN. I think Mr. Owens' point is the public is not aware of it and if they were aware of it, they would be—

Mr. MACKLIN. It is a matter of basic judgment. Our board consists of 26 people, all of them in the business, and, as they discuss this matter, some of them use this in their ad but unanimously they are opposed to forcing 2,800 members to use this. They felt if there is a benefit, the members are smart, they will find it.

Mr. LUKEN. We are talking about protecting not just the members but the public.

Mr. MACKLIN. We are not debating this coverage of the insurance. We think the coverage should be there. Our only concern is the mandatory requirement to include the SIPC logo in every one of our members' ads, radio and television and newspaper.

Mr. LUKEN. Mr. Oppen.

Mr. OPPER. We have heard from some sources one of the reasons many firms do not advertise the SIPC logo is they are concerned that if they were to and competitors were not, the customers might conclude that the firm was in some kind of trouble having to advertise its SIPC insurance. Can you give any credence to that suggestion?

Mr. MACKLIN. No. There are a number of firms that use the SIPC logo both on display—there is a display in the office—and some of them use it in their ads.

Mr. OPPER. Do you feel the ads would be a financial burden?

Mr. MACKLIN. Yes, modest, but they feel it takes extra space and it is an extra burden. The thing they are most disturbed about is those who do not care to. I am sure you see it in other matters you address—there is among many revulsion with those of us who live in Washington putting out mandatory requirements as to how to operate their business. This one seemed to our board members, particularly the smaller ones, to be a textbook example of useless regulation.

Mr. OPPER. SIPC was created in order to provide some investor confidence. I do not think anyone would disagree with that. It would seem to be consistent with that, that we try to educate the public as to the existence and function of SIPC in order that they would feel more secure in dealing with broker-dealers. I am wondering how we can do it more efficiently than simply having each broker-dealer advertise the fact he is a member of SIPC.

Mr. MACKLIN. We agree with everything but the conclusion. When we have people meeting with the members we mention among other major improvements in the market the SIPC protection in the last several years, and we think the idea of publicizing SIPC's protection and activities is very worthwhile. However, we are still repelled as an organization with requiring all of our members to include this in their ad whether they want to or not.

Mr. LUKEN. This coverage is pretty nearly universal; is that right?

Mr. MACKLIN. Yes.

Mr. LUKEN. Therefore, there is a valid distinction between SIPC and FDIC. Are all banks members, or just federally-chartered banks?

Mr. MACKLIN. I think for the most part it is all banks.

What I am getting at, who are members? Certainly it is valid compared to the savings and loans, and I think one the public should know about since the public is interested in which ones are covered by the Federal insurance and which ones by the State and which ones are not covered by either one.

Mr. MACKLIN. There is a strong reason for savings and loans that have that coverage to put that in their ads. It hardly seems necessary to have to tell them to do it.

Mr. LUKEN. I think you have a point, since it is universal that the public is not going to be guided to one or the other, if they are all covered.

Mr. WILSON. Also I think another point, all depositors of the bank or savings and loan will be covered, all customers of a broker-dealer would not necessarily be covered; for instance commodities customers are not covered by SIPC, so to that extent it would appear to me it might be misleading.

Mr. LUKEN. Proceed, sir.

Mr. MACKLIN. Other than those objections, we strongly favor the bill. In addition to those two objections we raised last year we are concerned with the proposal to cover cash to the extent of \$20,000 rather than the original proposed \$40,000. As I mentioned, Frank Wilson was part of a task force that spent many long hours arriving at what would be a fair coverage, and we heartily agree with that recommendation. The task force recommended \$50,000 cash, \$125,000 per customer. The SIPC board recommended \$40,000 cash and \$100,000, and we feel that those are proper figures.

Our statement covers some of the same data Chairman Owens put forth as to losses, and we would strongly recommend that you redo the legislation to go back to the original recommendation of the SIPC board of \$40,000.

Another concern with the bill as currently written is the definition of consolidated group in proposed section 4(i). Such would require that gross revenues from the securities business of a parent of a broker-dealer or an entity under common control with a broker-dealer might be subject to assessment.

There are some possible unusual interpretations to this language, and we feel that at a bare minimum this provision is unclear and should be modified to clearly explain which revenues of which parent companies will be included. Our written statement has an example as to the types of ambiguities that could be derived from that language.

Finally, we note that the definition of security appears to have been changed to eliminate the exclusions of money market instruments, and our view is that until and unless there is a demonstrated need for it, backed by hard data, we do not think that is an appropriate inclusion.

That is a general summary of what is in our statement. We also included our statement from the previous time we testified. We would be happy to answer any questions you may have.

[Mr. Macklin's prepared statement and attachments follow:]

STATEMENT OF
GORDON S. MACKLIN, PRESIDENT
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
TO THE
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
OF THE
HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
ON
H.R. 8331 - SECURITIES INVESTOR PROTECTION ACT AMENDMENTS OF 1977

August 1, 1977

Mr. Chairman and members of the Subcommittee, it is a distinct pleasure to appear today to testify in support of H. R. 8331, the so-called SIPC bill.

Last year, we testified in behalf of its predecessor bill, H. R. 8064, during hearings held before the last Congress. Our position remains essentially the same inasmuch as we do not believe, except in certain respects discussed below, this bill is substantially different from H. R. 8064. I will, therefore, summarize the position we presented last year, comment upon two new provisions, and then be pleased to answer such questions as the Subcommittee may have. In addition, I would like to submit for the record our full statement of last year which expands on certain of our views in greater detail. Accompanying me today is Frank J. Wilson, Senior Vice President Regulatory Policy and General Counsel.

Last year, we stated that with two major exceptions, we supported the bill in its entirety. We noted that the proposed bill would do much to streamline and make more efficient the protection to public investors originally envisaged by Congress. We believed then, and still do, that the many innovative provisions contained therein admirably deal with many complex legal and financial problems.

Nevertheless, we must object most strongly, as we did last year, to the elimination of the present exclusions from SIPC membership for those broker/dealers engaged exclusively in the distribution of mutual funds and variable annuities, as well as those engaged in the business of rendering investment advisory services in respect to variable annuities and mutual funds. As we said last year, we know of no failures by these limited risk firms. We also strongly oppose elimination of the exclusion from assessable gross income of SIPC members, of that income which is derived from the distribution of mutual funds and variable annuities, as well as investment advisory income related to them. Last year, we noted that of the total claims of some forty-one million dollars, only \$170,000 or .41 % of all SIPC disbursements were paid to customers for losses relating to mutual fund transactions. We have been informed that this figure remains proportionately the same and that the total amount of disbursements has risen to 53.4 million with mutual fund transactions accounting for \$190,656. Again, as we did last year, we must emphasize that these small losses must be compared to what the huge additional assessment on the industry would have been if the exemption had not existed. Our statement last year noted that as of the end of 1974, additional assessments would have amounted to \$5,395,209. Three additional years of assessment would significantly add to this sum.

Our second objection relates to that section of the bill which would give SIPC the power to provide for the mandatory display of signs or advertising relating to SIPC membership. SIPC has previously proposed an amendment to its By-Laws which would make mandatory the use of the official SIPC symbol in

members' offices and in certain advertising. However, that proposal was rejected by the Securities and Exchange Commission. The present bill contains provisions, with slight modifications, comparable to those of last year. We strongly oppose these provisions and refer you to our previous statement on H.R. 8064 detailing our reasons therefor. As rewritten, they would allow SIPC to require mandatory display of the SIPC logo. However, they also include the words "or shall" after the word "may" in the existing Act. Though it is unclear from the proposal, we are informed that the intent behind this proviso is to insure that if SIPC By-Laws require mandatory display of the symbol the Securities and Exchange Commission will be powerless to reject such a requirement. We can see no reason for this particular area of rulemaking to be eliminated from SEC oversight. Thus, we strongly object to these provisions.

In addition to the two objections we raised last year, we also object to the present bill's modification of the maximum amount SIPC may advance to satisfy cash claims as distinct from a claim for securities. Under Section 9(a)(1) of last year's bill which we agreed with, that amount was \$40,000. However, the present version of the bill would reduce that amount to \$20,000, the amount presently allowed under Section 6(f)(1) of the Act. Since the maximum amount of advances in liquidation proceedings is to be doubled from \$50,000 to \$100,000, we believe that allowing only \$20,000 for cash claims is unfairly disproportionate to those public customers who have lost cash instead of securities. We understand

that the purpose of leaving this amount at \$20,000 is to discourage the keeping of large cash balances with the broker/dealer. That assumption may not be valid, however. We note that the recommendation of the Special Task Force in this area was that the limits of SIPC protection should be raised to \$125,000 per separate customer with the limits on cash claims to be raised to \$50,000. The SIPC Board of Directors recommended the amounts be increased to \$40,000 and \$100,000. In connection with these limitations, it should be noted that of the 163 claims to date which have been over the existing limits, 106 were for cash over the \$20,000 limit aggregating \$1.2 million. We are informed that with a \$40,000 ceiling, 96 of those claimants would have been fully satisfied at an additional cost of \$900,000. In view of the fact that an industry Task Force recommended even higher limits, it would appear the industry is willing to and desirous of adding the additional protections. We recommend, therefore, that the \$40,000 limit proposed by H.R. 8064 be retained in the current proposals, especially in view of the fact that the total number of firms placed in SIPC trusteeship, and the total number of customers' claims, have been significantly reduced in recent years.

We are concerned with the redefinition of "Consolidated Group" contained in proposed Section 4(i). Such would require that gross revenues from the securities business of a parent of a broker/dealer or an entity under common control with a broker/dealer are subject to assessment. If this change is interpreted to include, for example, principal transactions in a parent insurance

company's trading account (which it would appear to do when read literally with Section 16(9)(C)), we see no reason for it and believe it would be most unfair. Since we have opposed the elimination of the exemption for investment advisory services in respect to variable annuities and mutual funds we, of course, also object to inclusion of a parent's investment advisor's advisory fee in the consolidated gross revenues as the provision would appear to require. In any event, we believe this provision is very unclear and should be modified to clearly explain which revenues of which parent companies will be included. Further, we do not believe the scope of the provisions has been adequately studied and no explanation thereof has been offered at this point.

Finally, we note that the definition of security appears to have been changed to eliminate the exclusion of money market instruments, thereby including in the "gross revenues from the securities business" assessments on money market transactions of members, their parents and affiliates. We do not believe a need has been demonstrated for this added assessment, either with respect to the need for additional revenues or the losses incurred in money market transactions. Without knowing why this modification was made, we can only suggest that unless there is a demonstrated need for it, we would object to its inclusion.

We appreciate the opportunity to comment on this bill and would be glad to furnish the Subcommittee with any further information they desire.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Mr. Chairman and members of the subcommittee, it is a distinct pleasure to appear today to testify in support of H.R. 8064. Accompanying me are Lloyd J. Derrickson, senior vice president and general counsel, and Frank J. Wilson, senior vice president--regulation.

With two major exceptions, we support the bill in its entirety. It will do much to streamline and make more efficient the protections to public investors originally envisaged by Congress. We commend the innovative provisions of the bill which deal admirably with many complex legal and financial problems.

Our first objection deals with the elimination of present exclusions from SIPC membership for those broker/dealers engaged exclusively in the distribution of mutual funds and variable annuities, as well as those engaged in the business of insurance and the rendering of investment advisory services in respect to variable annuities and mutual funds. In addition, we oppose elimination of the exclusion, from assessable gross income of SIPC members, of that income which is derived from the distribution of mutual funds and variable annuities, as well as investment advisory income related to them. Our second objection relates to Section 11 of the Bill which would give SIPC the power to provide for the mandatory display of signs or advertising relating to SIPC membership. SIPC has previously proposed an amendment to its by-laws which would make mandatory the use of the official SIPC symbol in members' sales office and in certain advertising. However, that proposal was rejected by the Securities and Exchange Commission.

As you may be aware, the NASD, together with other interested groups, participated in the Special Task Force formed by Chairman Owens of SIPC in late

1973 to consider amendments to SIPC. In view of the comprehensive report of the Task Force, which sets forth in detail reasons for the recommendations which are embodied in the Bill, it will not be necessary for me to comment further as to those additional and more flexible means to be afforded SIPC in administering the Act. We would, however, be pleased to answer such questions as the Subcommittee may have in that area. We appreciate the opportunity afforded us by Chairman Owens to participate on the Task Force and are hopeful that its recommendations will become law without undue delay, with the exception, of course, of the two areas to which I have just referred.

I would like to call to the attention of the Subcommittee that the NASD representative to the Task Force, Frank J. Wilson, strongly objected to the inclusion in SIPC membership of those broker/dealers engaged exclusively in mutual fund and variable annuity distribution. The Board of Governors of the NASD unanimously believes that inclusion of such broker/dealers is not warranted since, to our knowledge, none has ever caused losses of the type the Act was designed to protect. Further, the Bill's proposal to assess gross relating to such transactions of present members of SIPC, as well as the income from insurance and investment advisory service related thereto, is, in our opinion, unwarranted since the risks involved are much too small to give rise to any change in the Act. Other customer-protective legislation has taken these factors into account and exempted this group. As Mr. Wilson has noted in his opposition to this portion of the Bill, "the extremely low-risk nature of such limited function broker/dealers is well recognized and codified in various exemptions from SEC rules, including Rules 15c3-1 (The Net Capital Rule) and 15c3-3 (The Customer Protection Rule) under the Securities Exchange Act of 1934."

The Association's membership now stands at 2,937. Of these, approximately 94 are engaged only in the underwriting phase of the distribution of funds and variable contracts. Approximately 422 members of the NASD are small broker/

dealers serving the investing public solely in the distribution of mutual funds or variable annuities in locations throughout the country. An additional 101 members distributing mutual funds and variable annuities are insurance companies or affiliates. To include them in SIPC with the additional expense involved, including the paperwork burden as to small members, with no showing of customer loss would result in a costly and unfair hardship at a particularly inopportune time with no justification. No losses of any kind have been occasioned by failures of NASD members whose activities are solely related to the underwriting of mutual funds and variable contracts.

While we recognize that all engaged in this industry should bear an equitable share of the cost of certain investor protection, there has been, in our opinion, no adequate showing that the original exclusions of the 1970 Act should be removed. Losses which have been paid by SIPC relating to mutual fund transactions were in connection with firms doing a general securities business which at the time of their liquidation were obligated to customers in respect to mutual fund securities. Even so, considering the enormity of total claims of some 41 million dollars, the \$170,000, or .41% of all SIPC disbursements paid to customers by SIPC does not weigh heavily in favor of eliminating the exclusion/

But even beyond the small amount of losses occasioned by mutual fund transactions, it is also important to understand the inequitable impact on the mutual fund and variable annuity industry if these exemptions are eliminated. For the loss of \$170,000 must be compared to what the assessment on the industry would have been if the exemption had not existed.

The following is an approximation of what the assessments would have been for the last four years had the exemption not existed.

Total SIPC Excluded Income

1971	\$286,445,951
1972	303,967,269
1973	293,214,790
1974	105,413,750

Total

\$1,079,041,769

The yearly SIPC assessment of .5% of this total income would have come to approximately \$5,395,209 for these four years. Therefore, had the exemption not existed, the mutual fund industry would have paid into the fund 31 times what it caused in losses.

An additional objection relates to the expansion of SIPC's by-law authority under Section 15 of the Act as redesignated so as to make mandatory members' display of the official SIPC symbol and require its use in certain advertising. While we understand and support the principle that the public be knowledgeable of SIPC protections in order to foster confidence, we believe that a mandatory requirement is unnecessarily burdensome and costly. Philosophically, the Board of NASD is deeply concerned with a policy which imposes an additional obligation on broker/dealers where there has been no showing that such is necessitated by and in the public interest. Moreover, we would like to point out that this requirement was neither discussed nor recommended by the Task Force and is now proposed without any substantive justification for it.

It is our view that the use of the symbol representing SIPC protections be encouraged but that it not be a requirement for those who, for reasons of cost or inconvenience, do not wish to carry the display, either in view of customers at members' offices or in advertising material.

We appreciate this opportunity to comment on the Bill.

APPENDIX A

	<u>Firms Retailing Mutual Funds</u>	<u>Firms Underwriting Mutual Funds</u>	<u>Firms Underwriting Variable Annuities</u>	<u>Firms Retailing Variable Annuities</u>	<u>Total SIPC Excluded Income</u>
1971	\$166,236,406	\$108,146,183	\$2,802,734	\$9,259,968	\$286,445,951
1972	191,143,284	84,743,738	9,715,094	18,365,153	303,967,269
1973	165,541,693	97,613,235	7,148,069	22,911,793	293,214,790
1974	116,299,903	51,708,641	8,473,338	18,931,877	195,413,759
					\$1,079,041,769

Mr. LUKEN. The gentleman from North Carolina.

Mr. BROYHILL. Thank you, Mr. Chairman.

I would like to ask a question with regard to the proposal in this bill that would assess what are called money market transactions of member dealers. You, as I understand, are opposed to this. Do you have any idea as to why this is included as a recommendation?

Mr. MACKLIN. Just what we heard this morning is all we know, and we feel that any such inclusions that have significant potential economic impact on the members ought to be supported and backed up by extensive data.

Mr. BROYHILL. Was that included in the recommendations of the special task force to consider possible amendments to the Securities Protection Act?

Mr. WILSON. I do not believe it was. I do not have a recollection it was.

Mr. MACKLIN. We do not have a recollection that it was even discussed or considered at that time.

Mr. BROYHILL. Thank you, Mr. Chairman.

Mr. LUKEN. You have noted strong objection to the inclusion of the income derived from mutual funds and variable annuities in the SIPC assessment base, and you have cited the experience of mutual funds and insurance companies. As we have observed, SIPC has been covering them even though the losses have been small or minimal. I don't think you've suggested a solution. Do you think SIPC should continue to cover the losses? Should we discontinue the coverage or try to arrive at some kind of variable rate?

Mr. MACKLIN. As we look at the problem, setting the matter of a variable rate aside because they do have a task force restudying their whole assessment matter, until the task force comes up with their new pronouncements it seems to us you have your choice of continuing what they are doing, which over 5½ years has cost \$190,000, that is less than \$40,000 a year, or making the change that they propose which would add over 500 firms to the SIPC rolls, paying in assessments, filling out forms, some of them requiring additional bonding coverage, and in addition would increase the assessment of those currently on the rolls to some figure—we will use Mr. McChesney's of somewhere between \$1.5 million and \$2 million.

Is it worth another \$1.5 million to \$2 million in laying that burden on over 500 firms to address a \$40,000 type of thing?

Mr. LUKEN. Those firms are not currently covered, so their customers are not covered.

Mr. MACKLIN. There is also no record that they have ever needed this coverage.

Mr. LUKEN. In the nature of losses, we do not always look to the experience in order to determine whether coverage is needed. There are certain variables, are there not? You had a bad experience back in 1968-70, which was the reason for this law, when some of them did go under and losses occurred. The experience has been pretty good since then, but that does not mean it could not happen again, or it could not happen in this area?

Mr. MACKLIN. The nature of most of these firms—it is hard to draw a profile for a universe of 500 firms—are small, what we call

cash-and-carry type firms where they take in the money and forward it directly to the mutual fund and the certificate is delivered.

Mr. BROYHILL. Would the gentleman yield?

Mr. LUKEN. Certainly.

Mr. BROYHILL. The gentleman from Ohio says we do not always look at the past experience. Do you not also look at the exposure in those firms that hold cash and certificates for the benefit of their customers? What I think Mr. Macklin is saying is, these firms do not do that. They may perhaps receive a payment from their customer and then perhaps on the same day or a day or two later remit that amount of money to the mutual fund company, whoever they are dealing with, so it is an in-and-out transaction and they are not maintaining those funds for the benefit of anyone.

Mr. MACKLIN. That is correct.

Mr. BROYHILL. The point I am trying to make is I do not see a lot of exposure for loss.

Mr. MACKLIN. We do not see it either.

Mr. LUKEN. There were some losses?

Mr. MACKLIN. Minimal.

Mr. LUKEN. How did they occur?

Mr. MACKLIN. The losses did not occur in the types of firms that are not covered. The losses occurred in the general securities firms.

Mr. LUKEN. Is that true?

Mr. BROYHILL. That is what Mr. Owens testified in answer to my question.

Mr. MACKLIN. Yes.

Mr. LUKEN. Thank you.

Does counsel have any questions?

Mr. DARROW. I have one question. This relates to section 4(i), which appears to be somewhat of a Pandora's box.

Mr. Macklin, do you think foreign subsidiaries or affiliates of holding companies transacting business in foreign countries ought to be assessed under section 4(i)? Do you think the transaction should be assessed?

Mr. MACKLIN. We did not address that.

Mr. DARROW. It is a thorny issue.

Mr. MACKLIN. It is, and nearly every other one that we did address we had the opportunity to cover with members of our board. I do not think we are prepared to speak to that.

Mr. DARROW. I do not want to push you into speaking for the members without having the members' expressed sentiment on the subject.

The problem, as you may realize, is that a number of broker-dealers, especially large firms, have adopted, within the last year a corporate structure which permits them to conduct certain aspects of their business through affiliates of holding companies, some of them foreign affiliates.

If we did not assess some of those transactions, we suspect that there might be some shift in the nature of their business so that more of their transactions are undertaken in foreign countries, and we are plainly concerned about that kind of evasive action.

I have no other questions.

Mr. OPPER. I just have one. Once again in connection with the \$20,000 or \$40,000 coverage for cash, you mention in your testimo-

ny that the maintenance of the present limits might discourage customers from selling large blocks of securities. In nearly 7 years of SIPC existence have you perceived reluctance of customers to sell large blocks because of the limit?

Mr. MACKLIN. No. It is a theoretical statement but we have seen some firms feeling it was to their advantage to buy additional coverage and use that additional coverage to attract business.

Mr. OPPER. That additional coverage does not cover cash; it covers securities.

Mr. MACKLIN. That is correct, but it looks toward the need. It appears there is some thinking that there is a need out there for larger coverage. We do not have any backup data to say what is a magic number, but we do have great respect for the work of the task force that came up with the \$50,000 number. Consequently we think the \$40,000 is very conservative.

Mr. OPPER. Thank you. No further questions.

Mr. LUKEN. Any further questions?

Mr. BROYHILL. No.

Mr. LUKEN. Thank you, Mr. Macklin.

If there is nothing further, this meeting of the Consumer Protection Finance Committee is adjourned until tomorrow.

[Whereupon, at 10:50 a.m., the subcommittee adjourned, to reconvene at 8 a.m., Tuesday, August 2, 1977.]

SECURITIES INVESTOR PROTECTION ACT OF 1977

TUESDAY, AUGUST 2, 1977

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 8:10 a.m., in room 2322, Rayburn House Office Building, Hon. Ralph H. Metcalfe, presiding.

Mr. METCALFE. The Subcommittee on Consumer Protection and Finance will be in order.

This morning the subcommittee begins the second day of hearings on H.R. 8331, the Securities Investor Protection Act Amendments of 1977.

Yesterday, the subcommittee heard the remarks of SIPC Chairman Hugh Owens, and Gordon Macklin, President of NASD. Chairman Owens supplied us with a fairly detailed description of the procedural changes proposed by the amendments.

In addition, he sought to justify some of the more controversial provisions currently contained in the bill.

Specifically, he argued in favor of excluding the exemption from assessment for mutual funds, variable annuities, unit investment trusts and the business of rendering investment advisory services to registered investment companies or insurance company separate accounts.

Chairman Owens also testified in favor of the inclusion of money market instruments for purposes of assessment, and emphasized the importance SIPC attaches to mandatory advertising by its members of SIPC protection.

In his testimony Mr. Macklin reflected the sentiment of certain segments of the securities industry to the provisions of the bill on these same subjects. He expressed his organization's opposition to any expansion of SIPC's assessment base, and criticizing any authorization which would permit mandatory advertising.

Today's witnesses will have an opportunity to elaborate on some of these controversial issues.

Our first witness this morning is Commissioner Philip A. Loomis, Jr., of the Securities and Exchange Commission.

Please proceed with your statement, Commissioner.

**STATEMENT OF HON. PHILIP A. LOOMIS, JR., COMMISSIONER,
SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED
BY ROBERT J. MILLSTONE, SENIOR SPECIAL COUNSEL, DIVI-
SION OF MARKET REGULATION**

Mr. LOOMIS. Mr. Chairman, members of the subcommittee, it is a pleasure to appear before you today to present the Commission's views on the proposed amendments to the Securities Investor Protection Act of 1970.

I have with me, on my right, Mr. Robert J. Millstone, Senior Special Counsel of the Division of Market Regulation of the Commission, who was a member of the SIPC task force which has been referred to in the testimony.

I have prepared testimony which has been submitted to the committee. I don't intend to read it in full, but merely summarize it.

Mr. METCALFE. You may summarize your testimony.

Mr. LOOMIS. The Commission has supported this legislation for a long time. When SIPC's first annual report came in, certain problems had already arisen, and it was recognized that eventually it would be necessary to consider revisions.

The SIPC task force was appointed for that purpose, and we applauded this, and participated in its deliberations.

The recommendations of the task force were first considered by the subcommittee 2 years ago, but the legislation was not enacted at that time, perhaps because the conditions in the securities market were more tranquil, and there was not a present emergency.

However, the safeguard provided under the SIPC act are vital to the protection of public investors. SIPC has returned to more than 100,000 customers approximately \$277 million in property, and has advanced more than \$53 million from the SIPC fund to satisfy customers' claims and pay expenses.

We hope that SIPC will never again be called upon to initiate 40 liquidations in a single year, as it did in 1972. The Congress, the Commission, and the self-regulatory organizations have taken steps to improve broker-dealer financial responsibility since that time.

Nevertheless, the SIPC act must be designed for periods of trouble as well as for tranquil periods. We believe that this legislation will provide greater protection to customers and minimize the financial burdens on SIPC members where that can be accomplished without sacrificing investor protection.

It is clear that the current SIPC act doesn't meet its objectives in some ways. I think the principal problems are that the procedures are rather slow and cumbersome, which both make SIPC less efficient and economical than it could be, and at the same time subjects investors to delays which sometimes are adverse to them, particularly where securities continue to be held by the debtor firm, so that investors cannot get at them, and they are at the risk of the market.

I want to emphasize that while we, like prior witnesses, have devoted considerable attention and to some of the controversial points, the important thing is that this is needed legislation, and that we strongly support it more or less without being dependent on any of these particular controversial questions.

This is very important legislation. The major provisions of it are needed. We should not focus solely on the controversies.

While I have limited my testimony to broad policy issues, in addition, I wish to submit to the subcommittee at this time a memorandum entitled "Written Comments of the Securities and Exchange Commission," which deals in more detail with some of these questions, together with some technical comments by the staff relating to technical and drafting matters [see p. 236.]

Mr. METCALFE. That will be entered into the record without objection.

Mr. LOOMIS. Turning now to the matters that have been the source of concern, first the bill would remove the exclusion from SIPC as the Chairman has mentioned, for broker-dealers who see exclusively mutual funds or certain products offered by insurance companies or act as investment advisers to investment companies.

The exclusion of these broker dealers from SIPC membership was prompted by the fact that they rarely hold customers funds and securities, and consequently they shouldn't have to pay assessments. Once this was done, it was deemed necessary to exclude revenues from the same sources for other broker dealers in order to avoid creating a competitive inequality.

SIPC advises us that over the past 7 years it has expended approximately \$190,000 to protect customers in relation to mutual fund claims, and has returned another \$70,000 in property relating to such claims to customers. Although this is not a large amount. I would like to emphasize that persons who deal under the present law with exclusive mutual fund dealers have no protection if these broker dealers misappropriate their funds.

In the way the mutual fund broker dealers operate, they are not supposed to have customers funds and securities, but on occasion they do, as when a customer pays money to a dealer for a mutual fund share. The dealer is supposed to send that money immediately to the fund, but in some instances he doesn't do so. He puts it in his pocket, or uses it to pay the expenses of his business.

For example, in May of this year the Commission brought an action against such a broker dealer in Tennessee, alleging violations of the antifraud provisions of the securities laws. A receiver was appointed. Although our investigation is not yet complete, the indications are that there are at least nine customers who have lost some \$200,000 with this broker dealer. These customers are in as much need of SIPC protection as any other customers of registered broker dealers.

We think it essential that all public customers of any registered broker dealer should be protected against that broker dealer's insolvency.

SIPC has suggested to the subcommittee that assessment of mutual fund revenues is the quid pro quo for protection of customers. We understand SIPC's argument that it shouldn't have to pay on account of people who don't pay assessments.

There is merit in the arguments of both sides on this problem. Nevertheless, we do feel that the protection of customers is foremost, and we believe there is a reasonable solution.

SIPC is required to levy assessments on the basis of a percentage of gross revenues only during the period when the SIPC fund is

below \$150 million. It is expected that that goal will be reached this year. Thereafter, SIPC can vary assessments on the basis of risk, among other factors, under the existing provisions of law which are not being changed, and is directed to levy assessments only to maintain its funds and cover its expenses.

Accordingly, we do support the removal of these exclusions from SIPC membership for these people, but suggest that the subcommittee perhaps in its report urge SIPC and the representatives of the affected broker dealers to develop an equitable assessment plan under the authority that SIPC will have at the end of this year, and on which they are already working.

We believe that this can and should be done under the existing statutory authority which is not changed by this bill, and it is not necessary to amend the bill to accomplish it.

Another area of some controversy is money market, instruments like certificates of deposit and commercial paper. These were not deemed to be securities under existing law, although SIPC has provided coverage with respect to them.

The definition of securities in H.R. 8331 would include these. Thus, there would be SIPC protection with respect to them. But—as in the case of the mutual funds, it is not necessary that the assessments be the same rate as to them.

Another matter is the amendment to 4(i) of the SIPC Act requires SIPC members to include in their assessment base securities revenues of affiliated entities. We think this proposal should be examined carefully by the subcommittee. It may have far-reaching and largely unintended effects on companies with large and complex corporate structures.

Again, the subcommittee may wish to suggest that this be mitigated through the rulemaking power of SIPC under the Commission's supervision.

Turning now to another aspect of investor protection, the bill provides limitation of protection different from that recommended. The 1975 proposal would have raised the existing protection to a limitation for each customer of \$100,000 with a cash limitation of \$40,000.

H.R. 8331 continues the \$100,000 level of protection for securities, but limits cash coverage to only \$20,000. We understand that the committee may not wish to encourage public customers to deposit funds with broker dealers for a long period of time. This may well prompt this legislation.

Mr. BROYHILL. Would you yield right there. I don't know that that is a subcommittee desire.

Mr. LOOMIS. Maybe I am misinformed. I couldn't see any other particular reason for cutting back the cash coverage in this way. We do not favor it.

We feel that, first, it may have an impact on customers who sell securities in substantial amounts, and before they can collect the proceeds, the broker dealer goes under.

In addition—this is not in my prepared testimony—it is a practice of broker dealers generally not to send the money back to the customer until the customer asks for it. So, it is not really a matter of the customer deciding to leave his money on deposit with the

broker dealer. It is more often the fact that he has not taken affirmative action to get the money out.

Moreover, there is also a psychological aspect here which I think is as important as any, and that is to preserve the appearance that SIPC provides adequate coverage and adequate protection to investors. That is important, for one of the general principles that led to the establishment of the SIPC, was to preserve investor confidence and investor protection.

If the amount that the customer can get back is limited, those objectives may be damaged to some extent, even though very few people will actually leave larger amounts with a broker-dealer.

Section 2 of the bill authorizes SIPC to exclude from membership any broker dealer whose principal business, including its affiliates, is conducted outside the United States. We are concerned with this provision, and believe that it is not well drafted to accomplish its important end.

SIPC is properly concerned that it should not be required to be responsible for foreign broker dealers whose assets are beyond its reach, and whom it could not liquidate. However, the bill as drafted would permit SIPC to exclude broker dealers in its unfettered discretion without direct review by the Commission or anyone else.

The only possible review would be a lawsuit by a customer against SIPC or a broker dealer, and that is not apt to be an adequate remedy.

In addition, this provision creates the possibility that a United States resident dealing with a registered broker dealer right here in the United States may find himself without SIPC protection.

For example, if a Canadian broker dealer were doing \$20 million of securities business worldwide, of which \$5 million occurred in the United States, in its United States office, SIPC could exclude that broker dealer under this provision, although another broker dealer whose total business is \$5 million in the United States would be included. Because of the short time since the introduction of the bill, we have not attempted to suggest to the subcommittee a revision of Section 2. Rather, we urge the subcommittee to re-examine this provision.

We recommended that the subcommittee consider placing some review process over SIPC's discretion, and in addition require broker dealers who are excluded from SIPC membership under this provision to make such disclosures to their customers of the situation as the Commission may require by rule. Our staff will be happy to assist the subcommittee staff in making these revisions.

Finally, SIPC has added a clause to the definition of customer, which appears in Section 16(3) of the bill. The existing section excludes from customer status any person who has a claim for cash or securities which is a part of the capital of the debtor or is subordinate to claims of creditors of the debtor.

The added clause excludes such persons notwithstanding the fact that they may have legal grounds to rescind the contract because of fraud or something of that sort.

There has been considerable concern about this provision in the past. When I appeared before this subcommittee in 1975, I expressed the thought that while subordinated lenders in general should be excluded from SIPC coverage, there could be exceptional

cases where we would want to permit coverage, particularly in the case of unsophisticated investors who don't know what they are getting into, so to speak.

While I am less convinced now that it is necessary to provide for exceptional cases, I still believe that the subcommittee should leave some flexibility in the statute, so that in an extraordinary case, where an unsophisticated investor was really imposed upon, he might receive protection, and not have an absolute prohibition against his customer status.

In conclusion, Mr. Chairman, let me reiterate the Commission's strong and continuing support for the prompt enactment of this legislation. We think it is important.

I will be happy to respond to any questions the subcommittee may have.

[Testimony resumes on p. 245.]

[Mr. Loomis' prepared statement and attachments follow:]

TESTIMONY OF COMMISSIONER PHILIP A. LOOMIS
BEFORE THE SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCE OF THE HOUSE COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE ON H.R. 8331,
NINETY-FIFTH CONGRESS, FIRST SESSION, 1977.

AUGUST 2, 1977

Mr. Chairman and members of the Subcommittee, it is a pleasure to appear before you today to present the Commission's views on the proposed amendments to the Securities Investor Protection Act of 1970.

As you know, the Commission has supported this legislation for a long time. When the Commission forwarded to Congress its comments on SIPC's first annual report, problems with the Act had already arisen. By the time our second letter of comment was forwarded, we recognized that further legislation would be necessary although the appropriate scope of that legislation was not yet clear. By the time of SIPC's third annual report, the SIPC Task Force had been appointed and had begun its work. We applauded the establishment of that Task Force and our staff devoted considerable time to its deliberations. Two years ago, the recommendations of that Task Force were first considered by this Subcommittee.

Legislation was not enacted at that time. In the intervening period, SIPC has initiated only seven liquidations, all of which have been relatively small. Because of this, and because SIPC has been effective in satisfying customer claims as quickly and completely as the law would permit, there has not been a sense of urgency about the enactment of this legislation. Nevertheless, as a few statistics point out, the safeguards provided under the SIPC Act are vital to the protection of public investors and the maintenance of confidence in the United States securities markets. During its existence, SIPC has returned to more than 100,000 customers approximately \$277 million in property and has advanced more than \$53 million from the SIPC fund to satisfy customer claims and pay expenses.

WE HOPE THAT SIPC WILL NEVER AGAIN BE CALLED UPON TO INITIATE FORTY LIQUIDATIONS IN A SINGLE YEAR AS IT DID IN 1972. SINCE THE PASSAGE OF THE SIPC ACT, THE COMMISSION HAS TAKEN VARIOUS STEPS TO STRENGTHEN THE FINANCIAL RESPONSIBILITY STANDARDS OF BROKER-DEALERS, TO EXPEDITE THE PROCESSING OF SECURITIES TRANSACTIONS, AND TO IMPROVE THE ENTRY STANDARDS IN THE SECURITIES INDUSTRY. AND CONGRESS HAS BEEN VIGILANT IN OVERSEEING OUR PROGRESS AND PROVIDING US WITH THE AUTHORITY TO MAKE NEEDED CHANGES. WE BELIEVE THESE DEVELOPMENTS AS WELL AS THE IMPROVEMENTS WHICH THE SELF-REGULATORY ORGANIZATIONS HAVE EFFECTED IN THE OVERSIGHT OF THEIR MEMBERS HAVE DONE MUCH TO REDUCE THE INCIDENCE OF BROKER-DEALER INSOLVENCY AND HAVE, IN GENERAL, ASSURED THAT SUCH INSOLVENCY DOES NOT RESULT IN THE LOSS OF CUSTOMER FUNDS AND SECURITIES.

NEVERTHELESS, THE SIPC ACT MUST BE DESIGNED NOT FOR A QUIET PERIOD IN TERMS OF BROKER INSOLVENCY SUCH AS THE PRESENT, BUT FOR THE POSSIBILITY, HOWEVER REMOTE, OF SERIOUS FUTURE PROBLEMS. THE ACT ALSO MUST BE DESIGNED TO MINIMIZE THE FINANCIAL BURDEN ON SIPC MEMBER FIRMS WHERE THAT CAN BE ACCOMPLISHED WITHOUT SACRIFICING CUSTOMER PROTECTION. IT IS CLEAR THAT THE CURRENT SIPC ACT DOES NOT MEET THESE OBJECTIVES IN SOME WAYS, NOR DOES IT PROVIDE SIPC WITH THE FLEXIBILITY TO EFFECT THE MOST EFFICIENT SOLUTIONS TO THE BROAD RANGE OF PROBLEMS WHICH MAY CONFRONT IT.

WHILE WE HAVE COMMENTS ABOUT SPECIFIC PROVISIONS OF THE AMENDMENTS, THE COMMISSION WISHES TO MAKE CLEAR ITS STRONG SUPPORT FOR THE PROPOSED LEGISLATION. AS I NOTED TWO YEARS AGO, IN THE OVERVIEW, IT CARRIES OUT THE REASONED AND THOUGHTFUL RECOMMENDATIONS OF THE SIPC TASK FORCE AND WOULD ASSURE THAT THE PROTECTIONS PROVIDED UNDER THE SIPC ACT WOULD MORE CLEARLY MEET THE REASONABLE

EXPECTATIONS OF PUBLIC CUSTOMERS WITHIN THE LIMITS OF PROTECTION PROVIDED IN THE ACT. MOST OF THE DISAGREEMENTS THAT EXISTED BETWEEN SIPC AND THE COMMISSION IN 1975 HAVE BEEN RESOLVED. IN SEVERAL OTHER CASES, THE COMMISSION HAS RECEDED FROM POSITIONS IT TOOK BEFORE THIS SUBCOMMITTEE IN 1975 BECAUSE DISCUSSIONS WITH SIPC, MEMBERS OF THE FINANCIAL COMMUNITY, OR OTHER COMMENTORS OR LEGAL SCHOLARS HAVE LESSENED OUR CONCERNS ABOUT THESE PROBLEMS OR CONVINCED US THAT NO SIGNIFICANT HARM WOULD RESULT.

I HAVE LIMITED MY TESTIMONY, IN GENERAL, TO A DISCUSSION OF SEVERAL BROAD POLICY ISSUES WHICH I BELIEVE SHOULD BE CONSIDERED BY THE SUBCOMMITTEE IN ENACTING THIS LEGISLATION. IN ADDITION, MR. CHAIRMAN, I WISH TO SUBMIT TO THE SUBCOMMITTEE AT THIS TIME, A MEMORANDUM WHICH SETS FORTH THE COMMISSION'S POSITION ON A NUMBER OF SECTIONS OF THE PROPOSED AMENDMENTS WHICH WE BELIEVE SHOULD BE MODIFIED. THESE REPRESENT THE FEW REMAINING AREAS WHERE THE VIEWS OF THE COMMISSION AND SIPC DIFFER OR REFLECT NEW PROBLEMS WHICH WE FOUND IN REVIEWING H.R. 8331. IN ADDITION, I WISH TO SUBMIT A FEW TECHNICAL COMMENTS PREPARED BY OUR STAFF.

THE BILL WOULD REMOVE THE EXCLUSION FROM SIPC MEMBERSHIP FOR FOUR CLASSES OF BROKER-DEALERS -- THOSE DEALING EXCLUSIVELY IN THE SALE OF MUTUAL FUNDS, 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. AS THE SUBCOMMITTEE IS AWARE, THESE EXCLUSIONS HAVE BEEN THE SUBJECT OF CONSIDERABLE CONTROVERSY WHICH DATES BACK TO CONGRESSIONAL CONSIDERATION OF THE SIPC ACT IN 1970.

THE EXCLUSION OF THESE BROKER-DEALERS FROM SIPC MEMBERSHIP WAS PROMPTED BY THE IDEA THAT BECAUSE THEY RARELY HELD CUSTOMERS' FUNDS OR SECURITIES, THEIR CUSTOMERS DID NOT NEED SIPC PROTECTION, AND THEREFORE, THEY SHOULD NOT HAVE TO PAY SIPC ASSESSMENTS. ONCE THIS WAS DONE, IT WAS DEEMED NECESSARY TO EXCLUDE REVENUES FROM THE SAME SOURCES AS A BASIS FOR SIPC ASSESSMENTS FOR BROKER-DEALERS WHO WERE

MEMBERS OF SIPC IN ORDER TO AVOID CREATING A COMPETITIVE INEQUALITY BETWEEN MEMBERS AND NON-MEMBERS IN THESE FIELDS.

SIPC ADVISES US THAT OVER THE PAST SEVEN YEARS, IT HAS EXPENDED APPROXIMATELY \$190,000 TO PROTECT CUSTOMERS IN RELATION TO MUTUAL FUND CLAIMS AND HAS RETURNED ANOTHER \$70,000 IN PROPERTY RELATED TO MUTUAL FUND CLAIMS TO CUSTOMERS. WHILE THIS IS NOT A LARGE AMOUNT, SIPC ARGUES THAT BECAUSE SOME LOSSES DO OCCUR, MUTUAL FUND REVENUES SHOULD BE SUBJECT TO ASSESSMENT. IN ADDITION, SIPC ARGUES THAT THE MAINTENANCE OF PUBLIC CONFIDENCE IN THE MARKETS AS A RESULT OF THE SIPC ACT BENEFITS ALL BROKER-DEALERS AND, ACCORDINGLY, ALL BROKER-DEALERS SHOULD PAY ASSESSMENTS.

THERE IS ANOTHER ASPECT TO THIS PROBLEM, HOWEVER. PERSONS WHO DEAL WITH BROKER-DEALERS ENGAGED EXCLUSIVELY IN THE DISTRIBUTION OF MUTUAL FUNDS HAVE NO PROTECTION IF THOSE BROKER-DEALERS MISAPPROPRIATE THEIR FUNDS OR SECURITIES. IN MAY OF THIS YEAR, THE COMMISSION BROUGHT AN ACTION AGAINST SUCH A BROKER-DEALER IN TENNESSEE ALLEGING VIOLATIONS OF, AMONG OTHER THINGS, THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS. SUBSEQUENTLY, A RECEIVER WAS APPOINTED. ALTHOUGH OUR INVESTIGATION IS NOT YET COMPLETE, THE INDICATIONS ARE THAT AT LEAST NINE CUSTOMERS HAVE LOST SOME \$200,000 WITH THIS BROKER-DEALER. THOSE CUSTOMERS CLEARLY ARE AS MUCH IN NEED OF THE PROTECTION PROVIDED UNDER THE SIPC ACT AS ARE CUSTOMERS OF BROKER-DEALERS ENGAGED IN A GENERAL SECURITIES BUSINESS. MUTUAL FUNDS ARE TRADITIONALLY AN INVESTMENT MEDIUM FOR THE SMALL AND FREQUENTLY UNSOPHISTICATED INVESTOR AT WHOM THE SIPC ACT IS MOST CLEARLY DIRECTED. THE COMMISSION BELIEVES THAT ALL PUBLIC CUSTOMERS OF REGISTERED BROKER-DEALERS SHOULD BE PROTECTED AGAINST THEIR BROKERS' INSOLVENCY.

SIPC HAS SUGGESTED TO THE SUBCOMMITTEE THAT ASSESSMENT OF MUTUAL FUND REVENUES IS THE QUID PRO QUO FOR PROTECTION OF CUSTOMERS AGAINST LOSSES RELATING TO MUTUAL FUNDS. WE ARE SYMPATHETIC TO THE ARGUMENT THAT SIPC SHOULD NOT HAVE TO EXPEND MONIES TO PROTECT CUSTOMERS IN RELATION TO

SECURITIES FROM THE TRADING OF WHICH IT DERIVES NO REVENUES. BUT THERE IS MERIT IN THE ARGUMENTS ON BOTH SIDES.

THE MUTUAL FUND INDUSTRY AND OTHERS AFFECTED POINT OUT THAT THE ASSESSMENTS WHICH WOULD BE LEVIED WOULD BE GROSSLY DISPROPORTIONATE TO SIPC'S LOSS EXPERIENCE WITH MUTUAL FUND DEALERS OR PERSONS SELLING VARIABLE ANNUITIES.

WE BELIEVE THERE IS A REASONABLE SOLUTION. SIPC IS REQUIRED TO LEVY ASSESSMENTS ON THE BASIS OF A PERCENTAGE OF GROSS REVENUES OF A FIRM ONLY WHEN THE SIPC FUND IS BELOW \$150 MILLION. IT IS EXPECTED THAT THE GOAL OF \$150 MILLION WILL BE REACHED THIS YEAR. THEREAFTER, SIPC CAN VARY ASSESSMENTS ON THE BASIS OF RISK, AMONG OTHER FACTORS, AND IS DIRECTED TO LEVY ASSESSMENTS AT A RATE SUFFICIENT ONLY TO MAINTAIN THE FUND AND TO COVER CURRENT OPERATIONS.

ACCORDINGLY, WE RECOMMEND THAT THE SUBCOMMITTEE REMOVE THE CURRENT EXCLUSIONS IN THE SIPC ACT AND REQUIRE ALL REGISTERED BROKER-DEALERS TO BE MEMBERS OF SIPC. CONCOMITANTLY, THE ASSESSMENT EXCLUSION SHOULD ALSO BE REMOVED. WE SUGGEST, HOWEVER, THAT THE SUBCOMMITTEE URGE SIPC AND REPRESENTATIVES OF THE AFFECTED BROKER-DEALERS TO DISCUSS THE SITUATION AND TO DEVELOP AN ASSESSMENT PLAN WHICH WILL IMPOSE UPON THESE BROKER-DEALERS ASSESSMENTS WHICH ARE AT LEAST GENERALLY RELATED TO THE RISK INVOLVED AND TO THE LOSS EXPERIENCE. WE BELIEVE THIS CAN AND SHOULD BE DONE UNDER SIPC'S EXISTING STATUTORY AUTHORITY AND DO NOT BELIEVE IT IS NECESSARY TO AMEND THE ASSESSMENT PROVISIONS OF THE STATUTE TO ACCOMPLISH THIS END.

THERE IS ANOTHER AREA WHERE THE SIPC ASSESSMENT STRUCTURE MAY BE A PROBLEM. WE ARE ADVISED THAT IN THE PAST SIPC MEMBERS HAVE NOT, IN GENERAL, PAID ASSESSMENTS ON REVENUES RECEIVED IN CONNECTION WITH TRANSACTIONS IN MONEY MARKET INSTRUMENTS -- CERTIFICATES OF DEPOSIT, COMMERCIAL PAPER, BANKERS' ACCEPTANCES AND TREASURY BILLS -- BECAUSE THESE REVENUES WERE NOT DEEMED TO BE GROSS REVENUES FROM THE SECURITIES BUSINESS. AT THE SAME TIME, SIPC HAS PROVIDED CUSTOMER PROTECTION WITH REGARD TO SUCH

INSTRUMENTS. THE DEFINITION OF SECURITIES WHICH IS INCORPORATED INTO H.R. 8331 INCLUDES MONEY MARKET INSTRUMENTS, AND, THEREFORE, SIPC MEMBERS WILL NOW BE REQUIRED TO PAY ASSESSMENTS ON REVENUES FROM THAT SOURCE. AS WITH REVENUES FROM MUTUAL FUNDS AND VARIABLE ANNUITIES, WE BELIEVE THAT, IF SIPC IS TO PROVIDE PROTECTION WITH REGARD TO MONEY MARKET INSTRUMENTS, IT SHOULD RECEIVE SOME ASSESSMENTS, BUT THE ASSESSMENT RATE NEED NOT BE EQUAL TO THE RATE IMPOSED ON OTHER SECURITIES REVENUES.

H.R. 8331 ALSO AMENDS SECTION 4(i)(2) OF THE SIPC ACT TO REQUIRE MEMBERS TO INCLUDE IN THEIR ASSESSMENT BASE SECURITIES REVENUES OF ENTITIES WHICH CONTROL, ARE CONTROLLED BY OR ARE UNDER COMMON CONTROL WITH SUCH MEMBER. THE AMENDMENT OF SECTION 4(i)(2) WOULD APPEAR, AMONG OTHER THINGS, TO (i) REQUIRE SIPC MEMBERS TO INCLUDE SECURITIES REVENUES OF FOREIGN AFFILIATES IN THEIR ASSESSMENTS, (ii) BRING WITHIN THE AMBIT OF SIPC ASSESSMENTS SECURITIES REVENUES OF COMPANIES, SUCH AS INSURANCE COMPANIES, WHICH HAPPEN TO BE AFFILIATED WITH BROKER-DEALERS AND WHICH HAVE SECURITIES REVENUES, AND (iii) IN COMBINATION WITH THE INCLUSION OF MONEY MARKET INSTRUMENTS IN MEMBERS' ASSESSMENTS, CAUSE SIPC MEMBERS TO PAY ASSESSMENTS ON TRANSACTIONS IN MONEY MARKET INSTRUMENTS CONDUCTED THROUGH UNREGISTERED AFFILIATES.

WE BELIEVE THAT THE AMENDMENT OF SECTION 4(i)(2) SHOULD BE EXAMINED CAREFULLY BY THE SUBCOMMITTEE. THE PROVISION MAY HAVE FAR REACHING AND POSSIBLY UNINTENDED EFFECTS ON COMPANIES WITH LARGE AND COMPLEX CORPORATE STRUCTURES. IF SECTION 4(i)(2) IS ENACTED, THE SUBCOMMITTEE MAY WISH TO CONSIDER TAKING STEPS TO MITIGATE THE BURDEN WHICH WOULD BE PLACED ON PARTICULAR SEGMENTS OF THE BROKERAGE INDUSTRY.

THE BILL PROVIDES A LIMITATION OF PROTECTION DIFFERENT THAN THAT RECOMMENDED BY THE TASK FORCE OR INCLUDED IN THE PREVIOUS HOUSE AND SENATE BILLS. THE 1975 LEGISLATION PROVIDED A LIMITATION OF \$100,000 FOR EACH CUSTOMER ACCOUNT WITH A LIMITATION OF \$40,000 ON CLAIMS FOR CASH AS DISTINCT FROM SECURITIES. H.R. 8331 CONTINUES THE \$100,000 LEVEL OF PROTECTION FOR SECURITIES BUT LIMITS CASH COVERAGE TO ONLY

\$20,000. ALTHOUGH WE UNDERSTAND THAT THE SUBCOMMITTEE MAY NOT WISH TO ENCOURAGE PUBLIC CUSTOMERS TO DEPOSIT FUNDS WITH BROKER-DEALERS FOR LONG PERIODS OF TIME, THE EFFECT OF THIS PROVISION MAY BE TO DISABLE CUSTOMERS FROM FREELY TRADING IN THEIR SECURITIES ACCOUNTS AND FRUSTRATE THE LEGITIMATE EXPECTATIONS OF CUSTOMERS WHO DID NOT DELIBERATELY DEPOSIT FUNDS WITH BROKER-DEALERS.

WHEN A CUSTOMER SELLS SECURITIES, HIS CLAIM FROM THAT TIME UNTIL SETTLEMENT AND DELIVERY OF THE FUNDS IS A CLAIM FOR CASH. UNDER H.R. 8331, A CUSTOMER WITH \$100,000 IN SECURITIES IN AN ACCOUNT WOULD NEVER BE ABLE TO EXECUTE A SALE FOR MORE THAN \$20,000 OF THOSE SECURITIES WITHOUT LOSING, IN SOME PART, HIS SIPC PROTECTION. WHILE WE RECOGNIZE THAT A CUSTOMER IS NOT LIKELY TO SELL AN ENTIRE \$100,000 POSITION IN A SINGLE TRANSACTION, WE BELIEVE THAT THE \$20,000 LIMIT IS UNNECESSARILY RESTRICTIVE AND MIGHT HAVE UNFORTUNATE CONSEQUENCES FOR UNWARY PUBLIC CUSTOMERS. WE URGE THE SUBCOMMITTEE TO RETURN TO A \$40,000 LIMITATION FOR CLAIMS RELATING TO CASH.

SECTION 2 OF THE BILL AUTHORIZES SIPC TO EXCLUDE FROM MEMBERSHIP ANY BROKER-DEALER "WHOSE PRINCIPAL BUSINESS, IN THE DETERMINATION OF SIPC, TAKING INTO ACCOUNT BUSINESS OF AFFILIATED ENTITIES, IS CONDUCTED OUTSIDE THE UNITED STATES OR ITS TERRITORIES OR POSSESSIONS. . . ." THE COMMISSION IS MOST CONCERNED ABOUT THIS PROVISION, AND WE BELIEVE THAT IT IS NOT WELL DRAFTED TO ACCOMPLISH ITS IMPORTANT END. SIPC IS PROPERLY CONCERNED THAT IT NOT BE MADE RESPONSIBLE FOR FOREIGN BROKER-DEALERS WHOSE ASSETS ARE BEYOND ITS REACH AND IN REGARD TO WHOM IT COULD NOT CARRY OUT A LIQUIDATION AS DIRECTED BY THE STATUTE. AS DRAFTED, HOWEVER, THE PROVISION WOULD PERMIT SIPC TO EXCLUDE BROKER-DEALERS IN ITS UNFETTERED DISCRETION AND WITHOUT DIRECT REVIEW BY THE COMMISSION OR ANYONE ELSE. THE ONLY FORESEEABLE REVIEW OF SIPC'S ACTIONS WOULD BE A SUIT BY A CUSTOMER OF AN INSOLVENT BROKER-DEALER MAINTAINING THAT THE BROKER-DEALER SHOULD HAVE BEEN A MEMBER OF SIPC.

IN ADDITION, THE PROVISION CREATES THE POSSIBILITY THAT A UNITED STATES RESIDENT DEALING WITH A REGISTERED

BROKER-DEALER IN UNITED STATES TERRITORY MAY FIND HIMSELF EXCLUDED FROM SIPC COVERAGE WHICH WE BELIEVE DOES NOT COMPORT WITH THE INTENT OF THE SIPC ACT. FOR EXAMPLE, IF A CANADIAN BROKER-DEALER WERE DOING \$20 MILLION OF SECURITIES BUSINESS ANNUALLY, OF WHICH \$5 MILLION OCCURRED IN THE UNITED STATES, SIPC APPARENTLY COULD EXCLUDE THAT BROKER-DEALER UNDER THIS PROVISION. AT THE SAME TIME, ANOTHER BROKER-DEALER WHO HAS A TOTAL BUSINESS OF \$5 MILLION, ALL OF WHICH IT CONDUCTED IN THE UNITED STATES, WOULD BE A SIPC MEMBER. FROM THE STANDPOINT OF THE EFFECT ON UNITED STATES INVESTORS, HOWEVER, THERE IS NO DIFFERENCE BETWEEN THE TWO BROKER-DEALERS.

BECAUSE OF THE SHORT TIME SINCE INTRODUCTION OF THIS BILL, WE HAVE NOT ATTEMPTED TO SUGGEST TO THE SUBCOMMITTEE A REVISION OF SECTION 2. RATHER, WE URGE THE SUBCOMMITTEE TO RE-EXAMINE THIS PROVISION. WE RECOMMEND THE SUBCOMMITTEE CONSIDER PLACING SOME REVIEW PROCESS OVER SIPC'S DISCRETION, AND, IN ADDITION, REQUIRE BROKER-DEALERS EXCLUDED FROM SIPC MEMBERSHIP UNDER THIS PROVISION TO MAKE SUCH DISCLOSURES TO THEIR CUSTOMERS AS THE COMMISSION MAY REQUIRE BY RULE. IF THE SUBCOMMITTEE WISHES, I WOULD BE HAPPY TO OFFER THE SERVICES OF OUR STAFF TO ASSIST THE SUBCOMMITTEE IN REDRAFTING SECTION 2.

I WOULD LIKE TO NOTE A POTENTIAL PROBLEM WITH THE RULEMAKING PROCEDURE PROVIDED IN THE BILL. AS YOU ARE AWARE, THIS PROCEDURE IS MODELED AFTER SECTION 19(B) OF THE SECURITIES EXCHANGE ACT WHICH WAS ENACTED BY THE SECURITIES ACTS AMENDMENTS OF 1975. THE COMMISSION'S EXPERIENCE IN ADMINISTERING SECTION 19(B) HAS LED US TO CONCLUDE THAT THE FIXED TIME FRAMES PROVIDED IN THAT SECTION ARE, IN SOME CASES, TOO RIGID AND MAY CREATE UNNECESSARY BURDENS FOR BOTH THE COMMISSION AND THE AFFECTED SELF-REGULATORY ORGANIZATIONS. WE CONSIDERED SUGGESTING CERTAIN REVISIONS OF THE RULEMAKING PROCEDURE IN THE SIPC ACT TO DEAL WITH THOSE PROBLEMS, BUT CONCLUDED THAT THERE IS AN ADVANTAGE TO MAINTAINING COMPARABILITY BETWEEN THE TWO ACTS. THE SUBCOMMITTEE SHOULD BE AWARE, HOWEVER, THAT

AS THE COMMISSION GAINS ADDITIONAL EXPERIENCE IN ADMINISTERING THESE PROVISIONS, WE MAY WISH TO BRING BEFORE THE SUBCOMMITTEE A PROPOSAL TO REVISE THE RULEMAKING PROCEDURES OF BOTH SECTION 19(B) AND THE SIPC ACT.

FINALLY, SIPC HAS ADDED A CLAUSE TO THE DEFINITION OF "CUSTOMER" WHICH APPEARS AS SECTION 16(3) OF THE BILL. THE EXISTING SECTION EXCLUDES FROM CUSTOMER STATUS ANY PERSON WHO HAS A CLAIM FOR CASH OR SECURITIES WHICH IS PART OF THE CAPITAL OF THE DEBTOR OR IS SUBORDINATED TO CLAIMS OF CREDITORS OF THE DEBTOR. THE ADDED CLAUSE EXCLUDES SUCH PERSONS "NOTWITHSTANDING THAT SOME GROUND MIGHT HAVE EXISTED FOR DECLARING SUCH CONTRACT, AGREEMENT OR UNDERSTANDING VOID OR VOIDABLE IN A SUITE BETWEEN THE CLAIMANT AND THE DEBTOR."

WHEN I APPEARED BEFORE THIS SUBCOMMITTEE IN 1975, I EXPRESSED SOME CONCERN THAT WHILE SUBORDINATED LENDERS IN GENERAL SHOULD BE EXCLUDED FROM SIPC COVERAGE, THERE COULD BE EXCEPTIONAL CASES WHERE WE WOULD WANT TO GRANT A SUBORDINATED LENDER RELIEF. I SUGGESTED THAT PERHAPS SUCH A PERSON COULD BE TREATED AS A CUSTOMER IF SIPC OR THE COURT DETERMINED, IN VIEW OF ALL THE CIRCUMSTANCES OF A PARTICULAR CASE, THAT IT WOULD BE EQUITABLE TO DO SO. I EXPRESSED THE VIEW THAT THIS MIGHT PROVIDE AN AVENUE FOR COVERING SPECIAL CASES WITHOUT OPENING UP SIPC PROTECTION TO THE CLAIMS OF THE MORE COMMON SUBORDINATED LENDERS WHO ARE PARTNERS OR QUASI-INSIDERS OF THE DEBTOR.

AT THE SAME TIME, I RECOGNIZED THAT THE PROVISION PROPOSED BY SIPC DOES NOT DENY THE SUBORDINATED LENDER THE RIGHT TO ATTEMPT TO RESCIND HIS CONTRACT. RATHER, IT MERELY DENIES HIM THE RIGHT TO CUSTOMER STATUS WHICH IS A SPECIAL PRIVILEGE CONGRESS HAS GRANTED TO THE PUBLIC IN THE SIPC ACT AND WHICH NEED NOT BE GIVEN TO ALL PERSONS WHO DEAL WITH THE DEBTOR.

ALTHOUGH I AM LESS CONVINCED THAN I WAS THAT IT IS NECESSARY TO PROVIDE FOR EXCEPTIONAL CASES, I BELIEVE THE SUBCOMMITTEE SHOULD LEAVE FLEXIBILITY IN THE STATUTE AND SHOULD NOT ENACT AN ABSOLUTE PROHIBITION AGAINST SUBORDINATED LENDERS REGAINING CUSTOMER STATUS.

IN CONCLUSION, MR. CHAIRMAN, LET ME REITERATE THE COMMISSION'S STRONG AND CONTINUING SUPPORT FOR THE PROMPT ENACTMENT OF THIS LEGISLATION. I WILL BE HAPPY TO RESPOND TO ANY QUESTIONS THE SUBCOMMITTEE MAY HAVE.

WRITTEN COMMENTS OF THE SECURITIES AND EXCHANGE COMMISSION
ON H.R. 8331, 95TH CONGRESS, FIRST SESSION (1977), SUBMITTED
TO THE SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE OF
THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE OF THE
HOUSE OF REPRESENTATIVES, AUGUST 2, 1977.

The Securities and Exchange Commission wholeheartedly supports H.R. 8331, a bill to amend the Securities Investor Protection Act of 1970 (the "SIPC Act"). The steps taken to increase the scope of customer protection and to limit the time required to satisfy customer claims are clearly in the public interest. We have certain comments on the bill, however.

Substantive Comments on H.R. 8331*

1. In amending Section 3(c)(2)(C)(ii) (H-4) regarding the appointment of SIPC directors, the disqualification of persons associated with any "other securities industry group" from serving as public directors of SIPC was deleted. In addition, it may be useful to modify the provision slightly to reflect the fact that registered clearing agencies are now self-regulatory organizations. There is also a technical error in the manner in which Section 3(a)(21) of the Securities Exchange Act was carried over. Finally, the proposed amendment combined with the existing language refers to "persons who are persons associated" etc.; the repeat is unnecessary. Accordingly, we suggest the following changes: (i) In lines 5 and 6, delete "persons." (ii) In line 6, add "member of a" before "national." (iii) In line 8, after "Act" add "or similarly associated with any self-regulatory organization or other securities industry group,".

2. Proposed Section 3(e)(2) (H-5) provides a rulemaking procedure for SIPC. While the Commission is generally satisfied with the proposed procedure, we have several technical comments principally designed to make the procedure parallel to Section 19(b) of the Securities Exchange Act.

(i) Proposed subparagraph (E) (H-8) sets forth the situations in which a proposed rule change may take effect summarily. Under subparagraph (ii), there may be instances when an emergency rule proposal becomes effective before it is filed with the Commission. In order to clarify that such a rule change, though already in effect, must be filed and reviewed under Section 3(e)(2), we recommend the following sentence be added to subparagraph (ii) (H-8, at line 19):

"Any proposed rule change that takes effect under this subparagraph shall be filed promptly thereafter and reviewed in accordance with the provisions of Section 3(e)(2)(A)."

(ii) Subparagraph (E) also provides that the Commission may abrogate any rule change that becomes effective pursuant to the summary procedure within a sixty-day period that would run from the effective date of the rule change. Because the effective date is not necessarily the date of filing and may in fact be prior to the date of filing, we suggest that the deadline be calculated from the date the rule change is filed as is done in Section 19(b)(3)(C) of the Securities Exchange Act.

* References to the pages of H.R. 8331 are denoted by "H" and the page number.

(iii) Finally, the abrogation procedure provides that the Commission may require the abrogated rule change to be refiled. This provision should be amended to clarify that the refiled rule change would also be subject to review in accordance with the usual procedures of Section 3(e)(2). This can be accomplished by inserting the words "and reviewed" after "refiled" in line 24 of H-8.

3. The proposed amendment to Section 4(e)(1) is intended to apply the prior trust provision to registered clearing agencies (H-11). The proposal is inapposite because clearing agencies were not self-regulatory organizations prior to 1970.

4. Section 4(g), which involves SEC loans to SIPC, as amended by H.R. 8331 (H-12), provides that any transaction fees imposed upon purchasers of equity securities are to be collected by the broker-dealer effecting the transaction "or by such other person as provided by the Commission by rule. . . ." The requirement that the collected fees be paid to SIPC in the same manner as assessments may be inappropriate with respect to other designated persons. Accordingly, we suggest that the phrase "or in such other manner as the Commission may by rule provide" be inserted following "assessments" in line 3 of H-13.

5. The phrase "with respect to such member" in line 8 of H-15 is unnecessary and may restrict the scope of pending Commission actions with which an application for a protective decree may be combined. We recommend deletion of the phrase.

6. Proposed Section 5(b)(2)(B)(iii) (H-18) provides that the court in which an application for a protective decree has been filed may, for an appropriate length of time pending issuance of the decree, stay enforcement of, but may not abrogate, the right of set-off under the Bankruptcy Act and the right to enforce a valid nonpreferential lien against the property of the debtor. The section also provides that the court may continue the stay upon appointment of the trustee but does not place limits on the length of the latter stay. The legislative history of the SIPC Act indicates that the Committee on Interstate and Foreign Commerce intended such a stay to be limited. In House Report 91-1613 which accompanied the SIPC Act in 1970, the Committee stated that the Court could stay these rights only "for an appropriate period of short duration." (at 10). The Subcommittee should be aware that as revised, Section 5(b)(2)(B)(iii) may be viewed by the banking community and others as constituting a substantive change in current law.

7. SIPC has, in administering the current Act, experienced a problem with respect to customers who deal with a broker-dealer after the filing date. Because of the manner in which "filing date" is defined (proposed Section 16(8), H-59), the filing date may relate back to a time days or weeks before the trustee is appointed. Accordingly, some customers may deal with the debtor after the filing date but prior to the appointment of a trustee and thus have claims which arise after the time at which all customers' claims are fixed. Although SIPC has advised us that it has been paying such claims, SIPC would prefer to see the matter clarified.

Proposed Section 6(c) (H-26) provides that if the trustee finds that the customer dealt with the debtor in good faith and prior to the appointment of the trustee, the date on which such action was taken will be deemed to be the filing date for that customer's claim and the customer will be protected. Proposed Section 9(a)(4) (H-42) provides, however, that SIPC is not required to make advances to protect such a customer.

While we understand SIPC's desire to assure that fraudulent claims are not paid, we believe the burden of screening out such claims should be placed on the trustee, subject to the supervision of the court. If the trustee makes a finding of good faith, the claimant should be elevated to the status of all other customers and should be entitled to receive full protection. It would be most inequitable to permit SIPC to veto the court-approved decisions of the trustee in this regard. Accordingly, the Commission strongly recommends, as we did in 1975, that subsection 9(a)(4) be deleted.

8. There is an overlap between proposed Section 6(e) (H-27) and proposed Section 8(c)(1) (H-34). Under Section 6(e), SIPC recoups from the general estate all funds advanced to pay or guarantee bank loans. This repayment has a first priority under the Bankruptcy Act. In addition, pursuant to Section 8(c)(1)(A) (H-35), SIPC has a first priority claim against customer property to recoup advances made to pay bank loans to the extent that such advances recovered securities that were apportioned to customer property. Thus SIPC recovers part of its advances twice. This can be corrected by inserting after "Section 9(c)(1)" in line 19 on H-27, "(to the extent such advances recovered securities which were apportioned to the general estate pursuant to section 6(d))".

9. Proposed Section 7(d)(4) (H-30) requires a trustee to submit to SIPC and others a statement of his investigation of certain matters. To assure that the report is comprehensive, we suggest that "matters referred to in paragraph (1)." be substituted for the enumeration of matters in lines 1-3 on H-31. In addition, we believe the trustee should be required to file a copy of the report with the Commission.

10. In order to reflect otherwise parallel language in the current Act, proposed Section 8(a)(1) (H-31) should be amended by inserting the phrase "at the same time" between "and" and "shall" in line 12 of H-31.

11. Proposed Section 8(c)(3) (H-36), which provides for the trustee's recovery under the Bankruptcy Act of certain transfers, appears to misplace the qualification that the transfer be void or voidable. As written, this condition serves to define what property, recovered from a transfer, should be allocated to customer property rather than what property may be recovered. This may be corrected by moving the phrase that begins in line 18 with "if" and continues through "Bankruptcy Act" in line 20 to the middle of line 17 after "customer property."

12. The saving clause in proposed Section 8(e)(1) (H-37, lines 22-25, and H-38, lines 1-3), which preserves Commission Rule S6d-1 until SIPC adopts rules under the amended Act, might usefully be moved out of what will become the SIPC Act and made a separate section of the legislation itself. This would avoid having in the Act a provision which quickly will become obsolete.

13. Proposed Section 8(e) (H-37) provides for closing out executory contracts of the debtor with other broker-dealers. The other broker-dealer is entitled to make a claim, to be satisfied out of SIPC funds, up to a maximum amount of \$40,000, for each customer account with respect to which such broker-dealer sustains a loss in closing out contracts with the debtor.

If the claiming broker-dealer closes out an executory contract that was entered into on behalf of an associated person of that broker-dealer, it may not consider any loss on the transaction for purposes of its claim against SIPC because, under subsection (e)(4), an associated or controlling person of the broker-dealer is not deemed a customer. This should be contrasted with proposed Section 9(a)(6) (H-43) and the equivalent section of the current Act, Section 6(f)(1)(D) (p. 16 of the current Act). Those sections provide that where a broker has deposited funds or securities with the debtor on behalf of customers, 1/ each such customer is deemed to be a separate customer of the debtor. Under Section 9(a)(6) (and Section 6(f)(1)(D) of the current Act), associated and controlling persons of a broker-dealer other than the debtor are protected like all other customers.

An anomalous situation has thus been created in that where a broker-dealer has a claim for property left with a debtor on behalf of an associated or controlling person, the associated or controlling person is deemed a customer of the debtor, but where the broker-dealer suffers a loss closing transactions on behalf of an associated person, that person is not deemed a customer. We believe that associated persons of other broker-dealers should be treated as any other customer for purposes of both Sections 8(e)(4) and 9(a)(6) in the absence of any evidence of culpable behavior by those persons. Accordingly, we suggest that subparagraph (C) of proposed Section 8(e)(4) (H-40) be amended as follows (deletions in brackets):

"(C) had a relationship of the kind specified in subsection 9(a)(5) with [either] the debtor [or the claiming broker or dealer]."

14. Section 8(e)(3) (H-39) prohibits both a clearing corporation which has established a procedure for the closing out of open contracts between an insolvent broker-dealer and its participants, and the participants themselves, from receiving SIPC funds in payment of any losses on such contracts. The provision was recommended in 1974 by the SIPC Task Force and, at that time, represented the consensus view of the industry members, SIPC and the Commission. There have been significant changes since then, however. Clearing agencies are now subject to registration under the Securities Exchange Act, and are self-regulatory organizations charged with a quasi-public responsibility. Moreover, the Commission is directed under the Securities Exchange Act to assure, among other things, that registered clearing agencies are able to facilitate the prompt and accurate clearance and settlement of securities transactions. In view of these developments, we believe the Act should provide the flexibility to extend SIPC protection to clearing agencies and their participants if that proves desirable. Accordingly, we propose the following revisions of Section 8(e)(3):

(i) In line 13 after "contracts" add ", except as SIPC may otherwise provide by rule."; and

(ii) In line 19 after "trustee." add "Rules adopted by SIPC under this paragraph shall provide that in no case may a registered agency or its participants, to the extent such participants' claims are or may be processed within the clearing agency, be entitled to receive funds advanced by SIPC in an amount greater, in the aggregate, than could be received by the participants if such participants proceeded individually under Sections 8(e)(1) and 8(e)(2)."

1/ Generally, this would occur where the claiming broker-dealer has an omnibus account with the debtor.

15. Proposed Section 10 (H-44) creates a direct payment procedure that SIPC may use in lieu of instituting a liquidation proceeding with respect to a member of SIPC. Various aspects of the proposed procedure parallel those of the liquidation provisions of the Act, but the new procedure applies to "members" rather than "debtors" and the payment of customer claims is effected by SIPC rather than a court-appointed trustee. The direct payment procedure is not self-contained in Section 10, however, and, to implement this alternative method of satisfying claims, SIPC must rely on other provisions, such as Sections 16(3) and 16(11) which define "customer" and "net equity" respectively, Section 8(d) setting forth requirements for the purchase of securities, and Section 9(a) limiting the protection available to each customer. Because those sections refer to the "debtor" and "trustee," they are, on their face, inapplicable to the direct payment procedure. In order to accommodate such provisions to direct payment

procedures, we recommend that: (i) the definition of debtor in Section 16(6) (H-58) be amended to include a member with respect to whom a direct payment procedure has been instituted under Section 10(b); (ii) a new Section 10(g) be added as follows:

"For purposes of implementing this section, any reference to the 'trustee' in other applicable sections of the Act, including but not limited to sections 7(b)(1), 8(d), 8(f), 9(a), 16(3) and 16(11), shall be deemed a reference to SIPC and any reference to the date of publication of notice under section 8(a) shall be deemed a reference to the publication of notice under this section.";

(iii) the parenthetical material on H-46, lines 20-23 be conformed by placing a period and closing parenthesis after "section 9(a)" in line 21 and deleting the rest of the phrase; and (iv) Section 14(c)(2) (H-54) be deleted and Section 14(c)(1) (H-53) be renumbered Section 14(c).

16. Proposed Section 10(b) (H-45) requires customer claims in a direct payment procedure to be "filed" as well as "received" within a six month period in order to be entitled to protection. Section 8 on liquidations requires only that the claim be "received." We recommend deletion of the words "filed and" from line 10 on H-46.

17. The bill at H-49 proposes to repeal Section 7(d), page 18 of the current Act. Section 7(d) amends Section 15(c)(3) of the Securities Exchange Act of 1934, which empowers the Commission to establish financial responsibility standards for broker-dealers. The proposed deletion would appear to have the effect of repealing the amendments to Section 15(c)(3) enacted in 1970. Confusion may have arisen because of the addition of a definition of the term "financial responsibility rules" (H-64). Both the definition and Section 7(d) of the current Act should be retained.

18. Proposed Section 13(a) (H-49) designates the collection agents to whom SIPC members remit assessments. The proposed section is ambiguous with respect to the role of a registered clearing agency which, under the Securities Exchange Act is a self-regulatory organization. Proposed Section 13(a) states that the self-regulatory organization that is the examining authority for a SIPC member shall act as the member's collection agent unless, where the member is a member of or participant in more than one self-regulatory organizations, SIPC designates another self-regulatory organization.

When a registered clearing agency is the only self-regulatory organization in which a member is a participant, it often will not be the examining authority because Section 13(c)(1) (H-50) provides in that case that the Commission may designate itself as examining authority. We believe clearing agencies should act as collection agents if SIPC chooses to so designate them. Accordingly, we propose the following sentence be inserted at H-50, line 7 after the period:

"If the only self-regulatory organization of which a member of SIPC is a member or in which it is a participant is a registered clearing agency that is not the examining authority for the member, SIPC may, nevertheless, designate such clearing agency as collection agent for the member or may require that payments be made directly to SIPC."

19. Proposed Section 13(c) (H-50) discusses the allocation of inspection responsibility over SIPC members for compliance with applicable financial responsibility rules. The Securities Acts Amendments of 1975 amended Section 9(c) of the SIPC Act (predecessor of proposed Section 13(c)) to authorize the Commission, rather than SIPC, pursuant to Section 17(d) of the 1934 Act, to designate the examining authority when a member of SIPC is a member of more than one self-regulatory organization. In transposing the language, H.R. 8331 deleted the reference in current Section 9(c) to Section 17(d) of the Securities Exchange Act. The phrase ",pursuant to Section 17(d) of the 1934 Act," should be added in H-51, line 4, after "Commission."

20. If Section 10(a) of the current Act is amended by replacing "he" with "it" (H-51), the Subcommittee should assure that conforming changes, if needed, are made elsewhere in the Act.

21. H.R. 8331 revises Section 10(c), redesignated as Section 14(c) (H-52), which enumerates certain criminal acts. We have redrafted and renumbered the proposed language. In addition, we have prepared two new sections. Subparagraphs (1)(A) and (1)(B) of the proposed revision add general fraud language to cover violations not included in the enumeration of specific activities in subparagraphs (1)(C) and (2). The latter have been revised to make them clearer and to impose what we believe to be an appropriate standard of accountability throughout the section. Our suggested version of Section 14(c) ^{2/} is as follows:

"(c) Concealment of Assets; False Statements or Claims. --

"(1) Specific Prohibited Acts -- Any person who, directly or indirectly, in connection with or in contemplation of any liquidation proceeding or direct payment procedure --

(A) employs any device, scheme, or artifice to defraud; or

(B) engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person; or

^{2/} You will note in paragraph 15(iv) above that we recommend deletion of Section 14(c)(2).

(C) fraudulently or with intent to defeat this Act --

(i) conceals or transfers any property belonging to the estate of a debtor; or

(ii) makes a false statement or account; or

(iii) presents or uses any false claim for proof against the estate of a debtor; or

(iv) receives any material amount of property from a debtor; or

(v) gives, offers, receives, transfers or obtains any money or property, remuneration, compensation, reward, advantage, other consideration, or promise thereof, for acting or forebearing to act; or

(vi) conceals, destroys, mutilates, falsifies, makes a false entry in, or otherwise falsifies any document affecting or relating to the property or affairs of a debtor; or

(vii) withholds from any person entitled to its possession, any document affecting or relating to the property or affairs of a debtor --

shall be fined not more than \$5,000 or imprisoned for not more than five years, or both.

"(2) Any person who, directly or indirectly steals, embezzles, or fraudulently, or with intent to defeat this Act, abstracts, or converts to his own use or to the use of another, any of the moneys, securities, or other assets of SIPC, or otherwise defrauds or attempts to defraud SIPC or a trustee by any means, shall be fined not more than \$5,000 or imprisoned not more than five years, or both."

22. Proposed Section 16(3) (H-56), amending the definition of "customer," would eliminate clause (VI) of Section 6(c)(2)(A)(ii) of the current Act which could be construed as providing SIPC protection to persons who lend their securities to brokers. Although the amended provision does not address stock loans, SIPC has indicated that lenders would not be protected if they receive either collateral or consideration for their loans, but would be protected if they do not receive collateral or consideration.

It is the Commission's understanding that, under current industry practice, lending of securities is primarily an institutional business. Institutions lend securities in order to add leverage to their portfolios, and they recognize and are capable of accepting the associated business risk. On the other hand, brokers might borrow from individual investors who would not realize that by entering into such arrangements they would lose SIPC coverage.

The Commission does not object to the change, but we believe that what SIPC proposes to do should be made clear in the legislative history. Moreover, if the proposed change is made, the Commission will consider providing, by rule, additional protections for retail customers who lend securities to their brokers.

23. The exclusion of subordinated lenders of securities from the proposed definition of "customer" (Section 16(3), H-56) does not prevent subordinated lenders from seeking rescission but rather merely denies to them customer status. If some ground for the lender to seek rescission exists, the exclusion provision does not remove or modify that ground. The proposed "notwithstanding" clause (H-57, line 1) however, implies that the right of rescission is affected by the exclusion of the lender from customer status in that it refers to grounds that "might have existed." Since the exclusion does not derogate a subordinated lender's right to seek rescission, we recommend that the provision be clarified by substituting "exists" for "might have existed" in line 2.

24. We question whether, in the definition of "customer property" (Section 16(5), H-57), the explicit reference in paragraph (B) to Rule 15c3-3 under the 1934 Act and its reserve requirement formula is useful. The Subcommittee may wish to consider the following more general language as a substitute for paragraph (B) (H-58):

"resources provided through the use or realization of customers' debit cash balance and other customer-related debit items as defined by the Commission by rule;"

25. In Section 16(8)(C) (H-59) there is an unintended ambiguity in the definition of "filing date" in relation to the direct payment procedure. We believe it would be better phrased, "(C) if the debtor is the subject of a direct payment procedure, or has been the subject of a direct payment procedure discontinued by SIPC pursuant to section 10(f),"

26. Various provisions of the current Act have spent their force. The Subcommittee may wish to consider whether such provisions need to remain in the Act or whether they should be repealed.

TECHNICAL COMMENTS

<u>Page</u>	<u>Line</u>	<u>Comment</u>
3	12	Strike "and not opposed to" as redundant with "consistent with" (line 11).
4	18-19	Strike "After the date of the enactment of this paragraph," as superfluous, and capitalize "t" in "the".
5	23	Strike "After the date of enactment of this paragraph," as superfluous, and capitalize "t" in "the".

<u>Page</u>	<u>Line</u>	<u>Comment</u>
7	9	Strike "and".
--	20-21	"proposal" should read "proposed".
--	25	Strike "prescribed" and insert "promulgated".
12	7	Strike "4(f)" and replace with "4(g)".
14	14	Strike "and".
--	19	"exist" is misspelled.
20	15-16	Strike "appointed under paragraph (3)".
21	4	Strike "holding".
--	9	Strike "an application with the court" and replace with "with the court an application".
--	14	Strike "holding" as redundant.
32	1	"beneficial" is misspelled.
33	11	Strike "(a)(1)" and replace with "(a)(2)".
39	4	"participate" is misspelled.
--	6, 6-7, 11 and 13	Strike "clearing corporations"; replace with "registered clearing agencies".
44	22	Strike "and".
46	17	Strike "of each" and insert "to each" in lieu thereof.
47	3	"An" should read "Any".
49	5	Strike "SECURITIES AND EXCHANGE".
--	9	Strike "3(e)(4)" and insert "3(e)(3)".
50	6	Insert "or participant in" before "more".
--	10	Insert "or participants in" at the end of the line following "members of".
--	11-12	Strike "of assessments due" as superfluous.
51	16	Insert "of" after "members".
51	17	Strike "of" and insert "in".
55	16	Strike "(i)" and replace with "(g)".
57	23	Strike "only" as redundant.
61	17	Strike "law" and insert "bylaw".
62	24	Strike "(5)(b)(3)" and insert "5(a)(3)".
63	6	Insert comma after "subscription".

Page 2, Section 2 of the current SIPC Act: Strike "was" and replace with "were".

We note that in several places the Subcommittee has deleted "or regulations" from the phrase "rules or regulations". If the Subcommittee wishes to make this change uniformly, there are a number of other places in both the bill and the current SIPC Act where conforming changes should be made.

It has been suggested to the Commission that the term "referee in bankruptcy" is no longer the term of art and should be replaced with "bankruptcy judge." If this is so, appropriate changes should be made on page 19, line 24; page 20, lines 2-3, 4, 7 and 25; and page 21, lines 1-2 and 3.

Mr. METCALFE. Thank you, Commissioner Loomis.

You suggest that we work with SIPC to develop an assessment plan for mutual funds and variable annuities which is related to risk and to loss experience. You have also stated you believe such a plan could be developed without amending the act's assessment provision.

This appears to imply that as a practical matter you don't believe variable annuities should be assessed at all, nor unit investment trusts. You also suggested there should be a minimum assessment of mutual funds.

However, Chairman Owens yesterday expressed his opinion on these assessments, that they are less related to risk and are more of a cost of doing business, in which members benefit from increased investor confidence.

Do you think that firms in the securities industry should be required to pay a SIPC assessment as a cost of doing business?

Mr. LOOMIS. I would think that they should be required to pay at least a modest assessment as a cost of doing business, simply in view of the fact that the existence of SIPC benefits the whole industry.

On the other hand, I can see merit in the idea that the mutual fund people have that they should not be assessed at the same rates as other broker dealers who create far greater risk, for SIPC.

But as I pointed out in my testimony, now that SIPC is going to go over the top on \$150 million, it is possible under the provisions of existing law, which are not being changed, for SIPC to vary assessments to take account of the lower amount of risk.

Of course, if SIPC should fall on hard times, and go below \$150 million, maybe the assessments would have to be raised. But in that condition, perhaps the whole securities industry would have an obligation.

I understand there is some question as to how one judges risks. On the other hand, I don't think that is insuperably difficult. Insurance companies fix premiums in relation to the risks of the situation very frequently; so do banks in making loans. I think it is possible.

Mr. METCALFE. Thank you. Commissioner, wouldn't any assessment of money market instruments be more of a cost of doing business than an assessment related to risk?

Mr. LOOMIS. I would think that that probably would be so. There is not a great deal of risk in those instruments.

The problem with them, as I understand it, is the amounts are very large, they turn over very rapidly, and that some people, broker dealers, who deal in these instruments on a very large scale—there are a few broker dealers who do—are concerned that they may be coming to pay very large SIPC assessments on the existing overall gross revenue standard when there is very little risk in these instruments.

Again, that is a thing which I think can be dealt with through revising the assessment structure.

Mr. METCALFE. Commissioner, we share your concern over some of the unforeseen consequences of proposed section 4(I). In light of some of the thornier aspects of this section, we would like to determine the view of SEC. Do you think that either a foreign

subsidiary of SIPC members, or an unregistered affiliate should be assessed for its foreign transaction?

Mr. LOOMIS. I think that we are disposed to feel that that provision requires modification. I don't have anything with me today, so to speak, to do that. If I may, I will ask Mr. Millstone to respond further.

Mr. MILLSTONE. In regard to the foreign affiliates, there is one question which I think deserves serious consideration. The question has been raised from time to time whether customers of a foreign affiliate or subsidiary of a broker dealer might step forward in the event of that broker dealer's liquidation and seek SIPC protection.

I think that the concern over whether such persons would be protected should be a factor in the subcommittee's consideration of the provision. But as we suggested in our testimony, overall we believe that the provision requires further study before a determination can be made as to how it might be limited.

Mr. METCALFE. Thank you.

Back to you, Commissioner Loomis.

In your statement you express a concern which is shared by SIPC; namely, the increase of protection for securities in customer accounts without a parallel increase in protection for cash.

However, yesterday Gordon Macklin testified in response to a question that he had no knowledge whatsoever of customer reluctance to sell a large block of securities because of the \$20,000 limit.

Do you have any factual evidence which NASD lacks to support your concern?

Mr. LOOMIS. As I attempted to indicate, I don't know of any case where a customer has refused or declined to sell a security because of the lack of SIPC protection. I think it is probably unlikely that that particular thing would occur.

Our feeling rather is that the cash limitation should be raised in order to provide more general protection for those investors who for some reason or other have cash with broker dealers, and in effect to promote investor confidence by making it fairly clear on the face of the bill that almost all ordinary customers will be fully protected.

Mr. METCALFE. We are interested in your remarks on section 2, having to do with foreign subsidiaries. The bill contains what appears to be an unintended substantive amendment resulting from a textual change in the language.

Your statement suggests that under the language of this bill, all broker dealers who are engaged in foreign business are initially SIPC members, to be excluded by a SIPC rule if their principal place of business is outside of the United States.

This would, among other things, confer special authority upon SIPC to exclude firms from membership. If the language were changed to exclude initially all foreign subsidiaries to be included by SIPC by bylaw, would the SEC take a different position on this issue?

Mr. LOOMIS. As I understand it, you are suggesting that instead of these people being included, except when SIPC excludes them, it be turned around to exclude them unless SIPC includes them—it seems to me that would be a reasonable suggestion.

The real problem either way is to identify who these people are, and to arrive at a decision relevant to the facts of the situation as to where they should be.

Mr. METCALFE. Thank you.

I recognize the gentleman from North Carolina.

Mr. BROYHILL. Thank you, Mr. Chairman.

Mr. Loomis, of course overall the SIPC program I think has worked well. As you pointed out, the record speaks for itself. The fact that some \$277 million in property has been returned to 100,000 customers, and also advancing some \$57 million from the SIPC fund to these customers.

I think operation of the SIPC program has done much to shore up confidence in the securities market among investors.

Of course, as you pointed out, the SIPC program has been designed to cover potential exposure to loss, and that it should not be a financial burden on any one segment of member firms.

Now, as I understand it, the mutual fund dealers who will be brought under the purview of this act, and will be required to pay assessments, rarely hold customer funds or securities, and that the big exposure to potential loss are those firms who hold securities for the benefit of their customer.

I realize the arguments that have been advanced here; that is, that some losses have occurred. We heard testimony yesterday that the losses for the entire period are less than \$200,000, yet the SIPC is contemplating assessing these member firms in the area of \$1½ million to \$2 million per year, which if you multiplied that out by the number of years the program has been in existence, the fees would be many, many times the losses.

Now, you have indicated the moneys have been lost, funds have been lost by dealers who have not been covered. Can you give us some idea of the magnitude of these losses?

Mr. LOOMIS. I know of the case down in Tennessee, which is mentioned in our statement, which we are presently investigating where it appears that customers will lose something over \$200,000 and they will not be covered at all because this is an exclusive mutual fund dealer.

We are investigating. We don't know how this happened. It probably happened by reason of misconduct.

The problem here is that although it is true that there have been very modest losses from mutual fund dealers, and there shouldn't be any risk if the dealer conducts himself properly, sometimes he doesn't. We think it important that investors have protection in this situation.

We also recognize the merits of the argument of the mutual fund people that the assessments under the present schedule are very disproportionate to the risks.

But we think that once the fund gets over the \$150 million mark, it will be possible for SIPC, under Commission supervision, to adjust the assessments to correspond more nearly to the low risks in that business, while at the same time having the municipal fund dealers be members of SIPC and pay some money, partly as a cost of doing business, which reflects the fact that they are in the securities business, and SIPC is an asset of the securities business.

But the assessments that they would pay under the present schedule are in my judgment too high.

Mr. BROYHILL. Let me get back to the central point of the question. Does the Commission have any factual information that they could furnish to the subcommittee as to the losses that may have occurred in other cases other than the Tennessee case, in order to determine in some way the manitude of this problem?

Mr. LOOMIS. We will furnish whatever we have on that.

Mr. BROYHILL. I assume there is no way to look into the future——

Mr. LOOMIS. That is true.

Mr. BROYHILL [continuing]. To try to determine what the potential loss is in the future. You don't have any actuarial people for this sort of thing.

Mr. LOOMIS. It is sort of difficult to determine actuarially because in the mutual fund dealer area there are not apt to be losses unless the broker dealer is either incompetent or dishonest.

Mr. BROYHILL. That brings me to a question I want to ask. What sort of regulatory tools do you have to check on these broker dealers?

Mr. LOOMIS. Well, they are, of course, subject to our jurisdiction as well as that of the NASD. They are inspected. They have to file reports with the Commission and with the NASD. There are a great many of them. Most of them give no problem whatsoever. But, it is difficult by regulation to prevent a person who is bent upon stealing from doing it.

Mr. BROYHILL. To move to another point, you have expressed some opinion on what to do about the subordinated loan. I am not sure what you are suggesting.

Mr. LOOMIS. The bill would provide that a subordinated lender is never entitled to SIPC protection. That, I think, certainly should be the general rule and it is under existing law. A subordinated loan is generally a contribution to capital of the brokerage firm, or an investment by a sophisticated person who wishes to invest in the brokerage firm rather than being a customer. Consequently, he should be out at least 99 percent of the time.

Mr. BROYHILL. You mentioned some exceptional cases of——

Mr. LOOMIS. The only exception—this is not a matter about which I feel strongly. If the subcommittee feels there should be no exception, we could accept that. We really have no great problem with it.

But we suggest that SIPC might be given authority in an extraordinary case, where it found that the subordinated relationship was entered into, in effect, fraudulently, to take advantage of an unsophisticated investor who didn't recognize the difference between being a subordinated lender and just having an account with a broker dealer—maybe SIPC should be entitled to protect him if it concluded that that was just.

Mr. BROYHILL. I recall some of these discussions in prior years, as we have discussed, not only the formulation of this legislation, but in the intervening years. I don't feel that a subordinated lender, a bank, for example——

Mr. LOOMIS. They certainly should not be protected.

Mr. BROYHILL [continuing]. Should be given SIPC coverage. But you mentioned exceptional cases, and I was curious as to what kind of exceptional cases you are talking about. The only kind of cases that would occur to me would seem to me to be those where fraud is involved.

Mr. LOOMIS. I think that is probably the kind of case—certainly the only kind of cases where we would think that there should be coverage is where there is fraud involved, where the broker dealer goes to a widow and says, "I have got a nice secure investment for you here, just sign here and I will pay you 8 percent interest, and you will be protected by SIPC."

Mr. BROYHILL. You have called to the attention of the subcommittee your views on the limitations of coverage, and have pointed out, of course, that the task force had recommended a limitation of \$100,000 for each customer account, with a limitation of \$40,000 on claims for cash.

You mentioned, as I recall, that perhaps the subcommittee made some determination on this. I want to assure you that because of my involvement in another committee, and because of the involvement with this energy bill and many other bills that are up here, I have not had time to look into this, and to my knowledge no one has polled me or any other member of the subcommittee on this subject.

I don't think the subcommittee has made any determination on this particular point.

Mr. LOOMIS. I am glad to hear that.

Mr. BROYHILL. I would like to get into just a question or two about the comments on the rulemaking procedure.

Perhaps the best thing to do, rather than take the time right now, is to ask if you would submit to me, and for the record, and to the members of the subcommittee, a memorandum in which you express in more detail whatever concerns you may have with the rulemaking procedures that are outlined in this bill and, in addition, if you could furnish us with some further comments concerning your comments that you are having some bad experience—put it that way—in administering section 19(b).

Inasmuch as I have had some experience in trying to devise some of the rulemaking procedures in the past, I would like to work with you and your staff in trying to work these problems out.

Mr. LOOMIS. Yes. This is really not primarily related to the SIPC legislation, but what one might call a potentially larger problem. Section 19 of the Securities Exchange Act provides tight deadlines within which the Commission is supposed to act on rulemaking by the self-regulatory bodies.

So far it has been very difficult on some occasions for us to stay within those deadlines. We have had to get extensions by consent from the organization fairly frequently. We don't ask for any legislative change now, but we want to review that.

Mr. BROYHILL. I understand we will not be acting on this at this time, but I would like to be kept informed.

Mr. LOOMIS. We certainly would like to keep you informed about it. It is a significant problem. We appreciate your interest, but it is not an emergency.

Mr. BROYHILL. Thank you, Mr. Chairman.

Mr. METCALFE. Thank you, Mr. Broyhill.

Staff member, Mr. Oppen, has some questions.

Mr. OPPEN. Mr. Loomis, I noted your statement avoided any discussion of one of the issues which has created some controversy in this bill; that is, the provision which would permit SIPC to mandate advertising of the SIPC logo.

Perhaps the Commission doesn't take a position on this particular issue, but we would appreciate it, if you could discuss with us the various problems involved in permitting SIPC to mandate such advertising.

Mr. LOOMIS. I discussed that primarily in response to questions the last time when I appeared before the subcommittee on the SIPC act in 1975. At that time, SIPC was very anxious to require all of its members to post the SIPC logo on the theory that banks are required, as I understand it, to post the fact that they are members of the FDIC, and SIPC felt this would contribute to investor confidence, that everybody who went into a brokerage firm would see the SIPC logo on the wall and feel happy about it. I think that probably is true in most cases.

On the other hand, several broker dealers of high standing in the community complained to us at that time that they did not want to put that logo on the wall because it might give the impression that they were providing for the contingency of going bankrupt, and they wanted to make it clear that they didn't want to say that, or give that impression, because they did not feel their customers should think they were worried about that.

I, at that time, took what one might call a free enterprise position, that these people should not be required to do this if they did not want to, and that most SIPC members would want to, and that the minority who didn't probably wouldn't do much harm if they didn't.

I am still personally inclined to that view. The Commission itself, as you suggest, has not, in connection with this bill, taken an official position on the point. On the other hand, I believe that under the bill as it stands there is not a mandate that this be done.

SIPC would do it by rulemaking. We could review the rulemaking, and if we felt some exceptions were wise—and I don't know whether we would so conclude or not—we could provide them.

Mr. OPPEN. Thank you.

Mr. MILLSTONE. Mr. Oppen, could I add one small point. It is just a technical point, but I would like to note that the Commission's determination to deny SIPC's rulemaking on mandatory advertising was made on the grounds that the statute as currently written does not provide SIPC with that authority.

Mr. OPPEN. We recognize that.

Mr. LOOMIS, the ICI in its submission has urged again that the Commission with respect to the question of losses on mutual funds and variable annuities, and the question of including underwriters of investment company issues within the provisions of SIPC, should consider instead the possible fidelity bond coverage for these firms which they feel would, in effect, obviate the problem.

They point to the fact that they had conducted a survey of all those investors who had lost mutual fund shares in SIPC liquida-

tions. The universal response they received was this was a result of misappropriation or fraud.

Under these circumstances, do you think the problem could be better resolved by mandating more adequate fidelity bond coverage?

Mr. LOOMIS. If you are attempting to deal with the losses from fraud, that is an alternative. There are certain problems with it.

In the first place, a number of these mutual fund dealers are small firms, sole proprietors, and so forth; one- or two-man partnerships. It is my understanding that such organizations would have trouble obtaining an adequate fidelity bond.

In addition, if they are going to have to pay some money to somebody anyhow, maybe it is just as well that SIPC be there, in view of the general value of SIPC to the security industry.

Mr. OPPER. In the case that you adverted to in Tennessee, where there appear to have been substantial losses in mutual funds, do you know whether or not there was fidelity bond coverage.

Mr. LOOMIS. We do not know at this time.

Mr. OPPER. In connection with your suggestion with respect to subordination, that there be room for exceptions, would you suggest that this authority be given to SIPC to make exceptions, or perhaps to the SEC or the courts?

Mr. LOOMIS. I would suggest that SIPC probably have that authority in the first instance, perhaps subject to review by the Commission.

Mr. OPPER. Thank you.

Mr. DARROW. I have one brief question.

In the submission that accompanies your testimony, you make a recommendation for new language concerning the criminalization of certain fraudulent acts of people involved in liquidations, people who are officers, directors, or employees of a debtor. This would be section 14(c).

I have one question.

In the bill as it is currently written, the language repeats the phrase—knowingly and fraudulently—before each act, whether it was concealing things from SIPC, making false statements or presenting false claims, and so on. Instead, the SEC has recommended language which seems to dilute the standard of scienter in certain respects, and also perhaps more materially reduces the proposed fine from \$50,000 to \$5,000.

Now perhaps that is a misunderstanding. If that is not a misunderstanding, I cannot think of a better way to encourage people to engage in fraudulent conduct than reduce a fine tenfold.

Mr. LOOMIS. Mr. Millstone tells me that is a typographical error.

Mr. DARROW. Typographical error aside, the language nevertheless does suggest a considerably weaker standard for the criminalization of these acts. Specifically it says:

"Any person who, directly or indirectly, in connection with or in contemplation of any liquidation proceeding or direct payment procedure—

"(A) employs any device, scheme, or artifice to defraud; or

"(B) engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person;"

language which tracks, almost, the language in the antifraud provisions of the securities laws.

Mr. LOOMIS. Surely.

Mr. DARROW. Does that action by the commission contemplate the accomplishment of standard of scienter similar to that established by the Supreme Court in *Hochfelder* or do you have something else in mind?

Mr. LOOMIS. Well, I do not believe that *Hochfelder* applies generally except to private action for damages.

Mr. DARROW. That is what I thought.

Mr. LOOMIS. Since this is not a private action for damages, I do not think *Hochfelder* should apply to it.

Mr. DARROW. That is what I thought. In the absence of that kind of interpretational assistance from case law, it should be of some concern and we will obviously be reviewing this in the final drafting to insure that people who work with or are associated with broker-dealers are held to a sufficiently stringent standard for criminal acts.

Mr. LOOMIS. I am not quite clear. Do you think that this is too broad or too narrow?

Mr. DARROW. I think that, rather than being too broad or too narrow, it may cut both ways. I think it may prevent or it may make difficult the prosecution of certain individuals for failure to adequately define exactly what kind of mens rea, what kind of criminal intent is required as an element or a prerequisite for conviction.

Mr. LOOMIS. I think this type of language has been the subject of a number of successful criminal prosecutions in other contexts.

Frankly, I would rather worry about trying to redefine the exact state of mind that justifies a criminal prosecution in this particular context because that is a major question of criminal law that goes across the board. I do not know whether I could devise an improved formula for it.

Mr. DARROW. All right. We will simply take it under advisement or recommendation.

Thank you.

Mr. METCALFE. Thank you very much, Commissioner Loomis, and also Mr. Millstone, for your very fine testimony.

Mr. LOOMIS. Thank you, Mr. Chairman.

Mr. METCALFE. Next we will have a panel consisting of Mr. Paul Mason, American Council of Life Insurance; Mr. David Silver, President of the Investment Company Institute, and Mr. Roger Klein, Executive Director of Public Securities Association.

Would you please come to the table?

Originally we had planned for each one of the panelists to make a presentation individually but, because of the restraint of time, we felt it would be better to have a panel and therefore it would give you more opportunities to summarize your statements that you will present to us. So we will start off with Mr. Mason.

STATEMENTS OF PAUL J. MASON, CHIEF COUNSEL, SECURITIES, AMERICAN COUNCIL OF LIFE INSURANCE; DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE, ACCOMPANIED BY MATTHEW FINK, GENERAL COUNSEL; AND ROGER KLEIN, EXECUTIVE DIRECTOR, PUBLIC SECURITIES ASSOCIATION

Mr. MASON. I will limit my comments, Mr. Chairman, members of the subcommittee, to the situation with respect to the proposal involving variable annuities.

Mr. Silver, as president of the Investment Company Institute, will be addressing his remarks to the recommendation involving mutual funds.

In terms of your time pressure, I think I will probably say in advance that, having read Mr. Silver's statement, I concur in the views expressed by the institute with respect to mutual funds.

I would hope that the recommendation with respect to the deletion from the present exemption with respect to variable annuities might be a typographical error similar to that we just heard about in connection with another instance. I suspect that is not the case. I am equally surprised by the testimony given today by Mr. Loomis on behalf of the Commission.

You will recall that in 1975 when the Commission testified with respect to the present situation, the situation regarding exemptions for sellers of mutual funds or variable annuities, that they did not take a position with respect to the elimination of the exemption, just as perhaps they have not taken a position today with regard to advertising. So one should look, or should have a right to look, to the statement to find adequate evidence that something has transpired since 1975 that would justify a significant shift in the Commission's view. I find that absent in the Commission's written statement, as well as in the testimony of Commissioner Loomis.

The one example we heard of, there was some further elaboration in response to a question from Congressman Broyhill with regard to a situation existing in Tennessee about which we do not have further information. Since I indicated I am limiting my comments to variable annuities, more specifically the statement delivered yesterday by Chairman Owens of SIPC says that with respect to variable annuities we have not experienced losses to date. So that not only covers the 1970 to 1975 period, but the 1975 to 1977 period as well.

So we find no justification in either the written statement of the Commission or in the statement of SIPC itself which would justify the denial of this exemption. Our lengthier written statement, submitted to you Friday, does describe in some detail the nature of the variable annuity contract. We hope it justifies and explains the fact that these are individual contracts that are not negotiable or fungible, cannot be held in a street name and, in short, these contracts are not and cannot be held by broker-dealers for use in their own operations. Because they cannot be held in street name or bought on margin, cannot be held by these broker-dealers, we feel that the very basic exemption granted to us when SIPC was originally enacted should remain intact.

I would like to discuss briefly two other items which appear—two new items which appear in our statement as well as in the bill that was introduced. In particular, section 6(g) and 15, I do not think adequate attention was paid to it yesterday.

If you will turn to paragraph 14 on page 63 of the bill, this would give to SIPC rulemaking authority to include within the term security any contract that SIPC determines is within the purposes and policies of the act.

Concomitantly SIPC would have authority under paragraph (L) on page 61 to provide by law what fees and income in the securities business are part of the gross revenues and subject to change.

We think such rulemaking authority is unprecedented, not even being possessed by the SEC. The vestment of such authority in SIPC in our view is really unrelated to the functions for which SIPC is created and to the concerns of the act. Moreover, this authority might cloud innumerable commercial transactions and throw into confusion fundamental concepts of the Federal securities laws.

To illustrate, under proposed section 15 SIPC would become the arbiter of whether contract funding pension plans, including insurance policies, are investment contracts or participations in a profit-sharing agreement, and then include them, by rule, in the term security. Thereafter, and under the broad definition of consolidated group, in proposed section 6(g) of the bill, any broker selling such contracts or utilizing them in pension planning would have the revenues derived from pension operations subject to SIPC's assessments. Indeed, any pension manager affiliated with a broker-dealer might find the assets it manages subject to a SIPC assessment.

In this connection, under paragraphs (C), (D), and (I) section 16, as amended by section 15, the gains earned by an investment or trading account would be subject to SIPC's charge.

Under this definition any portfolio of securities, including those portfolios held by a pension fund, insurance company, or a mutual fund which realizes net earnings, could be charged by SIPC to the detriment of millions of people who are actually beneficiaries of those accounts, and who have no connection with any broker-dealer business.

I have kept this brief, but we do believe it demonstrates that the proposed definition of consolidated group and the expanded definitional paragraphs would have a tremendous impact on the financial community, and indeed go far beyond the intent or function of the SIPC Act. The history of the act and its administration offers no support for the proposition that such drastic measures are either necessary or wise.

Finally, again keeping in mind your time pressures this morning, Commissioner Loomis has suggested in his statement that there be developed by SIPC—by the SIPC board—which I might add is in large measure, I would not say dominated but certainly the significant representation is member firms of the exchange, a fee or assessment schedule based on some sort of a risk or a loss factor.

Number one, there is no risk factor as far as we are concerned in the variable annuity context. There has been no loss demonstrated, either with respect to SIPC members or, on the other hand, by any broker-dealers registered with the Commission selling variable an-

nuities exclusively that are not members of SIPC. So there is no evidence here.

In any event, this risk or loss factor which would be a total zero as demonstrated by the evidence in the case of variable annuities—yesterday there was a question, to Chairman Owen specifically, as to how they might develop a risk or a loss factor in that context.

Chairman Owens, to the best of my recollection, I do not have the transcript in front of me obviously, the question went to the sophistication capability or capacity. Chairman Owens I think quite honestly answered that he did not think that SIPC had the sophistication capacity to develop a fee or assessment schedule based on that type of a risk or loss situation. That comment was not limited to variable annuities, I believe it included mutual funds as well.

In conclusion, we do not feel that there is any justification for removing the exemption with respect to variable annuities.

Number two, we think the expanded definition of security will create unnecessary problems and exceed the authority the Congress had in mind in developing the SIPC corporation.

Lastly, the definitions and factors related to the consolidated group are troublesome, as spelled out in our statement.

I thank you.

Mr. METCALFE. Thank you, Mr. Mason.

Mr. MASON. Mr. Chairman, may the statement of Mr. Googins be made a part of the record?

Mr. METCALFE. Without objection it will be made a part of the record at this point.

[Mr. Googins' prepared statement follows:]

Statement of the American Council of Life Insurance
Submitted to the Subcommittee on Consumer Protection and Finance
of the House Committee on Interstate and Foreign Commerce
on H. R. 8331

August 2, 1977

Mr. Chairman and members of the Subcommittee. My name is Robert R. Googins and I am Vice President, General Counsel and Secretary of Connecticut Mutual Life Insurance Company in Hartford, Connecticut. I am accompanied by Paul J. Mason, Chief Counsel, Securities, of the American Council of Life Insurance. The Council has a membership of 470 United States and Canadian life insurance companies. These companies represent 96 percent of the total assets of all United States life insurance companies and U.S. branches of Canadian companies. We appreciate the opportunity you have extended to us to comment on H. R. 8331.

Our interest in H. R. 8331 is limited to the proposed amendments of the Securities Investor Protection Act (the "Act") contained in Sections 2(a), 6(b)(4) and 6(g) and certain parts of Section 15. The changes that would be wrought by these sections are two-fold. First, Sections 2(a) and 6(b)(4) would revoke the present exclusion from compulsory membership in the Securities Investor Protection Corporation ("SIPC") program for broker-dealers whose business consists exclusively of (1) the distribution of shares of registered open-end investment companies or unit investment trusts; (2) the sale of variable annuities; (3) the business of insurance; or (4) the business of providing investment advisory services to one or more registered investment companies or insurance company separate accounts. These two sections would also delete from the definition of "gross revenues", on which membership assessments are based, the exemption for income derived from these activities.

Second, Section 6(g), which defines the term "Consolidated Group" and Section 15 which defines, among other things, the term "Security" would extend SIPC's jurisdiction far beyond brokers and dealers and would redirect the thrust of the Act in a fashion the public interest does not require and, indeed, militates against. Accordingly, these sections should not be amended at all.

The Variable Annuity and Mutual Fund Exemption

In recent years, a substantial number of life insurance companies have begun marketing variable contracts or mutual funds. As a result, the company itself, a subsidiary, or an affiliated company, has been required to register as a broker-dealer under the Securities Exchange Act of 1934. At the present time, there are approximately 180 such insurance companies so involved.

The risks to which SIPC and the Act are addressed arise where broker-dealers (1) hold and use customers' free credit balances and customers' securities in their own operations; (2) accept orders from their customers on an open basis and become insolvent before the orders are filled; and (3) improperly liquidate securities held on margin. Life insurance companies (or their subsidiaries), as broker-dealers registered with the Securities and Exchange Commission for the purpose of offering variable contracts (and/or mutual funds), cannot engage in these practices. The bar against these practices is inherent in the very nature of the product insurance companies sell, namely the annuity contract.

An annuity is a contract under which an insurance company agrees that in return for a specified consideration the company will pay the individual contract owner a periodic income beginning at a particular time and continuing for the remainder of his life regardless of how long he lives. The amount of premiums and the amount of annuity payments are computed actuarially to achieve the objectives sought by the individual. Thus, each contract is a personal one keyed to the individual's age, sex and needs. A variable annuity is the same as a fixed-dollar annuity except that the amounts paid to the individual by the company are not fixed but will vary with the investment experience of a separate account established to fund such contracts. Since these are individual contracts, they are not negotiable or fungible. They cannot be held in a street name or be bought on margin. Moreover, under Section 22(c) of the Investment Company Act, and under the rules of the National Association of Securities Dealers, the shares of an investment company, including variable annuity contracts, cannot be the subject of a conditional or open order. In short, then, variable annuity contracts are not, and cannot be, held by broker-dealers for use in their own operations.

The same is true with regard to cash. In the case of many life insurance companies, the check for payment of premiums is made out directly to the insurance company. In other cases, the check may be made out to the broker-dealer subsidiary, but the money is not held by the broker-dealer for its own use but is transferred to the insurance company. When annuity payments are made, the check goes directly to the contractholder and not to the broker-dealer. Thus, in the case of broker-dealers which confine their operations to variable annuities, none of the risks at which SIPC is directed can arise. Accordingly, such broker-dealers were exempted from membership in the Corporation.

In summary, variable annuities are individualized, non-negotiable, non-fungible contracts. Because they cannot be held in street name or be bought on margin, these contracts cannot be held by broker-dealers for use in their own operations. Further, and with respect to cash, in the case of many life insurance companies, the check for payment of premiums is made out directly to the life insurance company. In other cases, where the check is made out to the broker-dealer, which, if not the insurance company itself, is an affiliate or a subsidiary of the company, the money is transferred immediately to the insurance company. When annuity payments are made, the check goes directly to the contractholder and not to the broker-dealer.

Similarly, mutual fund broker-dealers do not use customers' funds or customers' securities in the course of conducting their own operations. In many cases broker-dealers do not handle customers' money or securities at all. Where the broker-dealer does handle either the securities or the money, it is only for a transitory period limited to the time necessary to process the transaction. Again, none of the risks at which the bills are aimed are involved in these transactions. The exclusions presently in the Act recognize that the purpose and terms of the SIPC Act were, and remain, irrelevant to brokerage practices with respect to variable annuity contracts and mutual fund shares.

Another purpose of the SIPC Act was to mandate an upgrading, through the SEC, of the financial responsibility requirements of broker-dealers. The SEC has exempted broker-dealers engaged exclusively in the sale of variable annuity contracts and/or shares of open-end investment companies and unit investment trusts from Rules 15c3-3, 17a-5 and 17a-13 under the 1934 Act. These rules, or amendments thereto, were designed to implement the above-

indicated secondary purpose of the SIPC Act, and the exemptions from them were granted only after an examination by the SEC of the pertinent facts and a specific determination in each case.

The Arguments of SIPC are Without Merit

The original thrust for the amendments here urged by the Securities Investor Protection Corporation are found in a three year old report by a "Special Task Force to Consider Possible Amendments to the Securities Investor Protection Act of 1970." It is within the context of the above discussion that this report's recommendations must be evaluated, and it is within this context that the reasons for these recommendations fail.

The Task Force Report stated, in essence, three reasons to eliminate the exclusions with which we are here concerned. First, the Report cited a "very real danger that any broker who accepts funds from public customers for the purchase of securities may commingle or misappropriate those funds." The inaccuracy of this generalization is demonstrated in our above discussion. Moreover, it should be noted that not every instance of commingling or misappropriation brings into play the protections of SIPC, and conversely not every

*We refer the Subcommittee to the separate statement of Frank J. Wilson, now Senior Vice President and General Counsel of the National Association of Securities Dealers, a member of the Special Task Force organized by SIPC to consider possible amendments to the Securities Investor Protection Act of 1970. This statement strongly opposes the recommendation that the existing exemption for membership in SIPC contained in Section 3(a) of the 1970 Act be eliminated. We concur in Mr. Wilson's view that variable annuity underwriters and dealers do not present the risk the Act is designed to protect against. As Mr. Wilson points out:

" . . . In addition to the fact that there is no evidence whatsoever that any such dealer has ever failed under circumstances which resulted in customer loss, the extremely low-risk nature of such limited function broker-dealers is well recognized and codified in various exemptions from SEC Rules, including Rules 15c3-1 (the net capital rule) and 15c3-3 (the customer protection rule) under the Securities Exchange Act of 1934. These types of broker-dealers do not, by definition, place customers' funds or securities at risk in the financing of other areas of business and, to a large degree, would not have funds or securities available to them in any event because a large proportion of their business involves the direct payment by customers to agents for the issuers. Some such broker-dealers handle no customers' funds or securities at all."

" . . . Without clear and convincing evidence that such is necessary (and in my opinion none has been presented), the impact of the elimination of the exemptions from SIPC membership is unfair and the recommendation is unwarranted. . . ."

case handled by SIPC involves, or was caused by, such practices. We are aware of no evidence, and the Report certainly cites none, that broker-dealers engaged exclusively in the sale of variable annuities, commingled or misappropriated customer funds and through such practices caused insolvencies. In the absence of clear and convincing evidence, there is no basis for withdrawal of the exclusions.

Secondly, the Report states that to date SIPC has satisfied "some 40 claims" involving mutual fund shares at a cost to SIPC of approximately \$170,000. ^{*} It is important to note that the Report gives no indication of SIPC having satisfied any claims involving variable annuities.

SIPC's 1976 Annual Report discloses that since SIPC's inception, 87,568 customer claims have been received and substantially satisfied in connection with the liquidation of 65 firms and an additional 14,295 claims have been satisfied in connection with 53 firms where liquidations have been completed. These 101,863 claims have required SIPC advances to trustees amounting to approximately \$52.8 million. While the 1976 Annual Report does not state the number of mutual fund claims that have arisen, the 1973 Annual Report cites the number 40 which we assume still to be correct. These 40 claims represent .000392 of the claims just in the above two categories.

Finally, the Report notes that broker-dealers excluded from SIPC "earn their livelihood from the securities market" and therefore should be included in its membership as are specialists, floor brokers and institutional brokers who also "have no customers protected by the Act." This observation overlooks the fact that specialists, institutional brokers and floor brokers are integral parts of any securities market, and particularly an exchange market. Through these brokers, the orders of all individuals and institutions find their way to the market. Contrariwise, because variable annuity contracts are individually written, and because there is no secondary market for such shares, the sale of these contracts occurs independently of any market mechanism. Clearly, broker-dealers engaged exclusively in the sale of variable annuities do not earn their livelihood from the securities market.

*SIPC's Fifth Annual Report states that almost \$200,000 has been advanced as a result of claims "related" to mutual fund transactions. SIPC has not disclosed what "related" means, or how the losses arose.

Indeed, as the Fourth Annual Report (1974) of SIPC itself indicates, the amendments contained in H.R. 8331 call for the elimination of these exclusions on the grounds that, although broker-dealers engaged exclusively in the sale of variable annuities do not "hold" funds, they do "handle" them. Therefore, it is obvious that SIPC concedes that such broker-dealers do not hold customer securities but somehow such firms should be penalized because they may "handle" them. So, too, do postmen, bank tellers, custodians, executors and scores of others.

SIPC says in the handling process, the possibility of "misappropriation" exists. This argument was not sustained during past Congressional considerations of SIPC legislation and it is certainly not sustained now. We urge that the exemption not be eliminated on the basis of vague and unsupported possibilities. There is no evidence that any broker-dealer engaged exclusively in the sale of variable annuities has misappropriated any such securities or funds.

Life insurance companies should not be required to finance a program for others. They should not be forced to pay for a program which they and their customers do not need and from which they and their customers derive no benefit. The Congress, in 1970, concurred in this view and provided for a statutory exemption for such non-involved broker-dealers. The record since 1970 emphatically underscores the wisdom of this policy, and thus it should not be changed.

Sections 6(g) and 15

Though broker-dealers selling exclusively annuity contracts and mutual fund shares are exempt from the Act, and are thus unaffected by the Act's definitions, we, nevertheless, wish to call to the Subcommittee's attention two sections of H.R. 8331 that, if enacted, would vastly and unnecessarily enlarge the scope of SIPC's authority and jurisdiction.

* Concomitantly, SIPC would have authority under paragraph (L) on page 61 (lines 15-17) to "provide by law" what fees and income in the securities business are part of the "gross revenues" and subject to change.

Paragraph 14, on page 63, line 3, of the Bill would give to SIPC (at lines 21, et seq.) the rulemaking authority to include within the term "security" any contract that SIPC determines is within the purposes and policy of the Act. Such rulemaking authority is unprecedented, not even being possessed by the Securities and Exchange Commission. The vestment of such authority in SIPC is unrelated to the functions for which it was created and to the concerns of the Act. Moreover, this authority would cloud innumerable commercial transactions and throw into confusion the fundamental concepts of the federal securities laws. *

To illustrate, under proposed Section 15, SIPC would be an arbiter of whether contracts funding pension plans, including insurance policies, were investment contracts or participations in a profit-sharing agreement, and then include them, by rule, in the term security. Thereafter, and under the broad definition of "consolidated group" in proposed Section 6(g) of the Bill (p. 13, lines 6-13), any broker selling such contracts or utilizing them in pension planning would have the revenues derived from pension operations subject to SIPC's assessments. Indeed, any pension manager affiliated with a broker-dealer may find the assets it manages subject to a SIPC assessment. In this regard, under paragraphs (C), (D) and (I), Section 16, as amended by Section 15 (p. 61) the gains earned by an investment or trading account would be subject to SIPC's charge. Under this definition, any portfolio of securities, including those portfolios held by a pension fund, an insurance company, or a mutual fund which realize net earnings, could be charged by SIPC to the detriment of the millions of persons who are beneficiaries of those accounts and who have no connection with any broker-dealer business.

The foregoing discussion, though brief, is sufficient to demonstrate that the proposed definition of "consolidated group" and the expanded definitional paragraphs will have an impact on the financial community and, indeed, on commerce, in general, far beyond the intent or function of the Act. The history of the Act and of its administration by SIPC offers no support for the proposition that such drastic measures are either necessary or wise.

To remedy these unnecessary and, we believe, unintended revisions of the Act, we urge that Sections 6(g) and Section 15 of the Bill not be amended.

Mr. METCALFE. Now, Mr. Silver

STATEMENT OF DAVID SILVER

Mr. SILVER. Thank you, Mr. Chairman.

I am well aware of the time constraints under which you operate and I will condense my statement.

My name is David Silver. I am testifying today on behalf of the Investment Company Institute, of which I am president. With me is the institute's general counsel, Matthew Fink.

The institute is the national association of the mutual fund industry. Its members consist of 415 open-end investment companies, commonly called mutual funds, their investment advisers and principal underwriters. Our mutual fund members have about 7½ million shareholders and assets of approximately \$47 billion, comprising over 90 percent of the assets of all U.S. mutual funds.

We appear in opposition to so much of sections 2(a), 6(b)(4), 6(g), and 15 of H.R. 8331 as would change the Securities Investor Protection Act by repealing certain existing exemptions for mutual funds and variable annuities and subject nonbroker-dealer affiliates of SIPC members to SIPC assessments.

More particularly, these sections would:

(1) Impose mandatory membership in the Securities Investor Protection Corporation on broker-dealers whose business consists exclusively of the distribution of mutual funds, unit investment trusts, or variable annuities, or rendering investment advisory services to mutual funds or insurance company separate accounts;

(2) require the inclusion in the SIPC assessment base of broker-dealers doing a general retail of mutual fund shares; and

(3) include gross revenues of investment advisers who are not broker-dealers in the SIPC assessment base if a related company is a broker-dealer.

I am certain that the chairman of this subcommittee, Mr. Eckhardt, who actively participated in the formulation of the SIPC legislation, remembers well the grim background of crisis and impending chaos in the Nation's security markets in 1970. It was in that atmosphere that SIPC was created as being the least disruptive alternative to the outright termination of the specific practices traditionally engaged in by stock exchange members, which created the potential for huge losses to investors. However, those who would repeal the mutual fund and variable annuity exemptions have deftly shaded the legislative history and background to make it appear that the mutual fund and variable annuity exemptions are anomalies in an insurance scheme which was designed to be universal. But SIPC was not created to cast an umbrella of insurance protection over the entire securities industry; any such assertion is merely an after-the-fact rationalization to justify an expansion of the jurisdiction of SIPC.

More importantly, the mutual fund and variable annuity exemptions were included in the law because they were justified by the circumstances and, as I will show later, demanded by equity. SIPC was created to protect investors against risks associated with practices of brokerage firms dealing with customers' funds and securities for their own benefit.

When SIPC was created in 1970, it was clearly understood that the risks to be insured against were the results of specific business practices of the brokerage industry. More particularly, these risks are created by the traditional practice of firms doing a general stock brokerage business using customers' funds—free credit balances—and customers' securities in the conduct of their own business. The 1970 reports of the Senate committee and of this committee isolated and focused on these activities as creating the hazards to the investing public which necessitated the creation of SIPC.

The Senate report stated:

"Free credit balances are funds left with the brokerage firm by customers who have the right to withdraw them on demand. These credit balances are used by the broker * * * in the conduct of the business * * * "

The report of this committee commences its discussion by stating:

"Broker-dealers, among their many obligations, are responsible for safeguarding billions of dollars in cash and securities which belong to investors."

The wave of brokerage house insolvencies which immediately preceded the creation of SIPC at the end of 1970 involved the potential of enormous losses for the millions of investors whose cash and securities were held and used by brokerage firms. The situation had become so grave that stock exchange trust funds which had been formed to take care of obligations owed customers of failed firms were near exhaustion. It was at this juncture that the Congress was implored by the industry itself to enact the legislation which evolved into the act.

At the 1970 legislative hearings, it was the position of the mutual fund and insurance industries that the distribution of mutual fund shares and variable annuities, as well as the rendering of investment advice to registered investment companies, did not present any significant potential for the kind of losses inherent in the traditional activities of stockbrokers who deal for their own benefit with the funds and securities of their customers. Moreover, since mutual fund and variable annuity organizations did not engage in such activities, they obviously did not profit from them. It was on this basis that Congress saw fit to include the mutual fund and variable annuity exemptions in the legislation.

The matter of SIPC jurisdiction over investment advisers who are affiliates of broker-dealers was not an issue in 1970. In a sense this proposed change illustrates best that the proponents of these amendments seek to extend the jurisdiction of SIPC far beyond the boundaries of the brokerage industry and the conditions which gave rise to the need for its creation. Investment advisers perform no function and earn no fee even remotely related to the risks covered by SIPC.

The mutual fund distribution system does not create the kind of risk created by general brokerage activities.

Before engaging in a description of the specific factors which in the present context differentiate purchases and sales of mutual fund shares from purchases and sales of other securities by customers of brokerage firms, it should be noted that the act—section 11(h)—mandated the SEC to conduct a study of unsafe and un-

sound practices of broker-dealers. The report specifically confirmed the factual basis underlying the exemptions for mutual funds and variable annuities. The report stated: "Also, broker-dealers who specialize in the sale of mutual fund shares or variable annuities do not hold customers' free credit balances in the normal course of business." Anticipating our discussion of this subject, it might be observed that this conclusion inevitably flows from the ordinary practices in the distribution of mutual fund shares.

The Mutual Fund Underwriter and Retail Dealer: Unlike broker-dealers doing a general securities business, a mutual fund underwriter does not use customers' funds or securities in the course of its business.

The mutual fund underwriter contracts with the fund to arrange for the distribution of the shares of the fund to the public. Often the underwriter and the fund's investment adviser are a single entity. Where they are separate companies, they are usually, but not always, under common control. Because the underwriter distributes securities, that is, the shares of the fund, it is required to register as a broker-dealer under the Securities Exchange Act of 1934. A mutual fund underwriter usually distributes the shares only of the one or more funds in a particular fund group.

When a customer purchases mutual fund shares, it is the fund's transfer agent which issues the shares to the customer against receipt of the purchase money and sends the money to the fund's custodian bank which often is the same entity as the transfer agent. When a customer redeems mutual fund shares, it is the fund's transfer agent which issues the redemption check against receipt of the shares being redeemed.

The important fact in the operations of the mutual fund underwriter is that the customer's purchase moneys are transmitted to the fund's custodian bank and none is retained by the underwriter. The period of possible jeopardy to any customer by reason of the underwriter's possession is thus limited to the time which it takes for the underwriter to process the trade—a maximum period usually of from 1 to 3 days. Customers' funds and securities, therefore, do not come to rest for an indefinite period of time in the hands of the underwriter.

Not only does the mutual fund underwriter derive no economic benefit from holding customers' money or securities, but so far as the underwriter's activities are concerned, the risk to mutual fund investors is restricted to items in transit.

The SIPC fourth annual report for 1974, page 8, confirms the finding in the SEC study and admits that mutual fund underwriters do not hold customers' securities or funds, but merely handle them. The type of risk involved is primarily that of possible misappropriation or embezzlement and is not a risk associated with the deliberate and continuing use by a broker-dealer in its business of a customer's cash or securities. The misappropriation or embezzlement type of risk is guarded against by fidelity bonds which mutual fund underwriters maintain.

It is not at all surprising that not a single claim, so far as we know, has been made against SIPC with respect to the activities of a mutual fund underwriter.

It is important to understand this, because there has been some talk about mutual fund losses. From the figures that I will come to in a moment you will see that the lion's share of SIPC assessments would be paid on the underwriter and investment adviser level and on this level of the mutual fund distribution chain there have been no losses whatsoever since SIPC was created. It is on the level of the retail broker-dealer that a few losses have occurred, because he is the person who most often deals directly with the public in the sale of mutual fund shares.

The recommendation to repeal the exemption from the SIPC assessment base of mutual fund revenues apparently stems from the fact that in the 6½-year period after SIPC was created, SIPC advanced money to meet the claims of some 50 customers who suffered losses on account of mutual fund transactions with eight small retail brokerage firms.

The cost to SIPC of these claims aggregated about \$190,655. These small claims are de minimis when contrasted with losses claimed by all brokerage firm customers during the same period. Total SIPC advances to such customers were about \$43 million, and these claims have been made, not by about 50, but by some 105,000 customers.

In other words, over a 6½-year period, alleged mutual fund loss claims involving retail broker-dealers amounted to 0.05 percent of the total number of claims and 0.43 percent of the total dollar value of all advances. Viewed another way, while investors' mutual fund sales and redemptions for the same 6½ year period amounted to over \$51 billion, the \$190,000 of SIPC advances amounted to 0.0004 percent of this total volume.

I submit this is an excellent record of honesty and integrity. There is no evidence to indicate that the losses occurred because of any practice on the part of the eight firms to use customers' money or securities during the course of their normal business. Rather, the evidence is that the losses occurred by reason of simple misappropriation.

The names of 39 claimants were supplied to us by SIPC. We sent each claimant a questionnaire seeking details of his loss. Fifteen of these 39 claimants responded and their responses dealt with transactions by three of the seven brokerage firms involved. It appears from these responses that the losses occurred because the broker-dealer pocketed the money received from his customer and then either failed to even advise the mutual fund underwriter of the order, or confirmed the order to the underwriter but sent a bad check to pay for the shares.

We think that even 50 cases of loss to mutual fund customers through some sort of misconduct is 50 cases too many. Although the figure is de minimis from the legislative standpoint, proper remedial steps should be taken, and we will discuss that issue in a moment.

We have analyzed the SIPC premiums which would have been collected through 1976 on account of mutual fund activities if there had been no exemptions in the original act. We do not have sufficient data available to include variable annuities in our analysis, and that would have been substantial.

Our estimate shows that the assessments on the mutual fund industry over this period would have amounted to some \$10,308,537. The components of these figures are as follows: Dues on account of retail broker-dealer transactions, \$3,827,575

Dues from underwriters' sales revenues, total, dues from sales revenues, \$2,547,819

Dues from mutual fund advisory and other advisory fees, \$3,933,143

Total SIPC dues from fund industry, \$10,308,537.

This figure has been computed solely on the basis that the exemptions would be deleted. If the act is also amended to include a new consolidation provision, the figure for advisor fees would increase to exceed \$8 million, and therefore the total would be \$15 million.

As you can see from the footnote on page 8, if the consolidation provision is adopted together with the repeal of the mutual fund and variable annuity exemptions, the \$3.9 million in advisory fee dues would go above \$8 million, and thus the total due from the mutual fund industry would have been \$15 million, since SIPC was formed to cover \$190,000 in losses. In other words, until now the witnesses have all spoken in terms of losses by customers, \$43,190,000 in mutual fund losses.

I think I have made the case that the losses are legislatively de minimis and amenable to another solution. But let's turn the coin over and really see what SIPC is all about. This adds simply another layer of inequity to repealing these exemptions.

When Congress was considering the legislation which established SIPC, a number of alternatives to an insurance scheme which would not have involved the creation of a new governmental agency were also discussed.

One such alternative would have been to bar broker-dealers from using customers' funds and securities in the course of their own business by requiring that they be segregated or held in a custodian bank, as is the case with mutual funds.

Another alternative would have been to impose high reserve requirements against the value of customers' securities held by broker-dealers. The adoption of either of the alternative solutions would have made SIPC unnecessary as a continuing institution since the problem, use of customers' funds and securities by brokerage firms, would have been eliminated at the source. Neither of these approaches would have had any impact at all on the mutual fund and variable annuity industries.

As pointed out above, this committee found in 1970, the SEC study confirmed, and SIPC admits, that mutual fund and variable annuity investors do not ordinarily leave free credit balances with broker-dealers. Moreover, variable annuity contracts cannot be hypothecated by broker-dealers in the manner of typical securities, and more than 90 percent of current mutual fund sales do not involve the issuance of stock certificates. In this regard, the mutual fund industry has advanced towards the certificateless society that is still the subject of discussion today throughout the rest of the securities industry.

Although the surgical solution to the risk-creating activities of broker-dealers would not have affected the mutual fund or variable

annuity industries, its impact on the general securities business would have been enormous. Chapters II and IV of the SEC Study of Unsafe and Unsound Practices make abundantly clear the enormous importance to brokerage firms, most notably stock exchange members, of their ability to use customers' funds and securities in their business. As the study states:

"To a large extent, the tremendous leverage available to many broker-dealers has come from their ability to rely on customers' funds and securities in the financing of their businesses . . . Normally, leverage to the degree that exists in the financial structure of broker-dealers would not be possible if customers' funds and securities were not available and these firms had to rely on the usual sources of financing available to other businesses."

The economic value to brokerage firms of their use of customers' funds and securities has been substantial over the years. We have included a table covering the years 1970 through 1976, the years in which SIPC was operative, showing estimates of revenues derived by brokerage firms which arise in connection with their use of customers assets and the percentage of total revenues which this represents [see p. 277.]

Mr. Chairman, it is the last two columns of this table which show that as a percentage of gross revenues over the period, interest on customers' accounts ranged between 12.3 percent on the high side and 5.5 percent of the total income of brokerage firms. In dollar amounts it ranged from a high of \$622 million to a low of \$379 million, aggregating over the period, Mr. Chairman, \$3.5 billion in revenues generated by the risk-creating activities that SIPC was formed to insure against.

Although it cannot be stated what percentage of these revenues would not have been generated if strict segregation of customers' assets had been required, it is certain that the ability to use these free credit balances, which run in the neighborhood of \$2 billion a year, and hypothecate investors' securities from the chief ingredients of what SEC has called in its report the tremendous leverage which produces this income.

Moreover, while there are no published profit data associated with these revenues, the figures are so large that they speak for themselves. Brokerage industry assessments paid to SIPC are a small price indeed when measured against the \$3.5 billion generated since 1970 through activities which were preserved through the legislation which made SIPC insurance available.

In contrast, the mutual fund and variable annuity industries generate no revenues whatsoever from these activities; in fact, were mutual fund organizations and variable annuity organizations to use customers' funds and securities in the conduct of their own business prior to investment of these funds in securities, it would be a felony under the Investment Company Act of 1940. So what is routine in the brokerage industry is prohibited by law in the mutual fund and variable annuity industries.

Now turning to the last point, the consolidation provisions presently in the act require the inclusion in the gross revenues of a broker-dealer member of SIPC the revenues of any subsidiary of the member. H.R. 8331—but not, as should be noted, the 1975 version of the bill—contains a provision extending this consolida-

tion requirement to all entities under common control with a broker-dealer. Whatever theoretical justification may be offered in support of this provision, its main practical effect would be to impose SIPC membership assessments on a number of investment advisers who are related to mutual fund organizations, but whose business it is to render advice to private, that is, nonmutual fund, clients.

When the business of providing investment advice is not conducted within the offices of a broker-dealer doing a general securities business or by a wholly owned subsidiary of such a broker-dealer, it is hard to see how there can be any conceivable benefit to the clients of the adviser from SIPC assessments, even though these assessments probably will be passed on to these clients. If SIPC has been able to come forward with only de minimis losses on account of mutual fund retail transactions, it has not as far as we know shown any instances of harm to advisory clients. However, the costs of this proposal will be enormous. We were not aware of this new provision until we actually received a copy of H.R. 8331 less than two weeks ago and we have not been able to conduct a detailed study of its consequences. However, as I have discussed, our best estimate is that the \$3,933,143, in assessments which would have been imposed on advisers if the mutual fund and variable annuity exemptions were deleted, would have exceeded \$8 million had the original consolidation provisions in the act tracked the present proposal.

When this proposal is looked at cumulatively with the provisions which would repeal the mutual fund and variable annuity exemptions, it can be readily seen that H.R. 8331 is not merely corrective legislation which seeks to straighten out gaps and conceptual inconsistencies in the act. It transforms SIPC into an agency whose scope goes far beyond the need which was demonstrated in 1970.

In summary, events have proved that Congress was clearly right when it refused in 1970 to force mutual fund underwriters to join SIPC. These underwriters do not use customers' funds or securities in their business, no claim against SIPC on account of a fund underwriter has ever been made. Under these circumstances, it would have been monstrously unfair for these underwriters to pay the almost \$6.4 million it would have cost in assessments had their membership been mandatory. There is nothing at present or in the foreseeable future to justify a change in the earlier view of Congress.

Further, the proposed new consolidation provision would subject investment advisers to private clients to SIPC assessments, although their businesses obviously do not create the risks which led to the creation of SIPC.

On the level of the retail broker-dealer, we think that the claims that SIPC has paid in connection with mutual fund trades are legislatively de minimis and that the cure is not to saddle the small retail broker-dealer with assessments on mutual fund revenues, but to tighten the regulatory process, possibly in the area of fidelity bonds.

We believe these exemptions were wisely legislated and should not be repealed or diluted.

We appreciate this opportunity to present our views.

I would be most happy to answer any questions.

[Mr. Silver's prepared statement follows:]

August 2, 1977

Before the Subcommittee on Consumer Protection
and Finance, House Interstate and Foreign
Commerce Committee

STATEMENT OF DAVID SILVER, PRESIDENT OF THE
INVESTMENT COMPANY INSTITUTE, WITH RESPECT TO
H. R. 8331

My name is David Silver. I am testifying today on behalf of the Investment Company Institute, of which I am President. With me is the Institute's General Counsel, Matthew Fink.

The Institute is the national association of the mutual fund industry. Its members consist of 415 open-end investment companies (commonly called "mutual funds"), their investment advisers and principal underwriters. Our mutual fund members have about 7 1/2 million shareholders and assets of approximately \$47 billion, comprising over 90% of the assets of all U. S. mutual funds.

We appear in opposition to so much of Sections 2(a), 6(b) (4) 6(g) and 15 of H. R. 8331 as would change the Securities Investor Protection Act (the "Act") by repealing certain existing exemptions for mutual funds and variable annuities and subject non-broker-dealer affiliates of SIPC members to SIPC assessments.*

I am certain that the Chairman of this Subcommittee, who actively participated in the formulation of the SIPC legislation, remembers well the grim background of crisis and impending chaos in the nation's securities markets in 1970. It was in that atmosphere that SIPC was created as being the least disruptive alternative to the outright termination of the specific practices traditionally engaged in by stock exchange members which created the potential for huge losses to investors. However, those who would repeal the mutual fund and variable annuity exemptions have deftly shaded the

* More particularly, these sections would: (1) impose mandatory membership in the Securities Investor Protection Corp. (SIPC) on broker-dealers whose business consists exclusively of the distribution of mutual funds, unit investment trusts or variable annuities, or rendering investment advisory services to mutual funds or insurance company separate accounts; (2) require the inclusion in the SIPC assessment base of broker-dealers doing a general retail securities business of the revenues which they derive from the sale of mutual fund shares; and (3) include gross revenues of investment advisers who are not broker-dealers in the SIPC assessment base if a related company is a broker-dealer.

legislative history and background to make it appear that the mutual fund and variable annuity exemptions are anomalies in an insurance scheme which was designed to be universal. But SIPC was not created to cast an umbrella of insurance protection over the entire securities industry -- any such assertion is merely an after-the-fact rationalization to justify an expansion of the jurisdiction of SIPC. More importantly, the mutual fund and variable annuity exemptions were included in the law because they were justified by the circumstances and, as I will show later, demanded by equity.

SIPC WAS CREATED TO PROTECT INVESTORS AGAINST RISKS ASSOCIATED WITH PRACTICES OF BROKERAGE FIRMS DEALING WITH CUSTOMERS' FUNDS AND SECURITIES FOR THEIR OWN BENEFIT

When SIPC was created in 1970, it was clearly understood that the risks to be insured against were the results of specific business practices of the brokerage industry. More particularly, these risks are created by the traditional practice of firms doing a general stock brokerage business using customers' funds (free credit balances) and customers' securities in the conduct of their own business. The 1970 reports of the Senate Committee and of this Committee isolated and focused on these activities as creating the hazards to the investing public which necessitated the creation of SIPC.*

The wave of brokerage house insolvencies which immediately preceded the creation of SIPC at the end of 1970 involved the potential of enormous losses for the millions of investors whose cash and securities were held and used by brokerage firms. The situation had become so grave that stock exchange trust funds which had been formed to take care of obligations owed customers of failed firms were near exhaustion. It was at this juncture that the Congress was implored by the industry itself to enact the legislation which evolved into the Act.**

* The Senate report stated: "Free credit balances are funds left with the brokerage firm by customers who have the right to withdraw them on demand. These credit balances are used by the broker...in the conduct of the business..." (Report No. 91-1218, Senate Committee on Banking and Currency, 91st Cong. 2d Sess. (1970)). The report of this Committee commences its discussion by stating: "Broker-dealers, among their many obligations, are responsible for safeguarding billions of dollars in cash and securities which belong to investors." (Report No. 91-1613, House Committee on Interstate and Foreign Commerce, 91st. Cong. 2d Sess. (1970)).

**Study of Unsafe and Unsound Practices of Brokers and Dealers, SEC, Vol. 2, Chapter IX, pages 15-16.

At the 1970 legislative hearings, it was the position of the mutual fund and insurance industries that the distribution of mutual fund shares and variable annuities, as well as the rendering of investment advice to registered investment companies, did not present any significant potential for the kind of losses inherent in the traditional activities of stock brokers who deal for their own benefit with the funds and securities of their customers. Moreover, since mutual fund and variable annuity organizations did not engage in such activities, they obviously did not profit from them. It was on this basis that Congress saw fit to include the mutual fund and variable annuity exemptions in the legislation.

The matter of SIPC jurisdiction over investment advisers who are affiliates of broker-dealers was not an issue in 1970. In a sense this proposed change illustrates best that the proponents of these amendments seek to extend the jurisdiction of SIPC far beyond the boundaries of the brokerage industry and the conditions which gave rise to the need for its creation. Investment advisers perform no function and earn no fee even remotely related to the risks covered by SIPC. We will return to this proposal after we discuss the mutual fund and variable annuity exemptions.

THE MUTUAL FUND DISTRIBUTION SYSTEM DOES NOT CREATE THE KIND OF RISK CREATED BY GENERAL BROKERAGE ACTIVITIES

Before engaging in a description of the specific factors which in the present context differentiate the purchases and sales of mutual fund shares from purchases and sales of other securities by customers of brokerage firms, it should be noted that the Act (Section 11(h)) mandated the SEC to conduct a study of unsafe and unsound practices of broker-dealers. The report specifically confirmed the factual basis underlying the exemptions for mutual funds and variable annuities. The report stated: "Also, broker-

dealers who specialize in the sale of mutual fund shares or variable annuities do not hold customers' free credit balances in the normal course of business.** Anticipating our discussion of this subject, it might be observed that this conclusion inevitably flows from the ordinary practices in the distribution of mutual fund shares.

The Mutual Fund Underwriter

Unlike broker-dealers doing a general securities business, a mutual fund underwriter does not use customers' funds or securities in the course of its business.** When a customer purchases mutual fund shares, it is the fund's transfer agent which issues the shares to the customer against receipt of the purchase money and sends the money to the fund's custodian bank which often is the same entity as the transfer agent. When a customer redeems mutual fund shares, it is the fund's transfer agent which issues the redemption check against receipt of the shares being redeemed.

The important fact in the operations of the mutual fund underwriter is that the customer's purchase moneys are transmitted to the fund's custodian bank and none is retained by the underwriter. The period of possible jeopardy to any customer by reason of the underwriter's possession is thus limited to the time which it takes for the underwriter to process the trade -- a maximum period usually of from one to three days. Customers' funds and securities, therefore, do not come to rest for an indefinite period of time in the hands of the underwriter.

Not only does the mutual fund underwriter derive no economic benefit from holding customers' money or securities, but so far as the underwriter's activities are concerned, the risk to mutual fund investors is restricted to items in transit. The SIPC Fourth Annual Report for 1974 (page 8) confirms the finding in the SEC study and admits that mutual fund underwriters do not "hold" customers' securities or funds but merely "handle" them. The type

* Study of Unsafe and Unsound Practices of Brokers and Dealers, SEC, Vol. 2, Chapter IV, Page 16.

** The mutual fund underwriter contracts with the fund to arrange for the distribution of the shares of the fund to the public. Often the underwriter and the fund's investment adviser are a single entity. Where they are separate companies, they are usually, but not always, under common control. Because the underwriter distributes securities, i.e., the shares of the fund, it is required to register as a broker-dealer under the Securities Exchange Act of 1934. A mutual fund underwriter usually distributes the shares only of the one or more funds in a particular fund group.

of risk involved is primarily that of possible misappropriation or embezzlement and is not a risk associated with the deliberate and continuing use by a broker-dealer in its business of a customer's cash or securities. The misappropriation or embezzlement type of risk is guarded against by fidelity bonds which mutual fund underwriters maintain.

It is not at all surprising that not a single claim, so far as we know, has been made against SIPC with respect to the activities of a mutual fund underwriter.

The Retail Broker-Dealer

The retail broker-dealer is the person who most often deals directly with the public in the sale of mutual fund shares. The recommendation to repeal the exemption from the SIPC assessment base of mutual fund revenues apparently stems from the fact that in the 6 1/2 year period after SIPC was created, SIPC advanced money to meet the claims of some 50 customers who suffered losses on account of mutual fund transactions with eight small retail brokerage firms. The cost to SIPC of these claims aggregated about \$190,655. These small claims are de minimis when contrasted with losses claimed by all brokerage firm customers during the same period. Total SIPC advances to such customers were about \$43.9 million and these claims have been made, not by about 50, but by some 105,000 customers. In other words, over a 6 1/2 year period, alleged mutual fund loss claims involving retail broker-dealers amounted to 0.05% of the total number of claims and 0.43% of the total dollar value of all advances. Viewed another way, while investors' mutual fund sales and redemptions for the same 6 1/2 year period amounted to over \$51 billion, the \$190,000 of SIPC advances amounted to 0.0004% of this total volume.

There is no evidence to indicate that the losses occurred because of any practice on the part of the eight firms to use customers' money or securities during the course of their normal business. Rather, the evidence is that the losses occurred by reason of simple misappropriation.*

* The names of 39 claimants were supplied to us by SIPC. We sent each claimant a questionnaire seeking the details of his loss. Fifteen of these 39 claimants responded and their responses dealt with transactions by three of the seven brokerage firms involved. It appears from these responses that the losses occurred because the broker-dealer pocketed the money received from his customer and then either failed to even advise the mutual fund underwriter of the order or confirmed the order to the underwriter but sent a bad check to pay for the shares.

Experience Justifies the Exemption

We think that even 50 cases of loss to mutual fund customers through some sort of misconduct is 50 cases too many. Although the figure is de minimis from the legislative standpoint, proper remedial steps should be taken, and we will discuss that issue in a moment.

We have analyzed the SIPC premiums which would have been collected through 1976 on account of mutual fund activities if there had been no exemptions in the original Act. (We do not have sufficient data available to include variable annuities in our analysis.) Our estimate shows that the assessments on the mutual fund industry over this period would have amounted to some \$10,308,537. The components of these figures are as follows:

Dues on account of retail broker-dealer transactions -	\$ 3,827,575
Dues from underwriters' sales revenues -	\$ 2,547,819
Total: dues from sales revenues -	\$ 6,375,394
Dues from mutual fund advisory and other advisory fees -	\$ 3,933,143 *
Total SIPC dues from fund industry -	\$ 10,308,537

These figures taken alone should be conclusive on the issue of the propriety of the exemptions. The total so far exceeds the losses claimed by SIPC, the disproportion so immense, that it is obvious that it would have been absurdly unfair not to have included the exemptions in the original legislation. It would be just as absurd to repeal them now.

In pointing to a remedy more in keeping with the problem we refer our own inquiry into the circumstances surrounding the \$190,000 in losses to mutual fund customers. These losses occurred not through any routine business practice but because of isolated instances of apparent dishonesty. It seems clear that such losses might well have been obviated if the broker-dealers in question had appropriate fidelity bonds. We urged in our testimony two years ago and take this occasion to re-emphasize our position that the SEC, after appropriate study, should adopt such changes in existing bonding requirements as to remedy even the minor problem which may exist.

* This figure has been computed solely on the basis that the exemptions would be deleted. If the Act is also amended to include a new consolidation provision, this figure would exceed \$8 million, and therefore the total would exceed \$18 million. See page 13 below.

The nostrum of compulsory SIPC membership is thus unnecessary to cure a specific and limited problem. Moreover, as we now show, such membership would also be grossly inequitable in terms of what may be termed the profit side of the ledger, as well as leading to assessments which would be disproportionate when measured against losses.

RESTRICTING SIPC MEMBERSHIP TO BROKER-DEALERS WHO PROFIT FROM
USING CUSTOMERS' FUNDS AND SECURITIES AND BASING ASSESSMENTS ON
SUCH ACTIVITIES IS WHOLLY APPROPRIATE

When Congress was considering the legislation which established SIPC a number of alternatives to an insurance scheme which would not have involved the creation of a new governmental agency were also discussed. One such alternative would have been to bar broker-dealers from using customers' funds and securities in the course of their own business by requiring that they be segregated or held in a custodian bank as is the case with mutual funds. Another alternative would have been to impose high reserve requirements against the value of customers' securities and free credit balances. The adoption of either of the alternative solutions would have made SIPC unnecessary as a continuing institution since the problem -- use of customers' funds and securities by brokerage firms -- would have been eliminated at the source. Neither of these approaches would have had any impact at all on the mutual fund and variable annuity industries. As pointed out above, this Committee found in 1970, the SEC study confirmed, and SIPC admits, that mutual fund and variable annuity investors do not ordinarily leave free credit balances with broker-dealers. Moreover, variable annuity contracts cannot be hypothecated by broker-dealers in the manner of typical securities, and more than 90% of current mutual fund sales do not involve the issuance of stock certificates.*

* In this regard, the mutual fund industry has advanced towards the "certificateless" society that is still the subject of discussion today throughout the rest of the securities industry.

Although the surgical solution to the risk creating activities of broker-dealers would not have affected the mutual fund or variable annuity industries, its impact on the general securities business would have been enormous. Chapters II and IV of the SEC Study of Unsafe and Unsound Practices make abundantly clear the enormous importance to brokerage firms, most notably stock exchange members, of their ability to use customers' funds and securities in their business.*

The economic value to brokerage firms of their use of customers' funds and securities has been substantial over the years. We have included a table covering the years 1970 through 1976 (the years in which SIPC was operative) showing estimates of revenues derived by brokerage firms which arise in connection with their use of customers' assets and the percentage of total revenues which this represents.

BROKER-DEALER FIRMS WITH GROSS REVENUE OF \$500,000 OR MORE*

Year	No. of Firms	Gross Revenue (In Millions)	Customer Net Credit Balances End of Year (In Millions)	Interest Income on Customer Accounts	
				(In Millions)	Percent of Gross Revenue
1976	N/A	\$ 8,500	\$ 2,023	\$ 550	6.5%
1975	764	6,996	1,733	591	8.4
1974	609	5,065	1,732	622	12.3
1973	652	5,250	2,184	621	11.8
1972	817	6,729	2,150	527	7.8
1971	788	6,583	2,104	364	5.5
1970	655	4,747	2,126	379	8.0

* Data for 1970-75 obtained from tables shown on pages 4 and 5 of the SEC's Statistical Bulletin, April 1977, Vol. 36, No. 4; Data for 1976 are preliminary estimates.

Although it cannot be stated what percentage of these revenues would not have been generated if strict segregation of customers' assets had been required, it is certain that the ability to use these free credit balances and hypothecate investors' securities is the chief ingredient of the "tremendous leverage" which produces this income. Moreover, while there are

* As the study states: "To a large extent, the tremendous leverage available to many broker-dealers has come from their ability to rely on customers' funds and securities in the financing [of their businesses]...Normally, leverage to the degree that exists in the financial structure of broker-dealers would not be possible if customers' funds and securities were not available and these firms had to rely on the usual sources of financing available to other businesses." (Chapter II, page 64).

no published profit data associated with these revenues, the figures are so large that they speak for themselves. Brokerage industry assessments paid to SIPC are a small price indeed when measured against the \$3.5 billion generated since 1970 through activities which were preserved through the legislation which made SIPC insurance available. In contrast, the mutual fund and variable annuity industries generate no revenues whatsoever from these activities. It would be shocking and indeed ludicrous to compel the mutual fund and variable annuity industries to pay insurance premiums to protect the profits of others flowing from activities in which they do not engage. This is wholly aside from the demonstrated fact, as discussed above, that the risk of loss created by mutual funds and variable annuities are by any standard de minimis.

SIPC SHOULD NOT BE PERMITTED TO INCLUDE IN ITS ASSESSMENT BASE
ADVISORY FEES OF INVESTMENT ADVISERS WHO ARE NOT BROKER-DEALERS

The present consolidation provisions of the Act require the inclusion in the gross revenues of a broker-dealer member of SIPC and the revenues of any subsidiary of the member. H.R. 8331 (but not, it should be noted, the 1975 version of the Bill) contains a provision extending this consolidation requirement to all entities under common control with a broker-dealer. Whatever theoretical justification may be offered in support of this provision, its main practical effect would be to impose SIPC membership assessments on a number of investment advisers who are related to mutual fund organizations, but whose business it is to render advice to private -- i.e., non-mutual fund -- clients.

When the business of providing investment advice is not conducted within the offices of a broker-dealer doing a general securities business or by a wholly-owned subsidiary of such a broker-dealer, it is hard to see how there can be any conceivable benefit to the clients of the adviser from SIPC assessments -- even though these assessments probably will be passed on to these clients. If SIPC has been able to come forward with only de minimis losses on account of mutual fund retail transactions it has not, as far as we know, shown any instances of harm to advisory clients. However, the costs of this proposal will be enormous. We were not aware of this new provision until we

actually received a copy of H.R. 8331 less than two weeks ago and we have not been able to conduct a detailed study of its consequences. However, our best estimate is that the \$3,933,143 in assessments which would have been imposed on advisers if the mutual fund and variable annuity exemptions were deleted, would have exceeded \$8 million had the original consolidation provisions in the Act tracked the present proposal. When this proposal is looked at cumulatively with the provisions which would repeal the mutual fund and variable annuity exemptions, it can be readily seen that H.R. 8331 is not merely corrective legislation which seeks to straighten out gaps and conceptual inconsistencies in the Act. It transforms SIPC into an agency whose scope goes far beyond the need which was demonstrated in 1970.

CONCLUSION

In summary, events have proved that Congress was clearly right when it refused in 1970 to force mutual fund underwriters to join SIPC. These underwriters do not use customers' money or securities in their business -- no claim against SIPC on account of a fund underwriter has ever been made. Under these circumstances it would have been monstrously unfair for these underwriters to pay the almost \$6.4 million it would have cost in assessments had their membership been mandatory. There is nothing at present or in the foreseeable future to justify a change in the earlier view of Congress.

Further, the proposed new consolidation provision would subject investment advisers to private clients to SIPC assessments, although their businesses obviously do not create the risks which led to the creation of SIPC.

On the level of the retail broker-dealer, we think that the claims that SIPC has paid in connection with mutual fund trades are legislatively de minimis and that the cure is not to saddle the small retail broker-dealer with assessments on mutual fund revenues, but to tighten the regulatory process, possibly in the area of fidelity bonds.

We believe these exemptions were wisely legislated and should not be repealed or diluted.

We appreciate this opportunity to present our views.

Mr. METCALFE. Thank you, Mr. Silver. We will withhold any questions until Mr. Klein has had his opportunity to make a summary of his statement.

Mr. Klein?

STATEMENT OF ROGER KLEIN

Mr. KLEIN. Thank you, Mr. Chairman.

My name is Roger Klein and I am the executive director of the Public Securities Association (PSA). The PSA appreciates being afforded an opportunity to present its views on H.R. 8331, a bill which we believe contains important provisions that will significantly affect both the investing public and members of the Securities Investor Protection Corporation, SIPC. Accompanying me today is Mr. Joseph W. Sack, who is PSA's assistant director for regulation.

Initially, Mr. Chairman, I would like to state that the Public Securities Association is a national trade association representing banks and dealers who underwrite, trade, and sell U.S. Government and Federal agency issues and State and local government securities.

There are a number of PSA member organizations whose activities involve the sponsorship and sale of municipal unit investment trusts. The PSA was formed in late 1976 to continue the work started more than 70 years ago by the Investment Bankers Association and its successor, the Securities Industry Association.

I have come here today to address the following items:

- (1) The overall advantages of H.R. 8331;
- (2) The treatment of unit investment trusts under the 1977 SIPC amendments; and,
- (3) Certain procedural aspects relating to the proposed amendments.

The practical advantages of H.R. 8331 relating to increased customer protection are fairly straightforward. The bill would grant a trustee in a liquidation proceeding the authority to promptly satisfy customer claims in a way that would give the customer what he had when the firm stopped doing business.

The Public Securities Association believes these changes are necessary and appropriate and, thus, we wholeheartedly support the adoption of proposed new sections 7 through 10 of the Securities Investor Protection Act of 1970.

There are, however, certain provisions of H.R. 8331 which we believe should be reexamined before final congressional action is taken. PSA's major concern is that under section 15 of the bill, commissions and fees in connection with the distribution of shares in a unit investment trust would be included in gross revenues from the securities business.

In our opinion, this change is generally inconsistent with the legislative intent of the 1970 act. Thus, we recommend that the exemption currently applicable to this kind of business be retained in the 1977 amendments.

Specifically, the key factor underlying our argument on this point is that the purchaser of a trust unit has an absolute interest in the security. The purchaser's rights and any risks associated with the investment are based largely on the terms of the trust

agreement. After the sale by a broker-dealer, these rights and risks in most instances bear no relationship to the broker-dealer's business activities.

We submit that these incidents of ownership and risk should be considered in light of the objectives of SIPC in order to determine whether to include revenues from unit trust business in the SIPC assessment. In this regard, we note that the purpose of the 1970 act is to afford certain protections against financial loss to customers of broker-dealers which fail and, thereby, to promote investor confidence in the Nation's securities markets. as I previously indicated, most holders of unit investment trusts are generally not subjected to potential loss as a result of traditional practices of a securities firm. Therefore, PSA submits that the inclusion of unit investment trust revenues for assessment purposes goes beyond the scope of the 1970 act. Accordingly, we believe that such an addition to the 1970 act would impose an unnecessary charge on SIPC members engaged in the sale of unit investment trusts.

At this point I would like to offer several comments and suggestions on matters which are procedural in nature.

First, under existing and proposed SIPC provisions, self-regulatory organizations may be consulted by SIPC or they may take certain action with respect to broker-dealers. In the Securities Acts Amendments of 1975, the Municipal Securities Rulemaking Board is deemed a self-regulatory organization in connection with certain sections of the Securities Exchange Act of 1934. PSA recommends that H.R. 8331 specify that the MSRB be deemed a self-regulatory organization for purposes of the 1970 act.

Second, section 6 of H.R. 8331 provides that SIPC's general assessment authority would be exercised pursuant to a bylaw. Further, the proposed amendments to section 3 of the 1970 act that would provide that bylaws would be approved by the Securities and Exchange Commission under a procedure that would not provide for a public comment period. On the other hand, a public comment period is mandatory when a proposed SIPC rule change is submitted to the SEC for approval. We feel that SIPC members should have an opportunity to comment on proposed changes in the SIPC bylaws that relate to the exercise of SIPC's general assessment authority. Thus, we recommend that such a procedure be incorporated in the 1977 amendments.

Third, under section 4(c) of the 1970 act, any assessment upon SIPC members may be based upon or measured by, the amount or composition of their gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities—whether in the securities business or otherwise—and the consequent risks, or other relevant factors. PSA believes that H.R. 8331 should require SIPC to take the above-quoted factors into account in imposing assessments on members. In addition, we suggest that variations in assessments for classes of members should be instituted based on such factors.

Fourth, the 1976 annual report of SIPC discusses the SIPC Assessments Task Force. The task force will consider whether a future rate reduction is warranted and whether variations in the

way members are assessed should be instituted. In view of (a) the complexities involved in the task force's undertaking, and (b) the fact that legislation may be necessary to enable major changes to be made in the method of determining assessments, PSA recommends that H.R. 8331 contain a provision that would require the task force's report to be submitted to Congress.

Mr. Chairman, I think my testimony highlights our general support for SIPC and the amendments contained in the bill under consideration. However, we are voicing a strong concern about the cost of SIPC to its members, which include, of course, municipal securities dealers who are members of the Public Securities Association. Our intention in this regard is to initiate interest on the part of the subcommittee and SIPC in making the subject of SIPC assessments a matter of high priority.

We believe investor confidence in the Nation's securities markets has been enhanced since 1970 due to SIPC. Having accomplished this goal the industry, in our opinion, should now identify the most appropriate and efficient means to continue to achieve the commendable accomplishments of SIPC.

We would be pleased to answer any questions you might have.

I would like to thank you for the opportunity to present our views.

[Mr. Klein's prepared statement follows:]

August 2, 1977

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION
BEFORE THE SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
REGARDING THE SECURITIES INVESTOR PROTECTION ACT AMENDMENTS OF
1977 (H.R. 8331)

My name is Roger Klein and I am the Executive Director of the Public Securities Association (PSA). The PSA appreciates being afforded an opportunity to present its views on H.R. 8331 -- a bill which we believe contains important provisions that will significantly affect both the investing public and members of the Securities Investor Protection Corporation (SIPC). Accompanying me today is Mr. Joseph W. Sack who is PSA's Assistant Director for Regulation.

Initially, Mr. Chairman, I would like to state that the Public Securities Association is a national trade association representing banks and dealers who underwrite, trade and sell U.S. Government and Federal agency issues and state and local government securities. In addition, there are a number of PSA member organizations whose activities involve the sale of units of investment trusts that hold municipal securities. The PSA was formed in late 1976 to continue the work started more than seventy years ago by the Investment Bankers Association and its successor, the Securities Industry Association.

I have come here today to address the following items: (1) the overall advantages of H.R. 8331; (2) the treatment of unit investment trusts under the 1977 SIPC Amendments; and (3) the proposals that would modify the procedures for making changes in the rules and by-laws of SIPC.

1. Advantages of H.R. 8331

The practical advantages of H.R. 8331 relating to increased customer protection are fairly straightforward. The bill would grant a trustee in a liquidation proceeding the authority to promptly satisfy customer claims in a way that would give the customer what he had when the firm stopped doing business. Other provisions are designed to enable the trustee and SIPC to dispose of claims under procedures that would result in reduced administrative expenses. The Public Securities Association believes these changes are necessary and appropriate and, thus, we

wholeheartedly support the adoption of proposed new sections 7 through 10 of the Securities Investor Protection Act of 1970 (the 1970 Act).

2. Unit Investment Trusts

There are, however, certain provisions of H.R. 8331 which we believe should be re-examined before final Congressional action is taken. PSA's major concern is that under Section 15 of the bill commissions and fees in connection with the distribution of shares in a unit investment trust would be included in "gross revenues from the securities business". In our opinion this change is generally inconsistent with the legislative intent of the 1970 Act. Thus, we recommend that the exemption currently applicable to this kind of business be retained in the 1977 Amendments.

Specifically, the key factor underlying our argument on this point is that the purchaser of a trust unit has an absolute interest in the security. The purchaser's rights and any risks associated with the investment are based largely on the terms of the trust agreement. After the sale by a broker-dealer, these rights and risks in most instances bear no relationship to such broker-dealer's business activities.

We submit that these incidents of ownership and risk should be considered in light of the objectives of SIPC in order to determine whether to include revenues from unit investment trust business in the SIPC assessment. In this regard, we note that the purpose of the 1970 Act is to afford certain protections against financial loss to customers of broker-dealers which fail and, thereby, to promote investor confidence in the nation's securities markets. As I previously indicated, most holders of unit investment trusts are generally not subjected to potential loss as a result of traditional practices of a securities firm. Therefore, PSA submits that the inclusion of unit investment trust revenues for assessment purposes goes beyond the scope of the 1970 Act. Accordingly, we believe that such an addition to the 1970 Act would impose an unnecessary charge on SIPC members engaged in the sale of unit investment trusts.

3. Comments Regarding Procedural Changes

At this point I would like to offer several comments and suggestions on matters which we believe are procedural in nature.

- First, under existing and proposed SIPC provisions self-regulatory organizations may be consulted by SIPC or they may take certain action with respect to broker-dealers. In the Securities Acts Amendments of 1975, the Municipal Securities Rulemaking Board (MSRB) is deemed a self-regulatory organization in connection with certain sections of the Securities Exchange Act of 1934. PSA recommends that H.R. 8331 specify that the MSRB be deemed a self-regulatory organization for purposes of the 1970 Act.

- Second, Section 6 of H.R. 8331 provides that SIPC's general assessment authority would be exercised pursuant to a by-law. Further, the proposed amendments to Section 3 of the 1970 Act would provide that by-laws would be approved by the Securities and Exchange Commission (SEC) under a procedure that would not provide for a public comment period. On the other hand, a public comment period is mandatory when a proposed SIPC rule change is submitted to the SEC for approval. We feel that SIPC members should have an opportunity to comment on proposed changes in the SIPC by-laws that relate to the exercise of SIPC's general assessment authority. Thus, we recommend that such a procedure be incorporated in the 1977 Amendments.

- Third, under Section 4(c)(2) of the 1970 Act any assessment upon SIPC members may be based upon or measured by, "the amount or composition of their gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors." PSA believes that H.R. 8331 should require SIPC to take the above-quoted factors into account in imposing assessments on members. In addition, we suggest that variations in

assessments for classes of members should be instituted based on such factors.

- Fourth, the 1976 Annual Report of SIPC discusses the SIPC Assessments Task Force. The Task Force will consider whether a future rate reduction is warranted and whether variations in the way members are assessed should be instituted. In view of (a) the complexities involved in the Task Force's undertaking and (b) the fact that legislation may be necessary to enable major changes to be made in the method of determining assessments, PSA recommends that H.R. 8331 contain a provision that would require the Task Force's report to be submitted to Congress for review and approval prior to implementation.

Conclusion

Mr. Chairman, I think my testimony highlights our general support for SIPC and the amendments contained in the bill under consideration. However, we are also voicing a strong concern about the cost of SIPC to its members -- which include, of course, municipal securities dealers who are affiliated with the Public Securities Association. Our intention in this regard is to initiate interest on the part of the Subcommittee and SIPC in making the subject of SIPC assessments a matter of high priority. We believe investor confidence in the nation's securities markets has been enhanced since 1970 due to SIPC. Having accomplished this goal, the industry, in our opinion, should now identify the most appropriate and least costly means to continue to achieve the commendable accomplishments of SIPC.

We would be pleased to answer any questions you might have.

Mr. METCALFE. Thank you, Mr. Klein.

The chairman would at the moment like to defer asking any questions and will recognize the gentleman from North Carolina.

Mr. BROYHILL. Thank you, Mr. Chairman.

I appreciate your recognizing me at this time. I do have to leave for an appointment over in the House Chamber. I was a member of this committee at the time that the SIPC legislation was enacted and I remember well, of course, the events that led up to the passage of this legislation.

The purpose, of course, was to extend a certain amount of protection against the financial loss to customers of broker-dealers who failed. Of course the events of that period led up to a complete study of the securities industry that was conducted by Mr. Moss and me and this subcommittee in the next Congress and of course that resulted in the 93d Congress in the passage of the most extensive rewrite of the Securities act since the 1930's, which was sponsored, as you know, by Chairman Moss and myself. But in my judgment the SIPC program has worked well.

I recall well the debate over the issue of who would be included, who would be included for assessment purposes. The decision was made at that time to assess those who were engaged in what you might call business practices that resulted in a greater exposure to loss for customers in the event of failure of the firm. I have seen no evidence so far to make me change my mind on the decision that I made at that time.

Now the evidence has been pointed out here and I am trying to find out what the magnitude of the problem is and I am getting very little information. I find that SIPC has paid out less than \$200,000 over several years to customers to reimburse for mutual fund holdings. I have also been informed by testimony of Mr. Owens yesterday that if the firms that they would intend to assess were assessed in the last year, they would have been assessed anywhere from \$1.4 million to \$2 million.

Your testimony today, I believe, Mr. Silver, indicates that in a study that you have conducted that if the member firms, or the businesses that had been assessed or defined in this bill, it would have totaled \$10,300,000. We were told today by Mr. Loomis of a firm in Tennessee with the potential loss to customers of \$200,000.

Now this is the only information that I have as to the magnitude of the problem. But it looks to me as if they have a slight problem and they are trying to cure it with a blunderbuss. But if you can shed any light, or have any other information on the magnitude of the losses, I would appreciate it.

Mr. SILVER. Yes, sir.

Mr. BROYHILL. The potential for loss.

Mr. SILVER. The potential for loss, sir, remains exactly as was stated in 1970. And I do think, I might make a preliminary comment, I think we have kept faith with you. We said in 1970 that the risk of loss was minimal. You just can't prevent people on occasion from stealing money. And that is really the only risk of loss. It does not arise in this industry from ordinary business operations, the commingling of customers' funds and securities with your own, which is what creates the problem through the general securities industry.

I don't know of any other cases, as far as SIPC's payments are concerned, than the \$190,000 over the 6-year period.

Mr. BROYHILL. Do you know of any losses that have occurred that were not covered by SIPC other than the \$200,000 case that was mentioned by Mr. Loomis this morning?

Mr. SILVER. I can say, sir, I do not know of any and I can also say that when this kind of thing happens, the SEC is usually the first place that a customer writes to and the Investment Company Institute may be the second place and the mutual fund, itself, which is likely a member, would of course be included in such correspondence. No such correspondence has come to our attention in the last 6 years.

Mr. BROYHILL. In your testimony you say that the SEC after appropriate study should adopt changes in the present bonding requirements.

Would you outline for me what are the present bonding requirements on your members?

Mr. SILVER. As far as—I now have to again separate between the level of the investment adviser, the fund and underwriter, which you may view as being on one level and the retail broker-dealer on another level.

There is a requirement in the Investment Company Act, and a schedule of fidelity bonds, which the funds itself and its own employees, must have. And these are very large fidelity bonds. As a matter of practice the underwriter and adviser universally, I believe, receive coverage under the same bonds. These numbers are substantial. I don't think there is any real problem on that level.

On the level of the retail broker-dealer, if he is only a mutual fund or variable annuity, I believe, dealer, the fidelity bonding requirement by the SEC is minimal. There is authority in the commission to adopt such fidelity bonding rules but there is only a minimal requirement at present. I don't remember the number. It could be \$5,000 or \$10,000.

Mr. BROYHILL. Could you very quickly suggest the changes that you are alluding to here in your testimony on page 9 or would you want to submit a memorandum for the record on that?

Mr. SILVER. I think I could refer to it. I think that one would look back through these cases and I am surprised that there is a case now as high as \$200,000. That is a surprise. But I don't think in any of the other cases, the eight cases SIPC spoke about, there were any losses that exceeded \$20,000 to \$30,000. I think one could simply analyze those cases and probably come out of it, if one wanted to go down this route, with a fidelity bond requirement around that level. As far as we can determine, all of these losses would have fallen within the coverage of standard fidelity bonds.

Mr. BROYHILL. Thank you very much.

I have no other questions.

Mr. METCALFE. Thank you, Mr. Broyhill.

I now recognize Mr. Oppen for any questions he may wish to ask at this time.

Mr. OPPEN. Mr. Silver, Mr. Loomis indicated that smaller underwriters may have difficulty in obtaining fidelity coverage.

Could you comment on that?

Mr. SILVER. Yes, I could. Again I want to—I don't really want to say there was a slip of the tongue. I want to distinguish very carefully: No underwriters have any problems in obtaining fidelity bonds at all. All underwriters have fidelity bonds and there is no problem whatsoever on the underwriter and fund level. I think he was really speaking of retail broker-dealers. That may be so. And I think one would really have to inquire carefully as to whether any such fidelity bond were available. I think they are. They could be costly, one supposes, but I don't think as costly as SIPC membership to these broker-dealers. Certainly any substantial broker-dealer has no trouble. There is a standard fidelity bond which is used throughout the securities industry and those fidelity bonds cover risks much broader than those associated with the mutual fund business.

The point is we urged this approach very strongly 2 years ago. The SEC study on unsound and unsafe practices, which was mandated by the original legislation back in 1970, analyzed the mutual fund situation and analyzed the sources of risk throughout the brokerage industry. It may be a little more complicated and it may require a little more work to develop specific rules to take care of specific problems than simply compelling everybody to be a member of a big insurance organization, but it certainly is worth the work here. There are specific cures to the specific problems.

Mr. OPPER. Yesterday Chairman Owens in commenting on the cost-risk relationship of SIPC assessments indicated that among other specialists on the New York Stock Exchange floor are members of SIPC and pay SIPC assessments although minimal or no risk is involved.

Would you comment on that?

Mr. SILVER. Well, I could give the kind of flippant answer that two wrongs don't make a right but that is not the case here. The fact is that specialists and floor brokers on the New York Stock Exchange derive substantial benefits from the existence of SIPC and it works this way: It is quite true they don't do any direct public business and carry customers' accounts. But individual trading on the New York Stock Exchange still accounts for almost half of all transactions, institutional transactions being the other half.

Of those individual transactions, about one half are margin transactions. So 22 percent, approximately, of all transactions on the New York Stock Exchange are margin transactions. That is the service of the \$3.5 billion I was talking about. Those transactions are financed by the brokerage firms who create the risk.

Next you must understand that half of specialists' income and all the floor brokers' income derive from volume. They are paid commissions for executing orders on the floor. Twenty-two percent of the transactions, as I say, are margin transactions which would be drastically curtailed were it not for the ability of member firms to continue lending money and securities to margin traders.

So there it is. That is how specialist and floor brokers have a direct monetary stake in the existence of SIPC.

Mr. MASON. This specific issue has arisen before, it arose in the original consideration of the legislation and then again in 1975. Our statement does address attention to your question. We make the statement, in our statement, that it is through these specialists,

institutional brokers, floor brokers, et cetera, that orders of all individuals and institutions find their way to the market.

I think once you analyze that situation, it leads to the conclusion that such persons, specialists, et cetera, is an integral part of the market in the way that is distinctly different I think from sellers of mutual fund shares and variable annuities. I think the comparison occasionally drawn by the SIPC and the commission to some extent is an unfair one as a result.

Mr. OPPER. Do either of you feel that the investment company industry, including variable annuities, has benefited from SIPC's existence?

Mr. SILVER. I would think, Mr. Oppen, that my industry is as sensitive to marketing as other industries and we see no advantage from SIPC insofar as we are concerned.

Mr. MASON. I think it would be unlikely that any purchaser of a variable annuity contract would ever have in mind that if there was coverage, for example, that that would be a factor in his determination to make a purchase. I think that what perhaps you are getting to and what Mr. Owens alluded to on earlier occasions is the general health of the securities business and whether or not that is a factor in terms of the mutual fund purchaser or variable annuity purchaser. I think no more so than in terms of an average customer, whether a customer like a Mr. Rockefeller or the average small investor. I think in very early consideration of the original SIPC legislation—Mr. Silver might correct me—I think one of the congressmen on the committee did consider the transaction charge in fact and that was rejected out of hand when an appropriate analysis clearly developed what the real problems are and what the solutions might be.

Mr. OPPER. Perhaps Mr. Klein would like to comment with respect to the unit investment trust sector?

Mr. KLEIN. Well, we feel that unit investment trusts are very much like mutual funds and present risks to SIPC that are very much in line with the risks that mutual funds present to SIPC.

Mr. OPPER. Mr. Silver, would you be willing to consider, or would your industry consent to a SIPC assessment if it were based solely on actual experience?

Mr. SILVER. The problem here, Mr. Oppen, is the point I tried to make and I think I am the only one that really brought that out, that is, as I called it—turning the coin over. Who really benefits from SIPC? Let's get away from the burdens of SIPC. The fact is that there are firms which have made \$3½ billion out of the perpetuation of their traditional business practices after SIPC was created in 1970. There is not one penny that has been made by the mutual fund industry or the insurance industry from those practices which were kept alive by SIPC.

Why we, in essence, should be walking down the street and suddenly be told that we are to pay insurance premiums to protect the profits of some third party is simply beyond me. The fact is that if this proposal were not made by responsible men, I think it would be laughed at, looking at the profit situation. There is \$3½ billion here that was added to the income stream of the firms protected by SIPC, the general brokerage firms.

Mr. OPPER. Thank you.

Mr. METCALFE. Because of the time factor—and I have a very urgent meeting to go to immediately—I would like to ask unanimous consent to submit some questions to the panel and any member of the panel may or may not answer it because the questions are not directed to any specific person.

Would you be willing to respond in writing to these questions?

Mr. MASON. Yes.

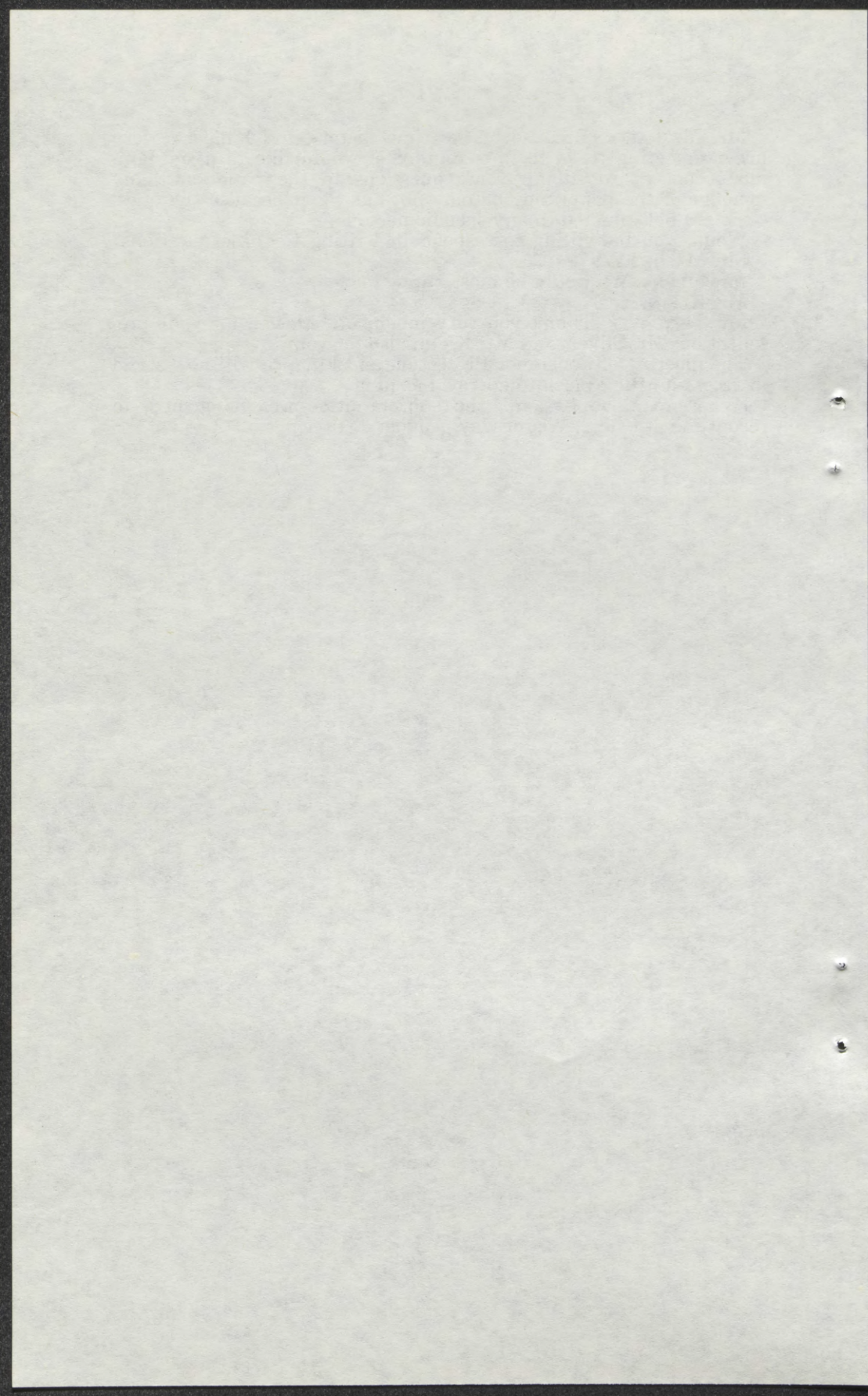
Mr. SILVER. We would be most happy to.

Mr. KLEIN. Yes.

Mr. METCALFE. Thank you very much, Mr. Mason, for your presentation; Mr. Silver, and Mr. Klein, also for yours.

The meeting of Consumer Protection and Finance will now stand in recess until 8 o'clock tomorrow morning.

[Whereupon, at 10 a.m., the subcommittee was adjourned, to reconvene at 8 a.m., Wednesday, August 3, 1977.]



SECURITIES INVESTOR PROTECTION ACT OF 1977

WEDNESDAY, AUGUST 3, 1977

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 8 a.m., in room 2322, Rayburn House Office Building, Hon. Ralph H. Metcalfe, presiding.

Mr. METCALFE. The Subcommittee on Consumer Protection and Finance will be in order.

This morning the subcommittee begins the third day of hearings on H.R. 8331, the Securities Investor Protection Act Amendments of 1977.

Thus far, most of the witnesses appearing before the subcommittee have concerned themselves with certain nonprocedural provisions of the bill. Specifically, witnesses have addressed the issues of the inclusion of mutual funds, variable annuities and unit investment trusts in the SIPC assessment base.

In addition, we have heard NASD criticize the authority of SIPC to require its members to advertise SIPC protection. We have also received both criticism and reservations about the language contained in proposed section 4(i), which would amend the consolidated reporting of gross revenues for purposes of assessment. This section admittedly raises some difficult issues.

Today's witnesses will, no doubt, further focus on that controversial provision. Our panel members will also be expressing their concerns over the proposed assessment of money market instruments. Finally, one of our witnesses will be addressing the issue of subordinated lending agreements.

Our first witnesses this morning, who represent two major investing institutions, will be appearing as a panel. We are pleased to have with us Alan Sher, Executive Vice President of Merrill Lynch, and Hyman Weinberg of Goldman, Sachs.

Please proceed with your statements.

STATEMENTS OF HYMAN WEINBERG, GENERAL PARTNER, GOLDMAN, SACHS AND CO., ACCOMPANIED BY JUDITH G. SHEPARD, ASSOCIATE HOUSE COUNSEL, AND ALLAN SHER, EXECUTIVE VICE PRESIDENT, MERRILL LYNCH, PIERCE, FENNER & SMITH INC.

Mr. WEINBERG. Good morning. My name is Hyman Weinberg. I am a general partner of Goldman, Sachs and Co., and am appearing today on behalf of my partners to present to you our concerns and views with respect to the apparent effect of certain of the amendments proposed in H.R. 8331.

First I want to say that we appreciate the opportunity to appear before you today and are prepared to answer any questions you may have regarding our remarks.

Since the inception of SIPC, Goldman Sachs has been assessed and has paid to the fund approximately \$2,900,000. We have never questioned the propriety of SIPC's aims and continue to be prepared to make our fair contribution to the growth and maintenance of the fund because we believe its purposes to be in the interest of the investing public and the securities markets.

We are here today representing one of the major investment banking and money market instrument dealers because we believe the proposed amendment as to the computation of gross revenues coupled with the definition of the term security will result in assessments that go far beyond that which was contemplated by the Congress in 1970, without practical justification for imposing such additional assessments.

The SIPC fund exists to provide protection for investors who leave funds or securities with their broker, in the event that the broker encounters financial difficulties. Within certain limitations the SIPC fund is intended to make it possible for public customers to recover that to which they are entitled and which the broker had been holding.

The markets for money market instruments are not a small offshoot of the stock market. They dwarf the stock market in terms of dollar activity by more than a 10 to 1 ratio.

It is our feeling that extending the SIPC assessment to these much larger money markets is inappropriate considering the manner in which the business is conducted, the nature of the customers and the nature of SIPC's actual loss experience.

In addition, we don't believe that appropriate study of the potential impact of SIPC assessments on this huge and important market has been made.

Average daily volume of transactions on the New York Stock Exchange for all of last year was about \$650 million per day. Contrast that with the volumes in the money markets. Average daily volume in Treasury bills runs about \$7.5 billion a day.

Average daily volume of commercial paper—and that is commercial paper that is sold by dealers—runs between \$900 million to \$1 billion a day; bankers acceptances, about \$1.5 billion a day; certificates of deposit, about three quarters of a billion dollars a day—far larger numbers than we are accustomed to seeing in the stock market.

As contrasted with conventional transactions in corporate stocks and bonds, purchasers of money market instruments are almost

exclusively large, sophisticated institutions and corporations enjoying large cash flows managed by experienced professionals. The instruments are generally sold in large denominations with the typical transaction at Goldman Sachs ranging from \$2 million for commercial paper to close to \$7 million for each Treasury bill transaction.

Purchasers capable of investing sums of this magnitude do not expect nor are they helped by the kinds of protection provided by the SIPC fund. Clearly the \$100,000 maximum SIPC payment would mean little, if anything, to a buyer whose average transaction ranges from \$2 million to \$7 million. In addition, and this is very important, a broker-dealer's money market transactions are almost always COD purchases; that is, the instrument is delivered directly by the dealer to the buyer or the buyer's bank against payment in Federal funds.

Thus, since neither the customer's funds nor securities are left with the dealer, the activities of dealers in this market create virtually no risk that any SIPC funds will be called upon to satisfy customer claims. It is unreasonable to impose a disproportionate burden of SIPC assessments on broker-dealers whose activities do not create the risks for which the SIPC fund was created. We also submit that imposing assessments on the money market activities of broker-dealers is neither required to correct any inequities or inadequacies in the present system, nor justified by any apparent public need.

The imposition of a SIPC assessment on money market instruments will put dealers such as Goldman Sachs at a competitive disadvantage with the major banks and nonregistered dealers who trade in Treasury bills, bankers' acceptances and other similar instruments.

Generally speaking, I would say a maximum profit or typical profit on a Treasury bill transaction is less than five basis points; that is, five one-hundredths of 1 percent. Very often the profit is $2\frac{1}{2}$ basis points, or $2\frac{1}{2}$ one-hundredths of 1 percent. We are talking about very, very small profit margins here. The dollars involved in terms of the magnitudes, \$7.5 billion a day of Treasury bills traded is large, but, the profits here are very, very slim. Considering the very narrow spreads at which this business is done, the requirement to pay a SIPC assessment places firms such as ours at a competitive disadvantage relative to the banks and nonregistered dealers.

This competitive disadvantage might have an undesirable impact on the liquidity of the markets that exist in Treasury bills, CD's and the other money market instruments.

We believe that subjecting revenues of a dealer from transactions in money market instruments to SIPC assessment would impose an unreasonable burden on Goldman Sachs and the small number of other broker-dealers that account for the bulk of the trading in such instruments. Thus, the financial impact of SIPC assessment of revenues derived from money market transactions will fall almost entirely on this limited number of dealers who are already paying substantial assessments to SIPC based on their general securities business.

For example, Goldman Sachs last year paid over \$625,000 as its contribution to the SIPC fund.

It is our understanding that the SIPC fund, even without any new assessment authority, will probably meet the statutory target of \$150,000,000 as of the end of this year.

We also have been given to understand by SIPC that to date no moneys have been expended to pay customers for losses in commercial paper or bankers' acceptances and that of the approximately \$52 million paid out to date, payouts for certificates of deposit and Treasury bills have amounted to \$1.8 million or 3.5 percent.

It is further our understanding that the \$1.8 million represented atypical losses caused by fraud on the part of the broker in not purchasing the instruments for the customer and not a loss related to a broker encountering financial and/or operational difficulties.

In view of the disproportionate burden that assessments of money market instruments would impose and the absence of any demonstrable need to provide SIPC benefits to purchasers of such instruments, we would first submit that expanding SIPC's assessment authority to include money market instruments at this time would be wholly unjustified.

Accordingly, we would propose that the act be changed in such a manner as to exclude such instruments from SIPC's assessment authority.

If Congress does believe that the SIPC should be given the authority to assess money market instruments, we would strongly urge that that authority be limited to such an assessment as would be an appropriate reflection of actual loss experience.

We have some language for these amendments which we will send to the committee as an appendix to our statement.

Finally, we do not wish to be understood as being opposed to the fundamental thrust of the major purposes of the bill. Many of the changes sought, including provisions designed to streamline liquidation proceedings and add needed flexibility to the methods available to satisfy customer claims, would clearly be in the public interest and should be adopted.

However, the basis for assessment should not be enlarged unless a demonstrated need to do so is shown.

Thank you very much.

[Mr. Weinberg's prepared statement and appendix follow:]

July 29, 1977

H.R. 8331

Testimony of Hyman Weinberg of Goldman, Sachs & Co.

Gentlemen, my name is Hyman Weinberg, I am a general partner of Goldman, Sachs & Co. and am appearing today on behalf of my partners to present to you our concerns and views with respect to the apparent effect of certain of the amendments proposed in H.R. 8331. With me is Judith G. Shepard our Associate House Counsel.

First I want to say that we appreciate the opportunity to appear before you today and are prepared to answer any questions you may have regarding our remarks, copies of which have been submitted to the Subcommittee.

Since the inception of SIPC Goldman Sachs has been assessed and has paid to the Fund approximately \$2,900,000. We have never questioned the propriety of SIPC's aims and continue to be prepared to make our fair contribution to the growth and maintenance of the Fund because we believe its purposes to be in the interest of the investing public and the securities markets.

We are here today representing one of the major dealers in money market instruments because we believe the proposed amendment as to the computation of gross revenues coupled with the definition of the term "security" will result in assessments that go far beyond that which was contemplated by the Congress in 1970, without practical justification for imposing such additional assessments.

The SIPC fund exists to provide protection for investors who leave funds or securities with their broker, in the event that the broker encounters financial difficulties. Within certain limitations the SIPC fund is intended to make it possible for public customers to recover that to which they are entitled and which the broker had been holding.

As shown by the following table, the markets for money market instruments are not a small offshoot of the stock market-- they dwarf the stock market in terms of dollar activity by more than a 10 to 1 ratio. It is our feeling that extending the SIPC assessment to these much larger money markets is inappropriate considering the manner in which the business is conducted, the nature of the customers and the nature of SIPC's actual loss experience. In addition, we don't believe that appropriate study of the potential impact of SIPC assessments on this huge and important market has been made.

	Average Daily Volume of Securities Sold (in millions)	Sample Period
Stock Markets:		
New York Stock Exchange	\$ 650	1976
All Registered Exchanges (Including NYSE)	820	1976
Money Markets:		
Treasury Bills	\$7,630*	Jan 1977
Commercial Paper	1,000	1976
Bankers' Acceptances	1,500*	Jan 1977
Certificates of Deposit	778*	Jan 1977

* Average for dealers reporting to the Federal Reserve Bank

As contrasted with conventional transactions in corporate stocks and bonds, purchasers of money market instruments are almost exclusively large, sophisticated institutions and corporations enjoying large cash flows managed by experienced professionals. The instruments are generally sold in large

denominations, with the typical transaction at Goldman Sachs ranging from \$2 million for commercial paper to close to \$7 million for Treasury bills.* Purchasers capable of investing sums of this magnitude do not expect nor are they helped by the kinds of protection provided by the SIPC fund. (Clearly, the \$100,000 maximum SIPC payment would mean little, if anything, to a buyer whose average transaction ranges from \$2 million to \$7 million.) In addition, a broker-dealer's money market transactions are almost always "COD" purchases, i.e., the instrument is delivered directly by the dealer to the buyer or the buyer's bank against payment in Federal funds. Thus, since neither customer funds nor securities are left with the dealer, the activities of dealers in this market create virtually no risk that any SIPC funds will be called upon to satisfy customer claims. It is unreasonable to impose a disproportionate burden of SIPC assessments on broker-dealers whose activities do not create the risks for which the SIPC fund was created. We also submit that imposing assessments on the money market activities of broker-dealers is neither required to correct any inequities or inadequacies in the present system nor justified by any apparent public need.

The imposition of a SIPC assessment on money market instruments will put dealers such as Goldman Sachs at a competitive disadvantage with the major banks and non-registered dealers who trade in Treasury bills, bankers' acceptances and other similar instruments. Considering the very narrow spreads, often no more than a couple of basis points, at which this business is done, the requirement to pay a SIPC assessment gives an unfair advantage to those major competitors who are

* We understand from our general experience in this market that the practices at Goldman Sachs are similar to those of other dealers. Although there may have been instances in the past involving the sale of notes having lesser denominations by some broker-dealers, this has clearly been the exception. In addition, individuals wishing to invest small sums in the money market can now do so through professionally managed money market funds which have expanded significantly in recent years.

not similarly treated. This competitive disadvantage might have an undesirable impact on the liquidity of the markets that exist in Treasury bills, CD's and the other money market instruments.

We believe that subjecting revenues of a dealer from transactions in money market instruments to SIPC assessment would impose an unreasonable burden on Goldman Sachs and the small number of other broker-dealers that account for the bulk of the trading in such instruments. Thus, the financial impact of SIPC assessment of revenues derived from money market transactions will fall almost entirely on this limited number of dealers who are already paying substantial assessments to SIPC based on their general securities business. For example, Goldman Sachs last year paid over \$625,000 as its contribution to the SIPC fund.

It is our understanding that the SIPC fund, even without any new assessment authority, will probably meet the statutory target of \$150,000,000 as of the end of this year. We also have been given to understand by SIPC that to date no monies have been expended to pay customers for losses in commercial paper or bankers' acceptances and that of the approximately \$52 million paid out to date, payouts for certificates of deposit and Treasury bills have amounted to \$1.8 million or 3.5%. And it is further our understanding that the \$1.8 million represented atypical losses caused by fraud on the part of the broker in not purchasing the instruments for the customer and not a loss related to a broker encountering financial and/or operational difficulties.

In view of the disproportionate burden that assessments of money market instruments would impose and the absence of any demonstrable need to provide SIPC benefits to purchasers of such instruments we would first submit that expanding SIPC's assessment authority to include money market instruments at this time would be wholly unjustified. Accordingly we would propose that Sec. 4(i)(2) of the 1970 Act be amended in such a manner as to exclude such instruments from SIPC's assessment authority.

If Congress does believe that SIPC should be given the authority to assess money market instruments we would strongly urge that that authority be coupled with the power of SIPC to exclude by by-law from such an assessment an appropriate percentage in the aggregate of revenues from certificates of deposit, Treasury bills, brokers' acceptances and commercial paper based on the loss experience for at least the preceding 5 years we have just described.

I have some language for both amendments which is included in our statement as Appendix A.

In addition to the specific exclusion of money market instruments from assessment we would like to see a clarification of the meaning of the computation on a consolidated basis as proposed in the amendment to Section 4(i)(2) of the Act to make certain that its language does not include gross revenues from partnerships formed by partners of broker-dealers for the purposes of personal investment. We do not believe that such partnerships can in any way be considered to be part of the securities business of a member nor do we believe that was intended by the drafters of the Bill. We think, however, that it would be helpful to have that point clarified in the final Committee Report on the Bill.

Finally we do not wish to be understood as being opposed to the fundamental thrust of the major purposes of the Bill. Many of the changes sought, including provisions designed to streamline liquidation proceedings and add needed flexibility to the methods available to satisfy customer claims, would clearly be in the public interest and should be adopted.

It is our hope that we have provided you with concrete facts on which to base a decision to review once more the position to be taken by Congress with respect to the appropriate assessment of gross revenues from transactions in money market instruments.

APPENDIX A

Proposed Amendment #1 to Sec. 6(g) of H.R. 8331

(g) Section 4(i) of such Act (15 U.S.C. 78ddd(i)) is amended to read as follows:

"(i) "GROSS REVENUES" DEFINED --

(1) IN GENERAL -- For purposes of this Act, the term "gross revenues from the securities business" means the sum of (but without duplication)

(A) commissions earned in connection with transactions in securities effected for customers as agent (net of commissions paid to other brokers and dealers in connection with such transactions) and markups in respect of purchases or sales of securities as principal, but shall not include such markups in respect of purchases or sales of certificates of deposit, Treasury bills, bankers acceptances or commercial paper which have a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited."

Proposed Amendment #2 to Sec. 6(g) of H.R. 8331

(g) Section 4(i) of such Act (15 U.S.C. 78ddd(i)) is amended to read as follows:

"(i) "GROSS REVENUES" DEFINED --

(1) IN GENERAL -- For purposes of this Act, the term "gross revenues from the securities business" means the sum of (but without duplication)

(A) commissions earned in connection with transactions in securities effected for customers as agent (net of commissions paid to other brokers and dealers in connection with such transactions) and markups in respect of purchases or sales of securities as principal. With respect to such revenues from certificates of deposit, Treasury bills, bankers acceptances or commercial paper which have a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, gross revenues shall include only such amount as represents the percentage derived by dividing the total loss experience from such money market instruments by the total loss experience from all other securities for at least the preceding 5 years, multiplied by the member's Gross Revenues from money market instruments.

Mr. METCALFE. Thank you, Mr. Weinberg.
Mr. Sher?

STATEMENT OF ALLAN SHER

Mr. SHER. My name is Allan Sher. I am an Executive Vice President of Merrill Lynch, Pierce, Fenner and Smith, Inc.

When the legislation creating the Securities Investor Protection Corporation was first proposed in 1970, my firm actively supported the concept of insurance to protect customers against losses due to their broker's insolvency. We assisted in drafting the bill and are the largest single contributor to the funding of SIPC.

Since its inception, Merrill Lynch has paid in excess of \$18 million in SIPC assessments. Our chairman, Don Regan, served as one of the initial industry directors of the new corporation and actively participated in its affairs during the early years of its existence.

We continue to support the concept of an insurance company funded by the industry to protect customers against broker insolvency.

We support those portions of H.R. 8331 which clarify the application of the bankruptcy act to SIPC liquidations, establish a procedure for SEC review of SIPC rules, and increase the basic coverage to \$100,000 for each customer.

But we strongly oppose two proposed amendments to the Securities Investor Protection Act. We disagree with the proposal to expand, not the basic SIPC coverage, but the assessment base. As stated by Chairman Owens in the 1976 SIPC Annual Report:

"SIPC is in good shape after 6 years of operations. The fund is growing. Improved regulatory procedures have been implemented by the self-regulatory organizations and the SEC.

"The number of broker-dealer failures resulting in SIPC liquidations continues to decline, making lower operating costs possible. In short, SIPC is meeting the purpose for which it was intended—to give greater protection to the investing public."

Those statements clearly demonstrate that there is no need for an increase in the assessment base.

Yet, as the SIPC fund comes within reach of its \$150 million threshold, H.R. 8331 proposes to greatly expand the assessment base of SIPC members by consolidating the securities revenues of their affiliates and their subsidiaries with those of the members and their own subsidiaries.

The effects of the revised definition of the consolidated group assessment base will simply be to generate increased assessment revenues at a time when the act dictates just the opposite.

Such an increase aggravates the longstanding gross inequity endured by the larger, better capitalized firms by imposing an added tax burden upon those members of SIPC who already are its greatest contributors and who present the least threat to the fund.

First, we refer to the statement of Hyman Weinberg, submitted today on behalf of Goldman Sachs and Company explaining the manner in which H.R. 8331 would expand the SIPC assessment base to include money market instruments.

While we do not wish to repeat those arguments, we would like the record to show our total agreement with those statements.

Second, we oppose the proposed amendment to section 4(g)(i) of the act which would also substantially increase the scope of the assessment base upon which members presently compute their respective assessments, by including the gross revenues from the securities business of the members' parents and affiliates, as well as their subsidiaries, in the consolidated group upon which such members' SIPC assessments are determined.

Heretofore excluded, these affiliate subsidiaries neither have customers in need of the protection of the act, as in the case of Merrill Lynch Government Securities, Inc., nor customers to whom the act would afford protection, as in the case of Merrill Lynch International and Co. and Merrill Lynch Royal Securities, Inc.

The experience with SIPC to date demonstrates that smaller brokers who in 1975 paid less than \$5,000 a year contributed only about \$1.9 million to the SIPC fund, but cost SIPC an average of \$5.5 million a year over a 5½-year period.

The existing disproportionate contribution of the larger firms will only be aggravated by the proposed amendment without any apparent justification. This industry is now, for the first time in its long existence, competing for business on the basis of competitive rates of commission. This additional burden would only add to the amounts that customers must pay for their brokerage services.

As of June 30 of this year, the SIPC fund stood at \$137 million, an increase of nearly \$50 million in the 18-month period from December 31, 1975. Given the same rate of assessment, revenues realized and interest income earned by the fund, it should top out at \$150 million in about 6 months.

Once \$150 million has been reached, SIPC may reduce the rate of its members' assessments. SIPC has, in fact, organized a task force, of which I am a member, to make recommendations with respect to the fund level and the basis for reductions in the assessment rate.

During 1977, to date, only two members have been placed in liquidation under the provisions of the 1970 act. The potential exposure to the fund is modest.

It is anomalous that while the revenues from integrated broker-dealers derived from their government securities business would now be included in the assessment base there is no similar proposal regarding the government business of banks with whom we must compete.

This is so in spite of the fact that there is absolutely no coverage for government securities today under the Federal Deposit Insurance Act.

The impact of the proposals will be substantial upon Merrill Lynch and Co., because its foreign subsidiaries would become subject to assessment although there is again absolutely no SIPC protection for customers of these companies, since SIPC has no authority to conduct a liquidation abroad.

We believe levying an assessment on the proposed consolidated group basis is grossly unfair. The proposal would magnify the existing inequity of requiring the Canadian subsidiary of Merrill Lynch, Pierce, Fenner and Smith, Inc. to pay SIPC revenues in spite of the fact that there is no SIPC coverage for customers of Merrill Lynch's Canadian broker-dealer subsidiary. The entire

focus of the legislative intent is to protect customers of registered domestic broker-dealers.

Further, to assess the foreign affiliates and subsidiaries of a U.S. broker-dealer would put those entities at a competitive disadvantage to foreign broker-dealers who are unaffiliated with a domestic broker. This will inevitably lead to customers abroad choosing to deal with our foreign competitors who do not need to add this additional charge to their cost of doing business.

It would undoubtedly impact unfavorably on the ability of domestic brokers to add liquidity to our markets through the participation of foreign investors.

We also oppose the extension in section (9) to expand the definition of gross revenues from the securities business to include commissions and fees in connection with the distribution of shares in a registered open end investment company or unit investment trust or from the sale of variable annuities.

These revenues were specifically excluded from the present assessment base by section 4(3) in the original statute and there is no demonstrated need for an expansion of the assessment base now. There is no need to add to an admittedly already adequate fund.

Finally, we believe that the proposed amendment to redesignate section 15(e), authorizing SIPC to prescribe the manner in which members may or shall advertise their membership in SIPC, might lead to the mandatory statement of SIPC membership in every television, radio or printed advertisement.

This would not only interfere with the message intended to be conveyed, but also perhaps give customers an assurance of protection beyond the actual coverage available.

This concludes our oral statement. We request that the record remain open for 15 days for the submission of a more formal written statement [see p. 317].

[Mr. Sher's prepared statement follows:]

STATEMENT OF ALLAN SHER,
EXECUTIVE VICE PRESIDENT, MERRILL
LYNCH, PIERCE, FENNER & SMITH
INC., BEFORE THE SUBCOMMITTEE ON
CONSUMER PROTECTION AND FINANCE
OF THE COMMITTEE ON INTERSTATE AND
FOREIGN COMMERCE OF THE HOUSE OF
REPRESENTATIVES CONCERNING H.R. 8331

August 3, 1977

My name is Allan Sher. I am an Executive Vice President of Merrill Lynch, Pierce, Fenner & Smith Inc.

When the legislation creating the Securities Investor Protection Corporation ("SIPC") was first proposed in 1970, my firm actively supported the concept of insurance to protect customers against losses due to their broker's insolvency. We assisted in drafting the bill and are the largest single contributor to the funding of SIPC. Since its inception, Merrill Lynch has paid in excess of \$18 million in SIPC assessments. Our Chairman, Don Regan, served as one of the initial industry directors of the new Corporation and actively participated in its affairs during the early years of its existence.

We continue to support the concept of an insurance company funded by the industry to protect customers against broker insolvency.

We support those portions of H.R. 8331 which clarify the application of the Bankruptcy Law to SIPC liquidations, establish a procedure for SEC review of SIPC rules, and increase the basic coverage to \$100,000 for each customer. But we strongly oppose two proposed amendments to the SIPC Act. We disagree with the proposal to expand, not the basic SIPC coverage, but the assessment base. As stated by Chairman Owens in the 1976 SIPC Annual Report:

SIPC is in good shape after six years of operations. The Fund is growing. Improved regulatory procedures have been implemented by the self-regulatory organizations and the SEC. The number of broker-dealer failures resulting in SIPC liquidations continues to decline,

making lower operating costs possible. In short, SIPC is meeting the purpose for which it was intended- to give greater protection to the investing public.

This demonstrates that there is no need for an increase in the assessment base.

And yet, as the SIPC Fund comes within reach of its \$150 million threshold, H.R. 8331 proposes to greatly expand members' assessment bases by consolidating the securities revenues of their affiliates and their subsidiaries with those of the members and their subsidiaries. The effects of the revised definition of the consolidated group assessment base will simply be to generate increased assessment revenues at a time when the Act dictates just the opposite and to aggravate the longstanding gross inequity endured by the larger, better capitalized firms by imposing an added tax burden upon those members of SIPC who already are its greatest contributors and who present the least threat to the Fund.

First; we refer to the statement of Hyman Weinberg, submitted today on behalf of Goldman Sachs explaining the manner in which H.R. 8331 would expand the SIPC assessment base to include money market instruments. While we do not wish to repeat those arguments, we would like the record to show our total agreement with those statements.

Second, we oppose the proposed amendment to Section 4(g) (i) of the Act which would greatly expand the assessment base upon which members presently compute their respective assessments, by including the gross revenues from the securities business of the members' parents and affiliates, as well as their subsidiaries, in the "consolidated group" upon which such members' SIPC assessments are determined. Heretofore excluded, these subsidiaries neither have customers in need of the protection of the Act, as in the case of Merrill Lynch Government Securities Inc., nor customers to whom the Act would afford protection, as in the case of Merrill Lynch International & Co. and Merrill Lynch Royal Securities Inc.

The experience with SIPC to date demonstrates that smaller brokers who in 1975 paid less than \$5,000 a year contributed only about \$1.9 million to the SIPC Fund, but cost SIPC an average of \$5.5 million a year over a 5½ year period. On the other hand, the firms paying over \$5,000 a year paid SIPC approximately \$24 million in 1975, but cost SIPC on the average only \$3.9 million a year over the same period. The existing disproportionate contribution of the larger firms will only be aggravated by the proposed amendment without any apparent reason. This industry is now, for the first time in its long existence, competing for business on the basis of competitive rates of commission. This additional burden would only add to the amounts that customers must pay for their brokerage services.

As of June 30th of this year, the SIPC Fund stood at \$137 million, an increase of nearly \$50 million in the 18 month period from December 31, 1975. Given the same rate of assessment, revenues realized and interest income earned by the Fund, it should top out at \$150 million, or such other amount as the Securities and Exchange Commission determines to be in the public interest. Once \$150 million has been reached, SIPC may reduce the rate of members' assessments. SIPC has, in fact, organized a Task Force, of which I am a member, to make recommendations with respect to the Fund level and the basis for reductions in the assessment rate.

During 1977, to date, only 2 members have been placed in liquidation under the provisions of the 1970 Act. The potential exposure to the Fund is modest.

broker-dealers who are unaffiliated with a domestic broker. This will inevitably lead to customers abroad choosing to deal with our foreign competitors who do not need to add this additional charge to their cost of doing business. It would undoubtedly impact unfavorably on the ability of domestic brokers to add liquidity to our markets through the participation of foreign investors.

We also oppose the extension in Section (9) to expand the definition of gross revenues from the securities business to include commissions and fees in connection with the distribution of shares in a registered open end investment company or unit investment trust or from the sale of variable annuities. These revenues were specifically excluded from the revenue base by Section 4(3) (C) in the original statute and there is no demonstrated need for an expansion of the assessment base now. There is no need to add to an admittedly already adequate fund.

Finally, we believe that the proposed amendment to redesignate Section 15 (e) authorizing SIPC to prescribe the manner in which members "may or shall" advertise their membership in SIPC might lead to the mandatory statement of SIPC membership in every television, radio or printed advertisement. This would not only interfere with the message intended to be conveyed but also perhaps give customers an assurance of protection beyond the actual coverage available.

This concludes our oral statement. We request that the record remain open for fifteen days for the submission of a more formal written statement.

Mr. METCALFE. It will be so ordered, unless there is objection. Hearing none, the record will remain open.

Mr. SHER. Thank you, sir.

Mr. METCALFE. Mr. Weinberg, for the record, would you kindly provide us with a definition of each of the various kinds of money market instruments, including who they are issued by, who the purchasers are, and the usual denomination and maturities?

Mr. WEINBERG. As far as maturity is concerned, maximum maturity, by definition, would be 270 days.

Money market instruments I would categorize as commercial paper, Treasury bills, certificates of deposit, bankers' acceptances. I would limit it to those four particular categories.

The maturity in all cases would be a maximum of 270 days.

In terms of denominations, in the experience of Goldman Sachs, and from my understanding as to how our competitors do business, generally speaking the denominations are generally very large.

For commercial paper, our average transaction size is \$2 million. The smallest transaction that we ever do would be \$100,000. I would doubt that we would do as many as six of those during the course of a month. More typically, it would be \$2 million, \$5 million, for commercial paper.

Treasury bills, the average transaction size is even larger. In our case it is \$6.97 million, average transaction size. A round lot is considered \$1 million. Most typically transactions are done for \$5 million, \$10 million. We have no small transactions in Treasury bills.

As 100 shares of common stock would be considered a round lot, in Treasury bills \$1 million would be considered a round lot, and \$5 million in many cases, with our larger institutional customers.

In all cases the people purchasing these instruments are institutional customers—insurance companies, pension funds, mutual funds, large corporations, what I would call very definitely professional investors, large institutions and corporations.

They are buying these investments for temporary investment of excess or surplus cash that they have.

Certificates of Deposit—I don't recall what our average transaction size is, but I would say it is somewhere in the probably \$3 million, \$4 million, \$5 million category, and again, sold to the same types of customers—trust departments of banks, large corporations, insurance companies, mutual funds and so forth.

At the present time we don't deal in bankers' acceptances, although I expect that before the end of the year we will do so. But again, the type and size of the transaction, the type of customer would be the same.

In terms of the issuers, in the case of Treasury bills obviously it is the U.S. Government that issues and sells the Treasury bills. But there is a very, very extremely large secondary market in these instruments.

As I mentioned before, on an average typical day—not on an extremely busy day—I would expect that the recognized or reporting dealers would buy and sell on a secondary basis—this does not include purchase from the Treasury Department—approximately \$7.5 billion worth of Treasury bills.

Commercial paper is issued by very large, very creditworthy corporations in the United States, and in some cases over in Europe as well. Generally speaking, you are talking about companies that are rated AAA, AA credit, types of credit ratings.

Companies that don't have the very highest types of credit rating cannot sell commercial paper in the United States, or really anywhere. These are promissory notes that are issued by very large, very creditworthy types of companies, the cream of the Fortune 500, so to speak.

I would guess there are probably less than 300 companies in the entire world that can qualify to sell commercial paper today. By qualify, I mean where the name is known well enough and investors are willing to buy those notes, and at rates that are almost as low as rates on Treasury bills sold by the U.S. Government because of the high degree of creditworthiness.

CD's would be issued generally speaking, by large banks. The ones that we would handle would be issued by very large banks in the money centers, primarily New York, Bank of America on the west coast, some of the large banks in Chicago.

Generally, I would say your top 30 or 50 commercial banks in the United States would be issuing certificates of deposit, that we would be making a market in, and be willing to buy and sell from investors on a daily basis.

Bankers' acceptances really are notes that originate in foreign commerce, issued by corporations, but are accepted by commercial banks, and they trade based, not on the name of the company that issued them initially, but rather they trade based on the name of the bank that has accepted or guaranteed payment of those acceptances at the time that they mature.

Again, you are talking about the very largest commercial banks in the United States that would be accepting or guaranteeing payment of these acceptances.

Mr. METCALFE. Mr. Sher, would you like to add anything to the statement of Mr. Weinberg?

Mr. SHER. No, I think he covered it very well.

Mr. METCALFE. The next two questions can be answered by either member of the panel.

It has been explained that most of the purchases of market instruments are made by corporate entities. However, it is acknowledged that there are some individual investors involved.

Can you describe the nature of these individual investor purchases from each of your representative firms? Can you characterize the investors themselves?

Mr. SHER. Individual investors do buy money market instruments, but rarely of the size described by Mr. Weinberg. Obviously it is unusual for an individual to buy \$7 million worth of Treasury bills. That is largely an institutional market.

However, individuals do make purchases of odd lots in money market instruments—\$50,000, \$100,000—perhaps there was the proceeds from the sale of a house, and the sellers are looking for a short-term investment. Commercial paper has a minimum transaction requirement of \$25,000, usually \$100,000.

Individuals do buy these, and we believe these individuals are protected right now by the assessment base which covers—if they leave them on deposit with a broker, they are protected as of now.

These individuals do not usually take delivery versus payment, as does an institution. Most often they leave it on deposit with the broker.

Mr. METCALFE. Mr. Weinberg?

Mr. WEINBERG. Our experience has been that relatively few transactions are made with individuals. Those that are made with individuals are with what I would call very wealthy, very sophisticated individual investors. It has also been our experience that there has been a very definite decline in the sale of money market instruments to individuals.

I am not sure exactly when the phenomenon began, but several years ago we saw the rise of so-called money market funds, such as Dreyfus Liquid Asset Reserve Fund and so forth. Effectively, these are mutual funds that invested, using professional management, in short-term money market instruments.

It made it very, very easy, much easier for individual investors to invest relatively nominal amounts of money, \$25,000, \$50,000, \$100,000—it is easier to invest it in a money market fund than it is to buy a Treasury bill, or to buy a CD, or commercial paper note.

So, our experience has been that while there was a very small amount of these purchases or sales to sophisticated investors several years ago, this has declined, and more typically today the sophisticated investor is buying a money market fund, rather than going to the trouble of buying a money market instrument.

Also, we—and I believe other brokers as well—generally do not carry or have on their premises any Treasury bills. Generally speaking, insurance companies will not allow a broker dealer to physically have a Treasury bill certificate on his premise.

Accordingly, all of these are handled by banks—the receipt, the delivery, transfer and so forth are all done by banks for us. They charge service fees to do this. So, this has tended to also cut down the attractiveness of investing in Treasury bills by small investors.

In our case we charge \$40 for each transaction for a Treasury bill. It just doesn't make it terribly attractive for someone to do that.

As I said, our very sophisticated, wealthy investors do it to a miniscule amount, and at a declining rate.

Mr. SHER. This is also a function sometimes of interest rates. When savings and loan or bank interest rates are much lower than commercial paper rates, you will attract more individuals to the commercial paper markets than when other short-term depository interest rates are higher than commercial paper.

Mr. METCALFE. Thank you. Either one of you gentlemen may answer the next question.

It was stated that most money market transactions are COD purchases. Is this true with respect to purchases by individual investors?

Mr. WEINBERG. In our case, yes.

Mr. SHER. In the case of Treasury bills, as Mr. Weinberg stated, we are not allowed to hold them. Other money market instruments

can be maintained by the broker-dealer for its customer's account, but it is not very often.

Again, these do occur, but they are not frequent transactions. The major market is the institutional market, the larger market.

Mr. METCALFE. Thank you.

Mr. Weinberg, you indicated that SIPC has expended \$1.8 million for CD's and Treasury bills, all of which losses were caused by fraud on the part of the broker.

If indeed fraud is the sole source of such losses, could the problem be largely resolved by requiring fidelity bond coverage?

Mr. WEINBERG. I am not familiar enough with the exact details of the fraud. My understanding is that what happened was the customer asked the broker to buy CD's or Treasuries for his account. When he went out of business, and the SIPC trustee went in, he found the transactions had never been made, and apparently the funds had been absconded with.

I don't know whether that would supplement or in effect replace the need for SIPC funds. I just don't know enough about the particular instances.

The information we have was given to us by SIPC, and I just don't know the details.

Mr. METCALFE. Mr. Sher, do you know?

Mr. SHER. I am sorry, I don't.

Mr. METCALFE. Yesterday we received testimony from Commissioner Loomis that some firms, because of their small size, cannot obtain fidelity coverage. Could this money market issue be resolved by requiring some kind of SIPC assessment with an exemption for firms with satisfactory fidelity bond coverage?

Either one of you gentlemen.

Mr. SHER. Merrill Lynch maintains a broker's blanket bond in the face amount of \$50 million. In addition, we have purchased insurance for our customers substantially in excess of the maximum protection provided by the SIPC Act. To the extent that the assessment base is widened and it increases our tax to support competitors in a competitive environment, obviously we find that a position we would have to disagree with.

We would encourage legislation which would require all broker dealers to protect their customers. Yes, we would endorse such a proposal.

Mr. METCALFE. Thank you.

Mr. Sher, your statement expresses some opposition to the authority contained in the bill for SIPC to mandate membership advertising. You indicate that this may not only interfere with the message intended to be conveyed, but might lead customers to believe that they have more protection than they really have.

This is despite the fact that Merrill Lynch, in its advertising, generally displays the SIPC logo. Has Merrill Lynch experienced either of these adverse effects which you mentioned?

Mr. SHER. We have not experienced such adverse effects, but I am not sure I agree with the statement that we generally display the SIPC logo. We do display it, but not in television advertising.

As we understand this language, it might be required that such a statement to be included. We would like to have the right to

advertise our way, rather than that which is being mandated by SIPC.

Mr. METCALFE. Banks, as you know, are required to advertise the FDIC logo. Are you aware of whether such advertising has interfered with their message or that bank depositors have been led to believe that their coverage is greater than it actually is?

Mr. SHER. I can't speak for all investors. The fact is that government securities on deposit with the bank are not covered by the Federal Deposit Insurance Corporation. I am not sure that all customers of banks understand that. There may be an implication there that is misunderstood by the public.

Mr. METCALFE. Thank you.

Mr. Oppen?

Mr. OPPER. Gentlemen, you have given us some understanding as to the money market instrument operations of both Merrill Lynch and Goldman Sachs. Of course, the proposed SIPC bill would also cover smaller brokerage firms.

How would the size of the transactions of such firms and the nature of their customers compare with yours?

Mr. WEINBERG. Well, I think that for those firms that are dealers in money market instruments, as Goldman Sachs is, that the size of their transactions would generally be very, very comparable.

In meeting and chatting with people on this issue, we have been told by people at Lehman Brothers, A. G. Becker and First Boston, as well as Merrill Lynch Government Securities Inc., that their transaction sizes are very comparable to ours. Essentially, we are selling to the same customers as they are, and the same size.

Now, there are brokers, not dealers, who from time to time might be selling CD's or even Treasury bills, conceivably, in very small size. But that is a different category of customer than the customer that is being serviced by Goldman Sachs, Becker, Merrill Lynch Government Securities Inc., Lehman Brothers or First Boston.

The losses that have been incurred by SIPC, as I understand it, none of those losses have been incurred by customers of any money market dealers. Those losses have been incurred by customers of brokers, relatively small brokers, who were requested to buy CD's and just never did it.

None of these customers ever did any business with a money market dealer.

Mr. SHER. If I could answer, the transactions of our government securities subsidiary, the affiliate of the broker-dealer—the dealer in Government securities, would be comparable to the experience of Goldman Sachs.

The transactions of Merrill Lynch, Pierce, Fenner and Smith, the brokerage firm, would have an average transaction size very typical, I would think, of broker dealers across the country. We are talking about transactions in different instruments.

I don't have the information available, but the Government security subsidiary is one of only 34 reporting dealers with the Treasury. Its transactions would be typical of the size described by Mr. Weinberg. Other brokers who are not dealers have different transactions in different securities.

Mr. OPPER. Mr. Weinberg, you mentioned that Goldman Sachs as a matter of course does not custody Treasury bills. Is my understanding correct that as of January 1 next year Treasury bills will no longer be available in physical form?

Mr. WEINBERG. I am not aware of that. It is rare today, and for some time, to ever physically see a Treasury bill. Virtually all of our transactions—not 100 percent, but probably well over 90 plus percent of the transactions—that we do every day, there is no physical receipt or delivery.

You never see a Treasury bill. It is all done on the so-called Fed wire, with transactions done by bookkeeping entries by the Federal Reserve Bank.

I suspect it will always be possible to get, and it is possible today, to actually get a Treasury bill if you want it. But it is time consuming, costly, and takes a rather extensive period of time. But today there is very, very little actual physical delivery or movement of certificates.

Mr. SHER. We do understand the Federal Reserve is going to take this over.

Mr. OPPER. It will be done by book entry?

Mr. SHER. That is right.

Mr. DARROW. I just have one question for Mr. Sher.

I want to go back to the statement made a moment ago. Did I understand you to say that the transactions of Merrill Lynch Government Securities, Inc., do not simply involve large denominations, and that the transactions of Merrill Lynch, Pierce, Fenner and Smith involve smaller denominations of money market instruments?

Mr. SHER. Again, Merrill Lynch Government Securities is one of the 34 reporting dealers, half of which are banks. Typically, their transaction size is quite large, as indicated.

Merrill Lynch, Pierce, Fenner and Smith will have more frequent individual transactions, again remembering that the minimum size for commercial paper is \$25,000, usually \$100,000. It is rare to have \$25,000. So, when you say small transactions, that is relatively speaking but they are still large.

Mr. DARROW. Can you give us some idea of how many individual customers you have who transact in money market instruments in denominations of up to \$100,000?

Mr. SHER. We have 1½ million customers. There is no way I could tell you without doing some research, what percentage of them are involved. Probably less than 1 percent have done business in money market instruments.

Mr. DARROW. With the Chairman's permission, could you please provide us with some sort of documentation because we would be interested to know exactly what the figures are. We consider this of some importance in reaching a judgment on this matter.

Mr. SHER. I am sure we could give you an indication—certainly a statistical sample—if that would help.

[The following letter was received for the record:]

Cine Liberty Plaza, 165 Broadway, New York, NY 10006 (212) 766-1212



**Merrill Lynch
Pierce
Fenner & Smith Inc.**

August 18, 1977

Hon. Bob Eckhardt, Chairman
The Subcommittee on Consumer Protection
and Finance of the Committee on Interstate
and Foreign Commerce of the
House of Representatives
1741 Longworth House Office Building
Washington, D.C. 20575

Dear Chairman Eckhardt:

This letter is respectfully submitted to the Subcommittee:
(1) in response to the request of Representative Metcalfe
and the Subcommittee Staff for information pertaining to
the scope of purchases of money market instruments by individual
investors; and, (2) to underscore the concerns of Merrill
Lynch, Pierce, Fenner & Smith inc. ("Merrill Lynch") with
respect to certain amendments to the Securities Investor
Protection Act proposed by H. R. 8331.

The 1970 Act - Historical Perspective

The Securities Investor Protection Act (the "Act")
was adopted by Congress to restore the quickly eroding con-
fidence of the investing public in the financial integrity
of the broker-dealer community as more and more brokerage
firms encountered financial difficulties and failed. The
losses suffered by individual investors aggravated the crisis-
like atmosphere of doom and gloom that pervaded Wall Street.
It was in this context that the Government, federal and
industry regulatory bodies and industry members all joined
together to design and implement legislation to regain the
lost confidence of investors and to elevate the required
standards of financial responsibility that broker-dealers
owed to their customers and to the public generally.

All components of the securities industry recognized
the need for protective legislation with affirmative remedial
provisions. The prompt funding of the Securities Investor
Protection Corporation, so that it could offer meaningful,
tangible protection to investors, was an important consideration
if the Act was to achieve its primary purpose. United in
their cause, nearly all participants in the securities industry
willingly contributed to the SIPC Fund, whether or not the
assessment base was co-extensive with the protections afforded
by the Act which, clearly, it is not.

Congress fully realized that the taxation of certain non-customer related, non-protected aspects of the securities business might be regarded as inequitable and, therefore, provided that when the SIPC Fund aggregated \$150 million the assessment rate of its membership would be reduced or even eliminated. [Section 4(d)(i)(A) and (B)]*. The SIPC Fund now stands at approximately \$137 million, only \$13 million from the statutory target. The Securities Investor Protection Corporation estimates that the \$150 million figure will be reached by the end of this year. Thus, SIPC's Chairman has organized the "SIPC Assessments Task Force," which has been commissioned to examine and evaluate the Fund level and to consider revisions to the assessment structure based upon, among the things, risks to the SIPC Fund presented by particular classes of members or types of securities transactions. This accords with Section 4(c)(2) of the Act, which establishes SIPC's general assessment authority.

By the terms of Section 4(c)(2), SIPC is authorized to impose such assessments upon its members, after consulting with the Securities and Exchange Commission, as SIPC may deem necessary and appropriate to establish and maintain the Fund. In determining what is an appropriate assessment of its members, or any one or more classes thereof, SIPC is authorized to consider the following:

"the amount or composition of their [the members'] gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors."

"The SIPC Fund Should Achieve The Statutory Target of \$150 Million By Year-end. No Reason or Justification for Increasing The Assessment Base Has Been Offered."

As noted in the testimony given by Merrill Lynch before the Subcommittee on August 3, 1977, Merrill Lynch has been assessed more than \$18 million since the inception of the Act in 1970. Now, as the SIPC Fund is about to achieve its \$150 million threshold, when all the facts and logic dictate the contrary, it is proposed that the assessment base be expanded.

As drafted, Section 6(g) of H.R. 8331 would capture the gross revenues from the securities business generated, not by the member alone, but by the member's affiliates and the subsidiaries of those affiliates. Absent an affirmative

* Unless otherwise indicated, citations are to the Securities Investor Protection Act of 1970.

showing that additional assessment revenue sources are required by SIPC to fulfill its statutory obligations and purposes, Merrill Lynch must protest such a possible development as manifestly unfair and rationally unsupportable.

The Act's Current "Consolidated Group" Assessment Base Should Not Be Expanded . It Should Be Reduced.

a) The Assessment Base Should Be Co-extensive With The Protections Afforded By The Act.

Unless one holds the overly-simplistic view that the SIPC assessment is simply a "cost of doing business," it is obvious that such an assessment tax should be levied only upon those whose customers receive direct benefits therefrom. And further, as with any other insurance premium, the rate of the assessment should reflect the risks presented by the member and the nature of the member's activities, as well as other salient factors. To do otherwise would be illogical and, contrary to Congress' expressed intention in Section 4(c)(2), would perpetuate the inequities that many SIPC members, including Merrill Lynch, have borne since 1970.

Insofar as a SIPC member transacts a securities business outside the United States, whether through its own subsidiary or an affiliated company, the gross revenues from such securities business should not be includable in the member's assessment base. Of course, if a member conducts such an enterprise directly, i.e. effects securities transactions with and on behalf of customers residing outside the United States, its customers enjoy the Act's protections and an assessment is warranted. But where the business is transacted by or through a non-U.S. subsidiary or affiliate (not registered as a broker with the SEC), no coverage exists because, as a matter of law, the Act does not recognize the customers of the foreign, non-member broker-dealer as a "customer" thereunder. Clearly, if the customers of the foreign broker-dealer subsidiary or affiliate are not entitled to receive the protections offered by the Act, the member should not be taxed on those revenues. At the very least, accepting arguendo the "cost of doing business" rationale, the assessment should only be applicable to the commissions received with respect to transactions in U.S. securities.

b) The Act Affords SIPC's "Foreign Members" A Competitive Cost Advantage In The International Securities Markets

Section 11(b) of the Act presently excludes foreign SIPC members (defined as a member the head office of which is located, and the principal business of which is conducted outside the United States) from the provisions of the Act, except with respect to "the business of such member conducted

in the United States." Many "foreign members" maintain U.S. offices and service U.S.-person customers as to whom the Act would make its protections available. However where the benefits of the Act are unavailable, (the usual case where foreign customers are involved) such "foreign members" are not subject to the added burden of the SIPC assessment. Foreign subsidiaries and affiliates of U.S. brokers, however, have not been granted this exclusion and, therefore, suffer the competitive cost disadvantage of the SIPC assessment.

The gross revenues from the securities business of Merrill Lynch, Royal Securities Inc. ("MLRS"), a wholly owned subsidiary of Merrill Lynch, are presently required to be consolidated with those of its member parent for purposes of determining Merrill Lynch's annual assessment. MLRS is a Canadian-based broker-dealer with predominantly Canadian customers and the substantial portion of its securities business is in non-U.S. securities. Nevertheless, the gross revenues from the securities business of that subsidiary, the principal office of which is located and the principal business of which is conducted outside the United States, are subject to the SIPC assessment by virtue of its parent's status. MLRS's customers are not protected by the Act.

This anomaly, whereby U.S. law disadvantages U.S. broker-dealers in the foreign securities business is most clearly demonstrated by the fact that various Canadian broker-dealers, direct competitors of MLRS, which have memberships on U.S. securities exchanges and are therefore direct members of SIPC are only required to pay assessments on the securities transactions they execute in the United States.

The blatant unfairness is apparent. First, the Canadian broker-dealers who are members of U.S. exchanges are paying a franchise ("cost of doing business") tax on U.S. securities transactions without any benefit to them or their customers. Second, the foreign subsidiaries of U.S. SIPC members, engaged in the same business as their Canadian counterparts, not only have their revenues realized from U.S. securities transaction included in the assessment base of their U.S. parents but, moreover, the gross revenues from their foreign securities activities. As is the case with Canadian brokerages, the customers of foreign broker-dealer subsidiaries of SIPC members, e.g. MLRS, are not the beneficiaries of the Act; they will not be awarded "customer" status.

c) Money Market Instruments Should Be Excluded From The SIPC Assessment. At The Very Least, The Assessment on Money Market Instruments Should Be Limited To Transactions With "Customers" Who Are Protected By The Act.

The testimony and data offered to the Subcommittee by Mr. Hyman Weinberg of Goldman, Sachs's Co. on August 3, 1977 attest to the fact that:

1) The overwhelming majority of participants in the "money market" are institutions, not individual customers.

2) From the sheer size and volume of money market transactions, it is evident that the protections afforded by the Act are not of any meaningful consequence to institutional customers, and to even the extremely wealthy individuals who may occasionally purchase money market instruments from time to time.

3) The overwhelming majority of transactions effected in money market instruments are settled by payment vs. delivery, which occurs by wire and bookkeeping entry systems. Since the securities are delivered to the purchaser and cash proceeds are delivered to the seller, the money market dealer holds no "customer property" which the Act protects.

4) Historically, since 1970, less than \$2 million in payments from the SIPC fund were attributable to losses incurred with respect to certificates of deposit and Treasury bills, and even that was due, we understand, to fraud by the brokers in failing to execute their customers' orders. Payment vs. delivery, or C.O.D. transactions, do not offer the possibility of defalcation of "customers'" securities or cash by the broker-dealer.

As requested by Representative Metcalfe and the Subcommittee's Staff, we have examined our records to the extent possible within the time allotted to determine the size of money market transactions by our customers. We find that:

1) Of a total of 522,150 transactions effected by Merrill Lynch (the SIPC member) during the month of June 1977, only 7,244, or .0028%, were in money market instruments, including Government securities.

2) Of the 7,244 money market transactions, only 1,594 (22%) represented trades for individual customers, as contrasted with institutional customers.

3) By contrast, Merrill Lynch's affiliate, Merrill Lynch Government Securities Inc. (MLGSI), maintains approximately 13,000 accounts, only a handful of which - perhaps as many as 10 - are accounts for individuals. MLGSI's transactions are all executed and settled by wire. MLGSI holds no customers' securities or funds, settlement being made by means of delivery vs. payment; and, consequently, MLGSI's customers are not in need of the protections of the Act.

d) Money Market Instruments Purchased By Customers of Merrill Lynch (The SIPC Member) Are Protected Under The Act.

All money market instruments purchased by Merrill Lynch's customers and held in safekeeping for them are presently covered by the provisions of the Act. Merrill Lynch, the

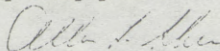
SIPC member, pays its assessment on those transactions and would continue to do so whether or not the "consolidated group" assessment base is increased in scope, as proposed. What we strenuously object to is the possible inclusion of the far larger category, in number and dollar amount, of money market transactions in the dealer market as to which SIPC protection is all but meaningless and unnecessary.

The most rational approach to the assessment of gross revenues derived from money market instrument transactions, we submit, is either (1) to exclude revenues realized on money market instrument transactions from the definition of the term "Gross Revenues" at Section 4(1) of the Act; (2) for assessment purposes, exclude money market instruments from the definition of the term "Security" at proposed Section 16(14) of H. R. 8331 or (3) assess only those revenues arising from money market transactions where potential exposure to the Fund exists, i.e. in those instances that the broker or dealer holds the money market instruments in safekeeping for the account its "customer". Only then does the possibility of fraud or defalcation exist; only then might the broker-dealer's "customer" have to look to the SIPC Fund.

While Merrill Lynch, as much as any SIPC member, appreciates the positive, substantive improvements in SIPC liquidations and customer benefits that are incorporated in H.R. 8331, we must strenuously contest the points raised herein. To the best of our knowledge SIPC, itself, has neither requested nor requires the additional assessment revenues that would flow into the Fund if the expanded "consolidated group" assessment base is adopted. Likewise, we are unaware that SIPC has taken any position with respect to eliminating or reducing assessments on revenues earned from money market instrument transactions.

The time is at hand to legislatively balance the equities and impose a just tax upon SIPC's membership, reflecting the availability of the Act's protections and the risks presented to the SIPC Fund. Merrill Lynch stands ready to lend whatever expertise and assistance that it possesses to the Subcommittee and its Staff to achieve that result.

Very truly yours,



Allan L. Sher
Executive Vice President

Mr. DARROW. That would help.

Mr. METCALFE. Your request will be honored, and the record will remain open for the introduction of this material.

Mr. DARROW. Thank you, Mr. Chairman.

Mr. METCALFE. Gentlemen, thank you very much for your participation.

Is Mr. Edward O'Brien, president of Securities Industries Association, present?

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY DONALD J. CRAWFORD, VICE PRESIDENT

Mr. O'BRIEN. Mr. Chairman, good morning.

I am Edward I. O'Brien, president of the Securities Industry Association (SIA). Accompanying me today is Donald J. Crawford, vice president of the association.

SIA represents approximately 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the Nation's securities transactions conducted in this country.

The business of our members includes retail brokerage conducted on behalf of 25 million shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions, and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

We are here today to testify in favor of H.R. 8331 and to suggest two specific changes in the bill which we believe will enhance investor protection and provide for fair treatment for all firms engaged in the securities business.

The central purpose of the proposed amendments is to correct the problems that developed as SIPC began to liquidate debtor members and indemnify public customers. It became apparent very early in the life of SIPC that the 1970 legislation was far too rigid for the efficient handling of many brokerage liquidations.

The act did not contemplate the complexities of such industry phenomena as clearing corporations, fungible securities, continuous net settlement accounts, and omnibus accounts. Accordingly, liquidations were lengthy and cumbersome, customers became disillusioned, and final settlements were inordinately protracted.

The public was unhappy with the indemnification procedures and trustees, because of their inability to exercise routine discretion or business judgments due to the rigidity of the act, were unable to be responsive to the many unique situations which occurred on a daily basis during the liquidation procedure.

The liquidation of Weis Securities, Inc., a large New York Stock Exchange member with over 35,000 public and institutional accounts, demonstrated conclusively the inflexibility of the 1970 act and how costly, inefficient, and unsatisfactory it was to the public investor.

Since many clients were receiving indemnification in cash instead of securities and because their accounts were frozen for protracted periods of time, it has become apparent that what the public customer wants is the speedy delivery of his account intact and not protection resembling insurance benefits.

In order to achieve these goals and for the purpose of expediency and economy, new flexible statutory guidelines are needed to allow SIPC and trustees to exercise discretion to make customers whole quickly and with minimum expense.

SIPC must be given such additional authority and discretion as are necessary to enable it to perform its role more effectively and efficiently and thereby to assist in maintaining investor confidence.

The provisions in H.R. 8331 will achieve the following goals:

One, added flexibility and discretion for trustees;

Two, improved allocation and liquidation procedures;

Three, simplified procedures for the liquidation of smaller and/or totally bankrupt estates;

Four, reduced liquidation expenditures;

Five, revised provisions for bulk delivery of securities to solvent members, maintenance of customer margin accounts, allowances for customer operation of accounts during a liquidation proceeding, and provisions for clients to receive the maximum amount of securities feasible in order to preserve their accounts as near as possible to their filing date status;

Six, added ability of SIPC to maintain lines of credit and to arrange for bridge financing as well as to guarantee delivery of securities in certain situations; and

Seven, expanded authority of SIPC to operate the business of a debtor long enough to realize some value from the operation of his going business as well as the sale of certain fixed assets.

The foregoing, together with a host of guidelines to reduce and simplify the legal procedures involved in a liquidation, are important measures incorporated in the Securities Investor Protection Amendments of 1977 which will correct the inadequacies of the present law. We fully support these measures.

SIA also supports the modified language in section 14 regarding advertising. Investor confidence in our securities markets can be increased by SIPC only if its protections become widely recognized by the investing public.

The proposed change will give SIPC the ability to mandate dissemination of the protections afforded by the act to the investing public, as well as give SIPC the flexibility to deal with any problems that might develop in the future.

We would also recommend two changes in the bill. While maximum coverage under SIPC is raised from \$50,000 to \$100,000, the amount of cash subject to protection remains at \$20,000. SIPC has recommended the level be raised to \$40,000. We agree that the cash coverage should be increased. If an investor's firm goes out of business after he has sold stock but before he has been paid, it would be very unfair not to provide him with SIPC protection.

Due to inflation and other factors, more money is involved in transactions today than was the case 7 years ago. The legislation should recognize this change. Regional firms in particular will benefit from this increased coverage.

In fact, to our knowledge we know of no one who would be affected by the legislation who is opposed to raising the amount of coverage to \$40,000.

Our second suggestion relates to the provisions of the bill which broaden the definition of gross revenues from the securities busi-

ness to include commission and fees earned from the sale of mutual fund shares and from the sale of variable annuities and broaden the definition of security to include money market instruments.

While we agree in principle with these changes, we realize that the Congress may feel fairness and equity dictate that a more flexible charge should apply to these activities. Perhaps a formula could be developed which would be based on the actual loss experience associated with accounts of these types.

We have taken note of the testimony of the earlier witnesses today, and we would hope that their experience would be taken into consideration as we have suggested here in our testimony.

We would be happy to work with the subcommittee members and staff in an attempt to reach an acceptable solution in this regard.

Finally, we wish to call attention to a notable achievement of SIPC which we would expect to be continued. That achievement is the fulfillment by the SIPC Board of its responsibilities without establishing an extensive and expensive bureaucracy.

We understand that SIPC has covered its administrative expenses for its internal operations by using one-half of the interest income SIPC has earned on its investments. The SIPC Board, with industry participation, has performed its job in an outstanding manner and deserves, in our view, public acknowledgement of the achievement and congratulations.

We appreciate having the opportunity to testify on H.R. 8331, and we would be happy to answer any questions you may have.

[Mr. O'Brien's prepared statement follows:]

Statement of the Securities Industry Association
Hearings on H.R. 8331, Amendments to the Securities Investor
Protection Act of 1970
before the
Subcommittee on Consumer Protection and Finance
Committee on Interstate and Foreign Commerce
United States House of Representatives

August 3, 1977

I am Edward I. O'Brien, President of the Securities Industry Association (SIA). Accompanying me today is Donald J. Crawford, Vice President of the Association.

SIA represents approximately 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the nation's securities transactions conducted in this country. The business of our members includes retail brokerage conducted on behalf of 25 million shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions, and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

We are here today to testify in favor of H.R. 8331 and to suggest two specific changes in the bill which we believe will enhance investor protection and provide for fair treatment for all firms engaged in the securities business.

The central purpose of the proposed amendments is to correct the problems that developed as SIPC began to liquidate debtor members and indemnify public customers. It became apparent very early in the life of SIPC that the 1970 legislation was far too rigid for the efficient handling of many brokerage liquidations. The Act did not contemplate the complexities of such industry phenomena as clearing corporations, fungible securities, continuous net settlement accounts, and omnibus accounts. Accordingly, liquidations were lengthy and cumbersome, customers became disillusioned, and final settlements were inordinately protracted. The public was unhappy with the indemnification procedures and trustees, because of their inability to exercise routine discretion or business judgments due to the rigidity of the Act, were unable to be responsive to the many unique situations which occurred on a daily basis during the liquidation procedure.

The liquidation of Weis Securities, Inc., a large New York Stock Exchange member with over 35,000 public and institutional accounts, demonstrated conclusively the inflexibility of the 1970 Act and how costly, inefficient, and unsatisfactory it was to the public investor.

Since many clients were receiving indemnification in cash instead of securities and because their accounts were frozen for protracted periods of time, it has become apparent that what the public customer wants is the speedy delivery of his account intact and not protection resembling insurance benefits.

In order to achieve these goals and for the purpose of expediency and economy, new flexible statutory guidelines are needed to allow SIPC and trustees to exercise discretion to make customers whole quickly and with minimum expense. SIPC must be given such additional authority and discretion as are necessary to enable it to perform its role more effectively and efficiently and thereby to assist in maintaining investor confidence.

The provisions in H.R. 8331 will achieve the following goals:

- Added flexibility and discretion for trustees;
- Improved allocation and liquidation procedures;
- Simplified procedures for the liquidation of smaller and/or totally bankrupt estates;
- Reduced liquidation expenditures;
- Revised provisions for bulk delivery of securities to solvent members, maintenance of customer margin accounts, allowances for customer operation of accounts during a liquidation proceeding, and provisions for clients to receive the maximum amount of securities feasible in order to preserve their accounts as near as possible to their filing date status;
- Added ability of SIPC to maintain lines of credit and to arrange for bridge financing as well as to guarantee delivery of securities in certain situations;
- Expanded authority of SIPC to operate the business of a debtor long enough to realize some value from the operation of his going business as well as the sale of certain fixed assets.

The foregoing, together with a host of guidelines to reduce and simplify the legal procedures involved in a liquidation, are important measures incorporated in the Securities Investor Protection Amendments of 1977 which will correct the inadequacies of the present law. We fully support these measures.

SIA also supports the modified language in Section 14 regarding advertising. Investor confidence in our securities markets can be increased by SIPC only if its protections become widely recognized by the investing public. The proposed change will give SIPC the ability to mandate dissemination of the protections afforded by the Act to the investing public, as well as give SIPC the flexibility to deal with any problems that might develop in the future.

We would also recommend two changes in the bill. While maximum coverage under SIPC is raised from \$50,000 to \$100,000, the amount of cash subject to protection remains at \$20,000. SIPC has recommended the level be raised to \$40,000. We agree that the cash coverage should be increased. If an investor's firm goes out of business after he has sold stock but before he has been paid, it would be very unfair not to provide him with SIPC protection.

Due to inflation and other factors, more money is involved in transactions today than was the case seven years ago. The legislation should recognize this change. Regional firms in particular will benefit from this increased coverage. In fact, to our knowledge we know of no one who would be affected by the legislation who is opposed to raising the amount of coverage to \$40,000.

Our second suggestion relates to the provisions of the bill which broaden the definition of "gross revenues from the securities business" to include commission and fees earned from the sale of mutual fund shares and from the sale of variable annuities and broaden the definition of "security" to include money market instruments. While we agree in principle with these changes, we realize that the Congress may feel fairness and equity dictate that a more flexible charge should apply to these activities. Perhaps, a formula could be developed which would be based on the actual loss experience associated with accounts of these types. We would be happy to work with the subcommittee members and staff in an attempt to reach an acceptable solution in this regard.

Finally, we wish to call attention to a notable achievement of SIPC which we would expect to be continued. That achievement is the fulfillment by the SIPC Board of its responsibilities without establishing an extensive and expensive bureaucracy. We understand that SIPC has covered its administrative expenses for its internal operations by using 1/2 of the interest income SIPC has earned on its investments. The SIPC Board, with industry participation, has performed its job in an outstanding manner and deserves, in our view, public acknowledgment of the achievement and congratulations.

We appreciate having the opportunity to testify on H. R. 8331, and we would be happy to answer any questions you may have.

Mr. METCALFE. Thank you, Mr. O'Brien.

You support mandatory SIPC advertising. Do you feel that SIPC advertising would impose a regulatory burden upon your membership?

Mr. O'BRIEN. I feel that the advertising provisions are extremely important. I don't think it would be an unreasonable burden. I think, if intelligently administered, it would not be unreasonable.

I think one of the most important points in the SIPC legislation—and I distinctly recall going back to the days of the late sixties and the early seventies, when customer confidence was at a low point and the installation of SIPC legislation was introduced—is the need to expand the public knowledge of the coverage, and the indemnification, which has served the customers so well. I think that knowledge should be fostered.

I don't think if it is intelligently run that it need create an unreasonable burden.

Mr. METCALFE. Your remarks concerning mutual funds, variable annuities, and money market instruments are interesting. You are one of the few persons in the industry who favors some kind of assessment on these securities.

Is that because you feel transactions in these securities involve some risk, or because you feel an assessment is justified as a cost of doing business in the securities industry?

Mr. O'BRIEN. Let me say—this may be a little bit of both—but as far as the risk factor is concerned, the risk factor in a money market instrument is really quite modest. In my testimony, I suggested that perhaps some weighing of risk has to be taken into consideration here.

The type of client who is involved, the level of risk, is really quite different from what has been experienced in the liquidations which have taken place to date—the Weis Securities and others. So, I don't think we know the answer exactly.

I think more work needs to be done on this point. As a general principle, we favor putting as much in the coverage as possible, but there should perhaps be some variation on the theme.

Mr. METCALFE. Thank you.

Mr. Oppen?

Mr. OPPER. Mr. O'Brien, how would you characterize the present public awareness of SIPC and what SIPC does do?

Mr. O'BRIEN. I am a little disappointed on that score. I don't think that the public is as aware as it should be, but I think it is getting better. I think more and more people understand the ramifications of SIPC and the protection which it affords them.

However, it is not at as high a level as I think it should be. After all the industry—not the public has contributed \$137 million to this protection, and in a way, it is like—I described it to one of my associates—playing a violin in an empty hall. I don't think that is a very good way to play a violin, and I don't think that the benefits of SIPC are as well known as they should be.

We made a major contribution on the protection of the public here by the enactment of SIPC 7 years ago. I would hope that it could improve the public knowledge.

Mr. OPPER. When you say that you feel that mandated advertising would be acceptable, if intelligently administered, would you elaborate on what you mean by intelligently administered?

Mr. O'BRIEN. I guess it is easier to say it than to describe it. But if one would say that in every last shred of, for example, radio or television advertising there needs to be a SIPC logo, or something of that nature, perhaps that is a little bit extreme.

But as a general proposition, as a principle, we should seek to have the SIPC coverage made known to people. I would think that the administration of that by the SIPC organization, working with the industry, will produce a reasonable compromise, so that the end result is a common sense approach a continually higher level of knowledge on the part of the public about the existence of it.

Mr. OPPER. Your feeling then is that it would be more burdensome, or perhaps would detract more from the message, if the SIPC logo were required to be displayed in television or radio, rather than in written material.

Mr. O'BRIEN. In a way, I would be somewhat taken aback I think if I am looking at a television advertisement, which frequently is intended to inform, educate and encourage people to give their investment services to a particular firm, and if at the same time I have any sort of a predilection toward bad nerves, to see something about SIPC.

It wouldn't bother me particularly. I understand these things. But I think it is really unnecessary. The coverage is there. Television advertising is not intended to allay fears. It is intended to educate and to stimulate business, which is a perfectly legitimate objective.

Mr. DARROW. I am not sure I quite understand the distinction between printed and televised advertising. I've noticed, for example, that FDIC, at the end of radio announcements, always state at the conclusion of the advertisement, Member of FDIC. Arguably that is no less effective a means of promoting confidence among investors than it is a device for promoting confidence among depositors.

You have the distinction of being one of the very few persons in the industry who has come forward so far in favor of advertising. Could you perhaps help us by suggesting some of the reasons why you think your brethren and the people that are represented by NASD seem so stridently opposed to this provision?

This is almost like a lightning rod. This has become the one provision that almost everybody has something to complain about.

Mr. O'BRIEN. I have spoken with different people about it. I can't say I have made any sort of extensive evaluation of it at all. I guess some people think it could be an extra burden, that it could be counterproductive in the sense that it would provide people with some fears at the same time we are trying to encourage them to do business.

So, there can be a number of reasons. Frankly—and I speak for myself in this area—going back to 1970, I have felt consistently, even before I had anything to do with the Securities Industries Association, when I was with one of the major firms—I was strongly in favor of advertising of the SIPC indemnification coverage.

The reasons were as indicated earlier. I haven't changed my mind on that score. I think that we have made an enormous contribution to the welfare of the American investor—people who lived through the late sixties should realize that. So, I feel strongly about it.

Mr. DARROW. Fine.

No further questions, Mr. Chairman.

Mr. METCALFE. Ms. Nord?

Ms. NORD. Just one question. One of the witnesses yesterday suggested that by requiring the SIPC logo to be placed in advertising, you could be doing a disservice to investors in that sometimes firms might offer services which were not covered by the SIPC protection, for example sale of commodities, and that investors might not understand that distinction.

How would you respond to that?

Mr. O'BRIEN. I suppose that is possible. I frankly have never—well, I have heard about the commodity perception of the matter. I have not really thought it through. I guess I don't really have a responsive answer. But I still stay with the same basic principle in favor of the advertising.

Ms. NORD. Thank you.

No further questions.

Mr. METCALFE. Thank you very much, Mr. O'Brien. We appreciate your testimony.

Is Mr. George T. Boggs here?

**STATEMENT OF GEORGE T. BOGGS, ATTORNEY, ON BEHALF OF
DICKSTEIN, SHAPIRO AND MORIN**

Mr. BOGGS. Mr. Chairman, my name is George Boggs. I am an associate of Charles H. Morin in the firm of Dickstein, Shapiro and Morin.

I apologize for being a few minutes late this morning. Unfortunately, I made the mistake of relying on the subway system to get me here on time.

I have made copies of our prepared statement available on the side table for those who did not have an opportunity to get them earlier.

Mr. Morin sincerely regrets that although he had been looking forward to the opportunity to testify before the subcommittee, he is unable to appear today due to a year-long speaking commitment in Minneapolis that conflicted with these hearings.

Thus, rather than appearing with Mr. Morin, as I did 2 years ago, I am appearing today on his behalf.

Mr. Morin and I wish to express our appreciation to the subcommittee for providing me the opportunity to testify today regarding one unfortunate provision of H.R. 8331.

In view of the time limitation of the hearing this morning, I will not read our prepared statement that we filed with the subcommittee. Rather, I shall simply summarize our position, and then answer any questions you may have.

Mr. METCALFE. Your entire statement will be entered into the record, unless there are objections.

Hearing none, it will be entered into the record.

Mr. BOGGS. Thank you, Mr. Chairman.

I should note that we support most of the provisions of the bill and their purpose of simplifying the liquidation process. However, one provision of the bill deserves closer scrutiny, and the provision to which I refer is an amendment to the definition of the term, customer that would specifically exclude from the protection of this act those customers of a broker dealer who are fraudulently induced to subordinate their customer accounts.

I refer you to pages 56 and 57 of the bill, and more particularly lines 1 through 4 of page 57.

I wish to emphasize that our concern here is with ordinary customers of broker-dealers, not insiders, partners, officers, or institutional lenders to a broker-dealer.

We do not propose to alter the general rule that under ordinary circumstances SIPC will not extend protection to subordinated lenders of a broker-dealer. However, what has occurred is that ordinary customers well known to the broker-dealer and who rely upon the close fiduciary relationship with that broker-dealer have been fraudulently induced to subordinate their customer accounts.

The effect of the amendment to which I have earlier referred is to state that once a customer is fraudulently induced to subordinate his customer account, he is forever denied the right to be considered a customer subject to the protection of SIPC even if that customer can successfully rescind his subordination agreement.

By denying defraud customers SIPC protection, such customers are effectively denied any remedy and any right of recovery under the securities laws against the broker-dealer is in fact a meaningless remedy. Obviously the broker-dealer is bankrupt and the bankrupt's estate rarely will have sufficient assets left over to satisfy any claim.

The only other natural remedy is against the New York Stock Exchange, which purports to regulate its members sufficiently to prevent such bankruptcies from occurring. Yet, this act and the courts have closed this door to defrauded subordinated customers.

Thus, without SIPC protection the defrauded customer in fact has no remedy. We believe that Congress does not intend to deny the protection of SIPC to such customers. Furthermore, we believe that the denial of protection to such customers under these circumstances results in the denial of a fundamental common law right to rescind the fraudulently induced agreement and to return to the position and status of customer.

As customers, they should not be denied the protection of SIPC.

I will be happy to answer any questions you may have.

[Mr. Boggs' prepared statement follows:]

H.R. 8331

"SECURITIES INVESTOR PROTECTION ACT
AMENDMENTS OF 1977"

STATEMENT OF GEORGE T. BOGGS, ESQUIRE
DICKSTEIN, SHAPIRO & MORIN CONCERNING
H.R. 8331

August 2, 1977

George T. Boggs
My name is ~~Charles H. Morin~~, and I am ~~a partner in~~ *with*
the law firm of Dickstein, Shapiro & Morin, 2101 L Street,
N.W., Washington, D.C. I am appearing before this Sub-
committee to oppose an amendment contained in H.R. 8331
which we believe would result in a shocking and unconscio-
nable denial of a fundamental common law right and which we
further believe is contrary to the intent of Congress and
the entire spirit of the Securities Investor Protection Act
of 1970.

The amendment to which I refer would change the def-
inition of "Customer" to exclude from protection under the
Act those customers of a broker-dealer who have been defraud-
ed by the broker-dealer into subordinating their account to
the claims of creditors of the broker-dealer, regardless of
the circumstances. This amendment to the definition of
"Customer" is set forth on page 57, lines 1 through 4 of
the Bill.

The present definition of "Customer" in the Act ex-
cludes from the protection of the Act those customers who
have subordinated their accounts to the claims of creditors
of a broker-dealer so that the value of the subordinated ac-
counts may be considered an asset by the broker-dealer in
computing his net capital position. Under ordinary circum-
stances, this exclusion is quite proper for at least two
reasons:

(1) the customer presumably understands the conse-
quences of subordinating his account; and

(2) the customer presumably is aware of the financial condition of the broker-dealer at the time of subordination, and he is willing to risk subordination in return for a premium paid by the broker-dealer for the use of the account as capital.

However, occasions have arisen since the establishment of SIPC in 1970 when customers, not insiders or partners, have been defrauded by a broker-dealer into subordinating their accounts and the broker-dealer subsequently went bankrupt. Usually, the fraud has occurred by means of fraudulent financial statements and verbal misrepresentations upon which the customers have relied in agreeing to subordinate their accounts.

At common law, one who has been fraudulently induced to enter a contract may rescind that contract upon proving the fraud unless it can be proved that third parties have relied upon that contract to their detriment. In the event that rescission is allowed, the defrauded party is returned to his status before entering the fraudulently induced contract. Accordingly, under fundamental common law principles, if the defrauded party was a lender, he would become a general creditor rather than a subordinated creditor, and if the defrauded party was a customer, he would be returned to his status as a customer unless it is proved that other parties relied to their detriment upon the subordination.

The amendment to the definition of "Customer" contained in this Bill is specifically aimed at denying this right to customers who have been defrauded by a broker-dealer. We cannot believe that it is the intent of this Congress to effect such a result. To do so would surely violate the spirit and intent of the Securities Investor Protection Act of 1970.

The House Committee Report of the 1970 Act (H.Rep. No. 91-1613, 91st Cong., 2d Sess., October 21, 1970) clearly expressed the aims of the Act as

(1) "to reinforce the confidence that investors have in the U.S. securities markets" by providing "investors protection against losses caused by the insolvency of their broker-dealer" (pages 2 and 4 of the House Report); and

(2) "to provide for a strengthening of the financial responsibilities of broker-dealers" (page 4 of the House Report).

The Senate Committee Report of the 1970 Act (S.Rep. No. 91-1218, 91st Cong., 2d Sess., September 21, 1970) likewise emphasized that the purposes of the Security Investor Protection Corporation were

(1) "to protect individual investors from financial hardship;"

(2) "to insulate the economy from the disruption which can follow the failure of major financial institutions; and"

(3) "to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss" (page 4 of the Senate Report).

Under the new amendment, however, defrauded customers would be denied, without any rational basis, the very protection that the 1970 Act intended to create. When a customer has been defrauded by his broker-dealer into subordinating his account, the premise under which customers with subordinated accounts are denied SIPC protection no longer applies. A customer who subordinated his account assumes the risk of bankruptcy but he cannot be deemed to assume the risk of fraud in the inducement. Were it not for the fraudulent financial statements or verbal misrepresentations the customer would not have agreed to the subordination. Thus, absent proof of third party reliance, a defrauded customer should be entitled to rescission and the same protection under SIPC that all other customers are entitled to under the Act.

The Honorable Marvin E. Frankel of the Southern District of New York rendered an opinion in 1975 in a case involving a customer defrauded into entering a subordination agreement. The Court granted the remedy of rescission when there was no proof of reliance upon the subordination agreements by third parties. (Angel M. Aixala, et al. v. W.E. Hutton & Co., et al., 74 Civ. 4393, February 10, 1975). Judge Frankel deemed rescission to be the appropriate remedy on the grounds of both common law fraud and section 10(b) of the Securities Exchange Act of 1934.

Some have argued that a customer that has been defrauded does not need the protection of SIPC because such a customer has a right of action against the broker-dealer under other securities laws. Such an argument is obviously without merit because a right of action against a bankrupt broker-dealer is no protection at all. To the contrary, the purpose of the 1970 Act was to protect customers from the "financial hardship" caused by the broker-dealer's insolvency. Congress has shown no intent to protect only those customers who have not been defrauded and to abandon all others. Rather, defrauded customers should be treated on an equal basis with all other customers.

To deny such protection to defrauded customers would only further erode confidence in the U.S. securities markets and would deter many from entering into such agreements in the first place. It is generally accepted that subordination agreements are very important to the securities business and that many broker-dealers rely upon such arrangements in order to continue operations and to protect their other customers. Thus, the securities markets depend in part upon the willingness of some customers to enter into such subordination agreements. If those customers are denied the protection of the Act from the fraud of their broker-dealer in the event of the insolvency that sometimes follows, few would be willing to risk the value of their accounts in subordination agreements.

Another specified purpose of the 1970 Act was "to provide for a strengthening of the financial responsibilities of broker-dealers." To deny rescission and protection to defrauded customers can hardly be said to strengthen the financial responsibilities of broker-dealers. The effect of this amendment would be that once a customer of a broker-dealer has been induced by fraud to subordinate his account to claims of creditors of the broker-dealer, he is forever estopped from challenging the circumstances of the inducement, regardless of how criminal or fraudulent. Such a result would repudiate the purpose of strengthening the financial responsibility of broker-dealers. What is worse, such a provision might very well cause the self-regulatory organizations to be even less vigilant in their own review of the integrity of brokers' financial statements because they would have no reason to question the integrity of the subordinated capital which might be recited therein. Congress surely does not intend such a result. Broker-dealers and self-regulatory organizations should be put on notice that defrauded customers will have the right to challenge fraudulently induced subordination agreements.

Furthermore, we note that the principles of bankruptcy law, incorporated by reference into SIPA, support the right to rescind. Under such principles, a party induced to enter a contract by fraud has the right to rescind even after the filing of bankruptcy proceedings and to reclaim property fraudulently obtained by the bankrupt. See generally 4A Collier on Bankruptcy §70.41 (14th ed. 1976).

We believe that the remedy to the problems created by this amendment is quite simple. The definition of "Customer" should be amended by eliminating the clause following the word "debtor" on lines 1 through 4 of page 57 of the Bill and inserting the clause "not procured by the fraud of the debtor" (a copy of which is attached) after the word understanding on line 24 of page 56 of the Bill. Similarly, the clause "not procured by the fraud of the debtor" should be inserted after the word "understanding" on line 24 of page 39 of the Bill. Such an amendment will not alter the principle that under ordinary circumstances a customer who has subordinated his account will not be protected under the Act and does no more than reaffirm established common law principles. Thus, on those occasions where a customer has been defrauded, the defrauded customer will be granted the same protection as all other customers of the broker-dealer. In this way the purposes of the Act to provide protection to innocent customers of an insolvent broker-dealer and upgrade the financial responsibility of broker-dealers will be more closely followed.

May I express my appreciation to the Subcommittee for providing me with the opportunity to appear before you this morning regarding this most important matter.

1 respect to whom it sustained a loss. With respect to a net
2 loss which is not payable under the preceding sentence
3 from funds advanced by SIPC, the broker or dealer shall
4 be entitled to participate in the general estate as an
5 unsecured creditor.

6 “(3) CLEARING CORPORATIONS.—Neither a clear-
7 ing corporation which by its rules has an established
8 procedure for the closing-out of open contracts between
9 an insolvent broker or dealer and its participants, nor
10 its participants to the extent such participants’ claims
11 are or may be processed within the clearing corporation,
12 shall be entitled to receive SIPC funds in payment of
13 any losses on such contracts. If such clearing corporation
14 or its participants sustain a net loss on the closing-out of
15 such contracts with the debtor, they shall have the right
16 to participate in the general estate as unsecured creditors
17 to the extent of such loss. Any funds or other property
18 owed to the debtor, after the closing-out of such contracts,
19 shall be promptly paid to the trustee.

20 “(4) DEFINITION.—For purposes of this subsection,
21 the term ‘customer’ does not include any person who—

22 “(A) is a broker or dealer;

23 “(B) had a claim for cash or securities which
24 not procured by the fraud of the debtor
25 by contract, agreement, or understanding, or by
operation of law, was part of the capital of the

1 now in effect or as amended from time to time, and
2 includes the rules of bankruptcy procedure promulgated
3 with respect to such provisions, but does not include the
4 provisions of section 60e of the Bankruptcy Act, relating
5 to stockbroker bankruptcies.

6 “(2) COMMISSION.—The term ‘Commission’ means
7 the Securities and Exchange Commission.

8 “(3) CUSTOMER.—The term ‘customer’ of a debtor
9 means any person (including any person with whom the
10 debtor deals as principal or agent) who has a claim on
11 account of securities received, acquired, or held by the
12 debtor in the ordinary course of its business as a broker
13 or dealer from or for the securities accounts of such per-
14 son (A) for safekeeping, (B) with a view to sale,
15 (C) to cover consummated sales, (D) pursuant to pur-
16 chases, (E) as collateral security, or (F) for purposes
17 of effecting transfer. The term ‘customer’ includes any
18 person who has a claim against the debtor arising out
19 of sales or conversions of such securities, and any person
20 who has deposited cash with the debtor for the purpose
21 of purchasing securities, but does not include any person
22 to the extent that such person has a claim for cash or
23 securities which by contract, agreement, or understand-
24 ing, or by operation of law, is part of the capital of the
25 debtor, or is subordinated to the claims of any or all

1 creditors of the debtor, ~~notwithstanding that xxxxx~~
 2 ~~might xxxxxxxxxx for xxxxxxxxxx xxxxxxxxxx, xxxxx~~
 3 ~~xxx, xxxxxxxxxx xxxxxxxxxx xxxxxxxxxx xxxxxxxxxx~~
 4 ~~the xxxxxxxxxx and the xxxxxxxxxx~~

5 “(4) CUSTOMER NAME SECURITIES.—The term
 6 ‘customer name securities’ means securities which were
 7 held for the account of a customer on the filing date by
 8 or on behalf of the debtor and which on the filing date
 9 were registered in the name of the customer, or were in
 10 the process of being so registered pursuant to instruc-
 11 tions from the debtor, but does not include securities
 12 registered in the name of the customer which, by en-
 13 dorsement or otherwise, were in negotiable form.

14 “(5) CUSTOMER PROPERTY.—The term ‘customer
 15 property’ means cash and securities (except customer
 16 name securities delivered to the customer) at any time
 17 received, acquired, or held by or for the account of a
 18 debtor from or for the securities accounts of a customer,
 19 and the proceeds of any such property transferred by
 20 the debtor, including property unlawfully converted.
 21 The term ‘customer property’ includes—

22 “(A) securities held as property of the debtor
 23 only to the extent that the inability of the debtor to
 24 meet its obligations to customers for their net equity
 25 claims based on securities of the same class and

Mr. METCALFE. Thank you very much, Mr. Boggs.

For the record, we understand that you represent some clients who have subordinated their capital to a now defunct brokerage house. Is that correct?

Mr. BOGGS. Yes, that is correct.

Mr. METCALFE. These amendments are primarily designed to streamline the liquidation procedure. Yet, if we were to follow your advice, we would allow persons who allege fraud in their loan agreements to seek this rescission. Presumably that would involve mitigation and might cause some significant delays.

Would you care to comment?

Mr. BOGGS. Yes, Mr. Chairman.

I have two comments to make. First, with respect to the question that we in fact represent in outside litigation defrauded customers—I think it also should be pointed out that the task force that in fact recommended, this amendment, and others, likewise contained the trustee in this liquidation, and in that litigation, who has opposed this position.

Now, with respect to your question, I find it to be a rather disturbing argument that the mere fact that litigation may result because a defrauded customer attempts to assert his legal rights, that he should be denied the right to do so.

It does not appear to me as though the attempt by a defrauded customer to assert his rights and to prove in fact that he has been defrauded will in any way slow up a normal liquidation.

I think you will find, for example, in one of the largest liquidations, the Weis Securities case, that most of the customer claims have in fact already been paid off. The reason for that is most of them were less than the maximum SIPC protection.

If, in fact, there are some subordinated customers who seek to rescind their agreement because they were induced by fraud to enter them, I have not seen any evidence that that attempt will in any way slow up significantly the usual liquidation.

Mr. METCALFE. The gentleman from North Carolina.

Mr. BROYHILL. I apologize for being late this morning. I had another meeting at 8 this morning. I was down here until about 2:30 last night, working on the Clean Air Act. So, I don't know if I have been able to focus much on this subject this morning or not. I am not going to ask any questions at this time.

Mr. METCALFE. Mr. Oppen?

Mr. OPPER. Mr. Boggs, in connection with your arguments as to rescission and restitution for a subordinated lender to a broker-dealer, let me ask you this:

Suppose the broker-dealer rather than inducing the customer to become a subordinated lender under fraudulent circumstances induces the customer to purchase securities of the broker-dealer, after the broker-dealer has gone public.

Subsequently, upon liquidation, it is determined that the broker-dealer was not in precisely the financial condition that had been represented to that customer who purchased those securities.

Meanwhile, at the time of liquidation, the market value of those securities had decreased substantially. Perhaps they were worthless at the time of liquidation. Presumably SIPC would pay that

customer only the amount of the market value of the securities in his account at the time of liquidation.

The customer may, of course, have some right of action against the broker-dealer for fraud.

Can you please distinguish that situation from the one involved in the case at hand where the customer has been induced to become a subordinated lender to the broker-dealer?

Mr. BOGGS. I am not sure I understand precisely how you envision the original transaction that you described. Are you speaking of a customer who has in fact been induced—that is an existing customer of a broker-dealer who has been in fact induced to purchase securities of that particular broker-dealer?

Mr. BOGGS. The distinction, it seems to me, that one would apply there is that by purchasing the securities of the broker-dealer one becomes a shareholder of that particular broker-dealer, and the fact that one may seek rescission of the transaction involving the purchase of the securities of the broker-dealer should not in any way interfere with that particular person's rights as a customer with respect to whatever he has in his customer accounts.

I am not sure that it really should make any difference here as to whether or not the person was induced to purchase securities or enter into subordination agreements. I am not sure the distinction can in fact be made.

Mr. OPPER. Your argument, it seems to me, is that the subordinated lender should, upon liquidation, and upon effecting rescission, be restored to the position he was at some time prior to liquidation, when he was falsely induced to purchase the securities, or when he became a subordinated lender under some kind of fraudulent representations.

I am really trying to distinguish the case of the investor in the securities of the broker-dealer that has gone public under fraudulent circumstances, and the investor who has become a subordinated lender to the broker-dealer under the same circumstances.

Why should the subordinated lender, as you suggest, be upon liquidation, placed in a better position than the purchaser of securities of the broker-dealer?

Mr. BOGGS. Well, I think in part it depends upon the position of the two so-called investors as you described them originally. What I am referring to are existing customers of a broker-dealer—

Mr. OPPER. So am I.

Mr. BOGGS [continuing]. Who have done no more than agree to subordinate their existing customer accounts. They have not in fact purchased shares or a proprietary interest in the broker-dealer, unlike the purchaser of a security of that broker-dealer. They have instead simply taken existing customer accounts and have agreed to subordinate them.

I am also not speaking of an outside investor who has agreed to enter into a subordination loan agreement, but rather to an existing customer.

Mr. OPPER. I am talking about an existing customer who pays in capital in the form of the purchase of common stock to that broker-dealer. I am having a difficult time distinguishing between that situation and the subordinated lender who contributes to the capital of the broker-dealer upon which the presumably other credi-

tors of the broker-dealer rely when doing business with that broker-dealer.

Mr. BOGGS. I think there is a difference in the nature of the contribution of the capital. In the subordination case it is not in fact a contribution to capital as such. It is merely treated as a contribution to capital. The customer still maintains his account but it is now on a subordinated basis.

On the other hand, when one purchases a security, for example, of a broker-dealer he in fact makes a direct contribution of capital, whether it be in the form of cash or some other commodity which he has contributed to purchase the security.

He then owns a security interest in that particular broker-dealer.

Mr. OPPER. The purchaser of the stock still maintains his account. He is still a customer of the broker-dealer. But the fact is that the value of his purchase has diminished substantially, for whatever reason. All he gets is the market value of the stock.

Now, under the agreement, the subordinated lender, of course, is usually wiped out if the broker-dealer is liquidated. What I am trying to understand is why he should receive the entire amount of his original account back at the time of a liquidation, rather than suffering the consequences of having become a subordinated lender.

Mr. BOGGS. I perhaps am having trouble understanding the way in which a customer that you have described as being a shareholder or has purchased securities of a broker-dealer.

Mr. OPPER. Let's just say he has sold his hundred shares of A.T. & T., and with the proceeds has purchased shares of the broker-dealer who was handling his account.

Mr. BOGGS. Well, it may very well be what you have presented is a case in which a person in that position—a very good argument could be made that he should receive some protection as well.

I don't think at this particular point I can argue that strongly that a person who is a customer, and who has agreed in fact to sell his existing—the securities in his customer account to purchase the security, shouldn't entirely be foreclosed from protection. I am not in a position to argue that.

Mr. OPPER. I am just suggesting that under the circumstances all the customer would receive, at least from SIPC, is the market value of the securities in his account at the time of liquidation.

Mr. BOGGS. I understand that. I do think, however, there is a distinction between the nature of the transactions themselves.

Mr. OPPER. Mr. Darrow?

Mr. DARROW. Mr. Boggs, you seem very concerned with the preservation of the common law rights of customers who enter into subordinated lending agreements. We share your concern, as a general proposition.

However, Judge Wyatt of the Southern District of New York, as well as SIPC and the SEC in their appellate briefs in the Weis litigation contend that there is a counterbalancing interest to the common law right of rescission over which you have expressed concern.

Judge Wyatt, for example, cited a concern for actual or implied reliance by customers and other general creditors of a broker-dealer upon a firm's compliance with the net capital rule.

As you know, the net capital rule of the New York Stock Exchange requires that a member maintain a ratio of 15 to 1 between its aggregate indebtedness on the one hand and its net capital on the other.

Subordinated capital is included in a firm's net capital for computation purposes in complying with this rule.

Do you think there is a legitimate expectation interest of other customers and creditors because of the net capital rule, and are there other competing interests involved here, or do you think that there is simply one discrete issue; namely, common law rights?

Mr. BOGGS. No. Far be it for me to argue there is only one interest at stake here. On the other hand, I would argue very strongly that the position stated by Judge Wyatt, as well as SIPC and the SEC in that particular case, is misplaced; that is, the argument that customers and creditors rely upon the net capital rule for the purposes of obtaining protection in the event the broker-dealer becomes insolvent—I have never seen any evidence to support that proposition.

It seems to me that the purpose of the net capital rule is to insure liquidity of the broker-dealer to meet current demands. It was because the net capital rule did not provide protection against insolvency that SIPC was originally created, to provide the very protection that the net capital rule could not provide.

It seems to me that customers and general creditors rely not upon any given or specific set of subordination agreements when they engage in transactions with a broker-dealer, but rather upon the fact that they are regulated in general by the SEC or the New York Stock Exchange, or another self-regulatory organization.

Another problem I see with that argument is that if you assume reliance merely because they are in fact subject to the regulation of the net capital rule, how do you treat those customers and general creditors who engaged in transactions prior to a fraudulent subordination?

How could they possibly even be assumed to have relied upon that subordination agreement? If you follow that argument, you would then have to draw a distinction and set up two separate categories of customers and creditors, those who entered into the transactions prior to this fraudulent subordination and those who entered after the subordination.

That doesn't make sense unless you insist upon actual proof of reliance in that case.

If you take a customer or general creditor, and if he can prove he relied upon that subordination agreement, then the subordinated customer in that case would be estopped from asserting his claim against that particular customer.

But I don't see how you can assume it amongst everyone.

Mr. DARROW. Let me go back to the first point you made about the insurance of liquidity because that is clearly one of the primary purposes of the rule. Perhaps I am mistaken but it strikes me that there exists a close causal relationship between insuring liquidity of a firm on the New York Stock Exchange on the one hand, and within a regulatory framework, providing some mental comfort to people who engage in transactions on the exchange by insuring that the firms with which they are dealing are in fact solvent.

Evidently you consider those two discrete and unrelated issues. Is that right or wrong?

Mr. BOGGS. No, I am not saying they are unrelated. I think that people have misplaced the emphasis of the net capital rule in terms of the purpose that it serves. It seems to me it is obvious that if a broker-dealer is totally undercapitalized, and becomes overextended, that insolvency may result.

So, clearly there is some relationship between the concern for maintaining sufficient capital in a broker-dealer and preventing that broker-dealer from in fact becoming insolvent and at the same time, enabling it to engage in business transactions.

Now, I don't see the two as being totally inconsistent or unrelated at all. But because the net capital rule exists and is being enforced and because subordinated accounts can be used by a broker-dealer to meet its net capital requirement is not to say that when a customer or creditor engages in a transaction with that broker-dealer, that it is relying upon the existence of all such subordination agreements or is relying upon the fact that even if they were fraudulent, that they would be enforced according to their terms.

I don't think there is evidence to support that proposition.

Mr. DARROW. Evidently you feel that specific reliance is essential.

Mr. BOGGS. Absolutely. As with any right of rescission, for example, if you have been defrauded and you attempt to rescind, that if a third party can prove that he relied to his detriment, that one may be estopped from asserting the claim against that particular third party. I have certainly no intention of altering that common law proposition.

Mr. DARROW. Fraud most commonly arises in the securities industry in litigation involving the anti-fraud provisions of the Federal security laws. How do you respond to the fact that in securities litigation, as a consequence of recent decisions, proof of reliance is not required in actions brought under section 10(b) and rule 10b-5 where there has been an alleged material omission?

Mr. BOGGS. If one were to suggest that we remove reliance as a defense by a third party from rescission in these circumstances, I would hardly oppose that. But on the other hand, it seems to me there would be some grounds in these circumstances to maintain that position.

In the transactions that we are concerned about here we know that the securities laws may be applied in some circumstances to subordination agreements because they have been deemed to be securities.

Our concern here is that even if you applied the securities laws, and the right of a defrauded customer to, for example, sue the broker-dealer under the securities laws for the fraud that has been perpetrated upon him, that, as we have pointed out, is really no remedy, it doesn't provide any protection at all to the subordinated customer, for the obvious reason that there will be no assets to meet any claim that he succeeds in asserting.

Mr. DARROW. I have one last question.

It is my understanding that persons who subordinate their capital to broker-dealers are often reasonably sophisticated individuals

or institutions. You say you are concerned with individuals and not institutions. So, we will confine my remarks to individuals.

We recognize the potential for fraud involving the unsophisticated investor in subordinated lending agreements, a potential acknowledged yesterday by the SEC. Do you think that the nature of the party who is subordinating his capital should be a consideration in enforcing the terms of these agreements, or do you feel that they should always be subject to rescission, where there has been fraud?

Mr. BOGGS. If what you mean by should the nature of the customer be taken into consideration, whether he is in fact a sophisticated or unsophisticated investor, I think the answer is no.

The reason is that there is not much doubt that the customer who agrees to subordinate his account assumes the risk of bankruptcy.

He is sufficiently sophisticated an investor to know when he subordinates his account he is assuming the risk of insolvency.

But, he is not assuming the risk of fraud, nor should we in fact impose such a risk upon a subordinated customer; that is, a customer who agrees to subordinate his account. It seems to me that fraud can be perpetrated upon a sophisticated as well as unsophisticated investor.

Mr. DARROW. Just a follow-up. As I understand, SIPC's experience reveals that a number of bankruptcies involve situations where fraud has been employed to deceive investors, and that has been a contributing factor in the insolvency of the broker-dealer.

Does that mean if, for example, half of all of SIPC's liquidation had involved some kind of fraud, that you would suggest that investors in each one of those situations, however sophisticated, would have been entitled to rescission of their agreement and participation as full-fledged customers in each of the liquidations?

Mr. BOGGS. I am not familiar with the figures and cannot in fact speak to the accuracy of that assertion, and it is impossible for me to know the facts with respect to that.

Mr. DARROW. In a hypothetical context.

Mr. BOGGS. I think the hypothetical, however, should not be even considered because I noticed in SIPC's prepared statement that was filed with the subcommittee that over the last 7 years they have had approximately 105,000 customer claims filed under SIPC liquidations.

Out of those 105,000 they noted approximately 163 were unsatisfied because they exceeded the SIPC protection; that is, the claim exceeded the protection, and that most of those were unsatisfied primarily because of the \$20,000 cash limitation.

Now, I don't see where in fact the customers that are involved in SIPC liquidations are going to be damaged in any way by providing defrauded customers who have agreed to subordinate their account the right to asset that fraud, and to rescind those agreements, and return to the position they once were customers. I don't see where the damage lies to anyone in that situation.

Mr. DARROW. Presumably there is damage if there is some significant depletion of the amount available to other customers.

Mr. BOGGS. I think probably the primary damage would be to SIPC, who has the claims to what is left over.

Mr. DARROW. And the general creditors?

Mr. BOGGS. And there may be some general creditors, that is right.

That is entirely possible. But it was our impression that the purpose of SIPC was in fact to protect customers, and here we have a particular class of customers that are effectively going to be denied any protection at all.

This amendment attempts under all circumstances to deny any remedies or rights whatsoever. I think even Commissioner Loomis in his testimony from the SEC is somewhat concerned about that.

Mr. DARROW. Commissioner Loomis didn't state that enforcement of the terms of subordinated lending agreements would result in a denial of rights and remedies—it doesn't deny you the right to attempt to rescind. It only denies you the right to participate as a customer. That is an important distinction.

Mr. BOGGS. I agree.

Mr. DARROW. You say it denies you an effective right, but not the right—

Mr. BOGGS. I would hope it doesn't deny the right to rescind. That is unsettled.

Mr. DARROW. It is an unsettled issue. We are obviously still considering the respective merits of each side. However, if this bill were adopted, in the form it is currently written, it would result in the strict enforcement of the terms of subordinated lending agreements, without prejudicing the right to seek rescission.

Mr. BOGGS. Yes, I think the intent, it appears to me, of the amendment is not necessarily to prevent rescission, but merely to prevent any remedies or protection these customers have. If that seems to be the intent of the amendment, so be it. I would certainly hope not.

Mr. DARROW. What about the SEC? They think you should be able to participate ahead of general creditors, but after customers. Would that be an equally ineffective remedy?

Mr. BOGGS. I think all you have to do is look at the results of most of the liquidations to see how much is left in the estate for general creditors, whether it be senior or junior, and one would see that that remedy is in fact a meaningless one; that there is rarely anything left after the cost of the administration on these liquidations, to provide to other general creditors or for that matter to subordinated customers.

Mr. DARROW. OK; thank you very much.

Mr. METCALFE. Ms. Nord?

Ms. NORD. My questions have been covered.

Mr. METCALFE. Mr. Broyhill?

Mr. BROYHILL. No questions.

Mr. METCALFE. Thank you very much.

The hearings on consumer protection and finance will stand adjourned subject to call of the Chair.

[The following letters and statement were received for the record:]

THE New York Stock
Exchange

June 7, 1977

The Honorable Bob Eckhardt, Chairman
Subcommittee on Consumer Protection and Finance
House Committee on Interstate and Foreign Commerce
1741 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Eckhardt:

I understand that your subcommittee's staff is actively at work to resolve the minor points of difference between interested parties in order to propose to Congress amendments to the Securities Investor Protection Act which incorporates the major recommendations proposed by SIPC based on work of a task force on which I served.

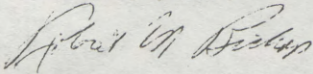
I write to commend this effort and to urge that this amendment be viewed as a priority for your subcommittee for action by Congress during the current session.

The SIPC amendments will greatly increase the facility of restoring accounts to customers in the event of failure of a larger brokerage firm. Although I am convinced that the 1968-70 style failures of broker-dealers are now precluded by basic changes in industry practices, there still remains the possibility of failure arising from fraud or sudden financial catastrophe. To me, it is therefore of great urgency that SIPA be amended promptly in order to be prepared for the unexpected.

The amendments will also reduce administrative costs and increase customer protection in SIPC liquidations of smaller firms. Although the failures of smaller firms have also been considerably reduced, there are still a few each year. The customers of firms which will fail in 1978 should not be deprived of the benefits of the amendments.

There is, to my knowledge, no controversy covering the substantive provisions of the proposed amendments. (I am sure your committee can equitably resolve the minor points of difference of opinion.) The securities industry as a whole, I believe, will support the amendments.

Sincerely yours,



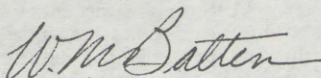
THE New York Stock
Exchange

Dear Mr. Chairman: August 17, 1977

I am herewith submitting, on behalf of the New York Stock Exchange Inc., our statement on H.R. 8331, the Securities Investor Protection Act Amendments of 1977.

Having long supported the goals to which the Securities Investor Protection Act is dedicated, the Exchange appreciates your Subcommittee's timely review of this important legislation, and hopes that this statement will be useful to you in your deliberations.

Best regards,



The Honorable Bob Eckhardt
Chairman, Subcommittee on
Consumer Protection and Finance
Committee on Interstate and
Foreign Commerce
U.S. House of Representatives
Washington, D.C. 20515

THE New York Stock
ExchangeSTATEMENT OF THE
NEW YORK STOCK EXCHANGE

The New York Stock Exchange appreciates the opportunity to comment on H.R. 8331, The Securities Investor Protection Act Amendments of 1977, introduced by Chairman Eckhardt on July 14 of this year. As you and your staff are aware, the Exchange testified before this Subcommittee in 1975 in support of the predecessor bill, H.R. 8064, which is substantially the same legislation as the legislation currently before the Subcommittee. The Exchange continues to support the thrust of this amendment package, and will not address again each of the issues in the bill. However, the Exchange wishes to focus on one area of concern -- an area in which we believe H.R. 8331 might be amended to further enhance investor confidence.

While the Exchange commends the Subcommittee for its timely review of this important legislation, we must express our disappointment in the cash coverage feature of H.R. 8331. It is regrettable that in the bill before you, the cash protection per customer remains at the current law level of \$20,000, rather than being increased to \$40,000 as was provided under the previous measure, H.R. 8064. The Exchange endorses the per customer increase in securities protection from \$50,000 to \$100,000 and respectfully requests that the Subcommittee reconsider the cash protection level currently provided for in H.R. 8331.

It is our understanding that the \$40,000 limit of cash coverage was not included in the legislation now being considered as a means to discourage customers from leaving larger amounts of money with brokers and, specifically, to favor the moving of such funds to the banking system.

We request that your Subcommittee give careful consideration to the arguments set forth below, which explain our rationale for the need to maintain the same ratio of cash and securities coverage that now exists. Our arguments are based upon the banking laws, the relative capital requirements of brokers and banks and, most particularly, the importance of cash coverage available to public investors.

In effect, the banking laws define parties engaged in the business of seeking and holding customers' deposits as banks, which are subject to appropriate state or federal regulation. Under the banking laws, banks, in general, may not engage in the activities of underwriting and distribution of corporate securities. Since underwriting and distribution of corporate securities are a significant securities industry activity, broker-dealers desire to avoid being classified as banks.

To avoid being classified as a bank, broker-dealers will only hold customer funds awaiting reinvestment of those funds, and will not accept or hold funds for deposit purposes. As a rule of thumb, brokers specifically question customers as to the customer's reinvestment intentions in those rare instances where a customer leaves cash with the broker for more than six months. Consequently, we question the need for the Act to encourage customers to deposit funds with banks, rather than with brokers, since the banking laws already accomplish that purpose.

On the other hand, we also submit that customers' funds left with brokers for reinvestment are at least as well protected as those deposited in banks. The SEC liquidity and capital requirements for brokers are far more severe than similar requirements imposed on banks. Further, under the SEC Rule 15c3-3, brokers may use customers' cash only for the purpose of financing other customers' debits and may not use those funds for financing the firm's business. Also, other customers' debits are collateralized by readily marketable securities. Readily marketable securities are far more liquid collateral than the various types of collateral upon which banks can utilize deposit monies of their customers. A further and significant point is that cash held by a broker, not used to finance other customers' debits, must be deposited by the broker in a special bank account that is specifically designated for the exclusive benefit of its customers in the event of insolvency.

This fabric of protection, designed specifically for the benefit and protection of brokerage customers, makes it inappropriate for Congress to discriminate through the provisions of the Act against public investor funds held by brokers.

Actually, a customer's cash in an account at liquidation often represents securities in the process of settlement. Several examples of this are:

- 1) A customer's option sale settles in 1 day, but a securities purchase at that same time settles 4 days later, with the customer's account showing cash for those 4 days.
- 2) A customer sells one security position and purchases rights to subscribe to another security on the same day. However, the cost of the rights is only a fraction of the entire subscription transaction, which typically takes place 10 to 20 days later. During the intervening days between the settlement of the rights purchase and the payment of the subscription price, there is cash in the customer's account.
- 3) A customer makes a security purchase and immediately thereafter is told by his registered representative what the total transaction price will be. In order to avoid any possible violation of Regulation T of the Federal Reserve Board, the customer pays for his purchase immediately. That will show as cash in the account until settlement of the transaction on the 5th day.
- 4) Customers also frequently decide to sell a position and delay further decision on a new purchase for several days. This factor alone accounts for a large part of the cash in customers' accounts awaiting reinvestment.

We believe that in all of these cash situations public investors deserve SIPC protection to the same extent as securities.

There are two inherent differences in securities and cash, within brokerage operations, that make it likely that there will be a relatively greater shortfall of customers' cash than of customers' securities in a SIPC liquidation of any larger firm such as those NYSE firms which carry perhaps 90% of all customer accounts.

- 1) A high percentage of customers' securities, in a SIPC liquidation, would be found intact. The securities would be specifically identifiable for delivery to the customer prior to any application of SIPC assistance to that part of a customer's securities which might be missing. Conversely, no cash is specifically identifiable to the particular customer. Customers, of course, will have a claim to a rateable share of cash in bank accounts, just as they do in the case of securities which are identifiable as belonging to customers of the firms, but not those of a particular customer.
- 2) Customers' assets involved in the settlement of security transactions are less likely to be identified as such for SIPC priority payment than the longer term holdings of customers. Most customers' cash held by brokers is involved in the process of settling transactions, with the remainder awaiting reinvestment within short periods. Most securities held by brokers for customers are on deposit for a long period and are not involved in current settlements.

Both of these factors make it more likely that, at a liquidation date, there would be a relatively greater shortage of cash, rather than securities, in a customer account, thus highlighting the need for cash protection.

The New York Stock Exchange hopes that these comments will be useful to the Subcommittee on Consumer Protection and Finance, and stands ready to be helpful to the Subcommittee on this or any related issue affecting the confidence and protection of the investor community.

August, 1977

SCUDDER, STEVENS & CLARK
INVESTMENT COUNSEL

175 FEDERAL STREET
BOSTON, MASSACHUSETTS 02110
(617) 482-3990

August 3, 1977

SCUDDER STEVENS & CLARK
A PARTNERSHIP
BOCA RATON
BOSTON
CINCINNATI
CLEVELAND
DALLAS
HOUSTON
NEW YORK
PHILADELPHIA

SCUDDER, STEVENS & CLARK, INC.
CHICAGO
LOS ANGELES
SAN FRANCISCO

House Sub-Committee for Consumer
Protection and Finance
Room 3161
House Office Building 2
Washington, D.C. 20515

Attention: Franz Oppen Esquire, Majority Counsel

Re: H.R. 8331 (95th Congress, 1st Session)

Gentlemen:

I am writing to register the opposition of myself and my firm to certain aspects of H.R. 8331 as presently drafted.

Scudder, Stevens & Clark ("SS&C"), a partnership, is one of the nation's oldest firms of investment counsel having been founded in 1919. It is also one of the largest, providing investment advice and supervision to accounts having investment assets of approximately \$12.5 billion of which approximately \$700 million are owned by registered investment companies with which the partnership has advisory contracts. The shares of these companies are sold on a "no-load" basis, that is to say, without any sales commission.

The firm derives no income from banking, brokerage, insurance or underwriting of securities. However, it has formed a wholly-owned subsidiary, Scudder Fund Distributors, Inc., ("Distributors") which is a registered broker-dealer within the meaning of Section 3(a)(2) of the Securities Investor Protection Act of 1970, as proposed to be amended by H.R. 8331. It is presently a member of the Securities Investor Protection Corporation ("SIPC"). Distributors performs two functions:

- (1) Without receiving any commissions or other compensation therefor, it acts as the distributor of shares of registered investment companies advised by the firm in order to insulate such companies from multiple filings and possible exposure to liability from selling activities in the various states; and
- (2) through its order desk are placed, without receipt of commissions or other compensation, the portfolio securities orders for the investment company clients and individual clients of SS&C. However, no investment

securities are received or delivered by Distributors for clients of the firm or registered investment companies. All receipts and deliveries are made by or to, as the case may be, banks employed by non-investment company clients in which they maintain safe-keeping accounts or to other custodial entities employed by such clients (except for a very few instances where the client receives or delivers shares in person) and the custodian banks of the registered investment companies, with deliveries being strictly against cash and payments strictly against receipt of securities. In the case of registered investment companies making a continuous offering of their shares, Distributors will, in some cases, receive checks drawn in its favor for delivery to the appropriate custodian bank in payment for shares, but all shares, both those sold and those redeemed, are handled by the transfer agent for the registered investment company rather than by Distributors.

Thus, Distributors derives no income from its activities as a broker-dealer and, in fact, functions as a broker-dealer only in the most minimal way.

The changes in the Securities Investor Protection Act of 1970 proposed in H.R. 8331 impinge, we believe, most unfairly on this firm, since their effect would be to subject to assessment income which is wholly unrelated to the purpose of the Act: the protection of customers of failed broker-dealer firms.

Thus we object to

- (1) The elimination of present Section 4(c)(3)(C) of that Act which excludes from the basis of assessment activities in (a) the distribution of shares of registered open-end investment companies and (b) the business of rendering investment advisory services to one or more registered investment companies;
- (2) the amendment to Section 4(i) of the Act to include in gross revenues from the securities business of a member of SIPC the revenues of all entities which control, are controlled by, or are under common control with a member; and
- (3) the definition of "Gross Revenues from the Securities Business" in paragraph (9) of redesignated Section 16 to include all fees for investment advisory services or account supervision with respect to securities.

We feel strongly that these proposed amendments, taken together, represent a totally unwarranted attempt by the Board of

the Securities Investor Protection Corporation to sweep within the scope of the Act organizations and revenues which bear no relation to the risks to investors against which the legislation is intended protect. In a political atmosphere in which the President has announced support for simplification of government bureaucracy and elimination of unwarranted governmental interference in the affairs of the governed, it seems ironic that an agency would propose legislation which will result in a subsidization of a fund for the benefit of customers of broker-dealers and, therefore, indirectly the broker-dealer community as such, by an institution which does not expose its own clients and customers to such risks through its own activities and arranges transactions on behalf of customers and clients in such a way that they are not exposed to those risks and thus derive no potential benefit from the protective fund.

Accordingly, we respectfully submit that the Committee consider revising the amendments proposed in H.R. 8331 so as to exclude broker-dealer affiliates of organizations such as Scudder, Stevens & Clark which perform the type of broker-dealer functions described from required membership. In the alternative we respectfully suggest that only the revenues of such broker-dealer affiliates of firms like Scudder, Stevens & Clark be included in, and the advisory income be totally excluded from, the basis of assessment of dues.

We should be glad to make available representatives of the firm, including legal counsel, to assist your staff in considering our proposals or drafting language.

In conclusion, we wish to thank you for your consideration and the opportunity to express our views.

Very truly yours,

W. Russell Peabody
W. Russell Peabody
Senior Vice President

WRP:jc

[Whereupon, at 9:30 a.m., the subcommittee adjourned.]

○

