

April 2, 2009

An *incisivemedia* publication

Madoff Scandal Spotlights the Securities Investor Protection Corp.

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Special to Law.com
April 2, 2009

Bernard Madoff's multibillion-dollar fraud has been front and center in the media and the minds of both those fallen victim and those left unscathed, and likely will remain so for quite some time as the massive Ponzi scheme continues to unfold. One of the ways in which Madoff victims are seeking relief is through the Securities Investor Protection Corp. and the court-appointed trustee, Irving Picard.

On Jan. 2, Irving Picard began mailing claim forms to customers, broker-dealers and general creditors of Madoff's brokerage firm, Bernard L. Madoff Investments Securities LLC.¹ On Friday, Feb. 25, Picard presided over the first meeting of BLMIS creditors.² At the meeting, Picard provided a status report of the liquidation of BLMIS, discussed the filing and review of customer claim forms, and stated that, if he determines that a customer's claim should be allowed, the first payment the customer will receive will be in the form of a SIPC advance payment.³ Picard began issuing notices of determination during the last week of February that certain customer claims were allowed, and at least twelve claimants will be paid \$500,000 from funds advanced by SIPC.⁴

But what is SIPC? In light of the Madoff scandal, this article attempts to answer some basic questions about SIPC's purpose and functions.

WHAT IS SIPC?

Created by the Securities Investor Protection Act in 1970,⁵ SIPC's purpose is to promote investor confidence in the securities markets by offering protections to customers after a brokerage firm fails owing its customers cash or securities. SIPC's main function is to return securities and funds to investors when a member brokerage firm (i) becomes insolvent, or (ii) engages in unauthorized trading.⁶ SIPC does not bail out investors when the value of their securities declines, and it does not cover those who buy worthless securities.⁷

SIPC is a nonprofit membership corporation consisting of securities broker-dealers.⁸ SIPC only protects customers of broker-dealers that are SIPC members.⁹ Nearly all broker-dealers registered with the Securities and Exchange Commission are SIPC members; the few registered broker-dealers that are not SIPC members must disclose this fact to their customers.¹⁰ If a SIPC member is no longer registered with the SEC, the broker-dealer's SIPC membership is automatically terminated.¹¹

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SIPC is neither a regulatory organization nor a government agency.¹² SIPC does not audit, regulate, or investigate its member firms.¹³ The SEC and the Financial Industry Regulatory Authority execute those regulatory and enforcement roles.¹⁴ Instead, SIPC steps in when the SEC, FINRA, or another securities industry regulatory organization alerts SIPC that customers of a brokerage firm might need protection.¹⁵

Under its statutory mandate, SIPC maintains a special fund from which it makes advances to customers of failed broker-dealers.¹⁶ SIPC member firms must pay assessments to SIPC to maintain the SIPC Fund.¹⁷ Since its inception through December 2007, SIPC has recovered \$15.7 billion in assets for an estimated 625,000 investors.¹⁸ Today, the SIPC Fund has approximately \$1.7 billion in assets.¹⁹

WHAT IS AND IS NOT PROTECTED BY SIPC?

SIPC protects customer cash and securities held at financially troubled brokerage firms.²⁰ SIPC does not protect against losses caused by a decline in the market value of securities.²¹ SIPC protection also does not extend to commodity futures contracts, currency, or investment contracts (including limited partnerships) that are not registered with the SEC.²² Nor does SIPC cover account holders at hedge funds, and it does not protect mutual fund investments unless mutual fund shares disappeared from a brokerage account.²³ Finally, the SIPC Fund cannot be used to pay the claim of any failed brokerage firm customer who also is a (i) general partner, officer or director of the firm; (ii) beneficial owner of 5 percent or more of equity stock; (iii) limited partner of the firm with a participation of 5 percent or more in the net assets or net profits of the firm; (iv) person capable of exercising a controlling influence over the management or policies of the firm; or (v) broker or dealer or bank acting for itself rather than for its own customers.²⁴

HOW DOES SIPC PROTECT INVESTORS?

In most cases, SIPC requests a federal district court or federal bankruptcy court to appoint a trustee to liquidate a SIPC member broker-dealer that is insolvent or cannot return customer cash or securities.²⁵ On Dec. 15, 2008, SIPC filed an application with the United States District Court for the



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Southern District of New York for a declaration that the customers of BLMIS were in need of the SIPC protections afforded under federal law.²⁶ United States District Judge Louis L. Stanton granted the application and appointed Irving H. Picard as trustee for the liquidation of BLMIS.²⁷

Where a failed brokerage firm maintained accurate records, the trustee and SIPC usually transfer some or all customer accounts to another brokerage firm.²⁸ Customers are notified of the transfer, and have the option of staying with the new firm or choosing another firm.²⁹ The brokerage firm's remaining customer assets are then allocated pro rata to customers.³⁰

If sufficient funds are not available in the firm's customer accounts to satisfy claims, SIPC utilizes its reserve funds to supplement the distribution. SIPC may pay customers up to \$500,000 per customer, of which as much as \$100,000 can be based upon a claim for cash.³¹ Additional funds of the brokerage firm, if any, may be available to satisfy the remainder of customer claims after the cost of liquidating the brokerage firm is taken into account, though no customer funds are ever used to pay administrative expenses or the trustee's, lawyers' or accountants' fees.³²

IS SIPC THE FEDERAL DEPOSIT INSURANCE CORPORATION OF BROKERAGE FIRMS?

As SIPC President Stephen Harbeck stated, "There are analogies and there also differences" between SIPC and the FDIC.³³ While sometimes described as "the FDIC of brokerage firms," SIPC differs from the FDIC in some very fundamental and important ways.

SIPC does not offer investors the same blanket protection that the FDIC offers bank depositors. Notably, Congress rejected the creation of a Federal Broker-Dealer Insurance Corporation, concluding that such a designation would be misleading and inconsistent with the risk-based securities investment marketplace.³⁴ When a covered bank fails, the FDIC insures depositors against all losses up to a certain dollar limit.³⁵ When a brokerage firm fails and has insufficient funds to satisfy customer claims, SIPC pays customers up to \$500,000 in securities, including a maximum of \$100,000 for cash claims.³⁶

HOW QUICKLY CAN INVESTORS GET THEIR SECURITIES OR CASH BACK?

Generally speaking, most customers can expect to receive SIPC funds in one to three months.³⁷ This process is streamlined where the records of the brokerage firm are accurate.³⁸ In such a case, deliveries of some securities and cash to customers may begin shortly after the trustee receives the completed claim forms from customers, or even earlier if the trustee can transfer customer accounts to another broker-dealer.³⁹ Delays can arise, however when the firm's records are inaccurate, particularly where the brokerage firm or its principals perpetrated a fraud like in the Madoff case.⁴⁰ Investigators have not found any evidence indicating that Madoff effectuated any trades on behalf of his customers since at least 1993, and perhaps never purchased securities for investors.⁴¹

HOW CAN INVESTORS MAKE A CLAIM IF A BROKERAGE FIRM FAILS?

If a brokerage firm is put into liquidation, the court-appointed trustee will send claim forms to each firm customer based on the firm's records, and publish notice of the liquidation in newspapers and other media outlets.⁴² In the liquidation of BLMIS, Picard mailed over 8,000 customer claim forms in early January with detailed instructions for the completion and filing of claims with the trustee.⁴³ Further, Picard made claim forms available on his Web site, and published a notice to customers and creditors in several newspapers, including the *Wall Street Journal*, *New York Times* and *Financial Times*, detailing the commencement of BLMIS liquidation proceedings and claims procedures.⁴⁴

The initial deadline for receipt of claims in the BLMIS liquidation was March 4; the outside deadline is July 2, 2009.⁴⁵ Upon receipt, the trustee's claims agent reviews each claim form and makes a determination of which claims should be allowed.⁴⁶ Customers who submit claims in the BLMIS liquidation receive notices informing them of the trustee's determination of their claims -- namely, whether the claim will be allowed and the steps a customer should take to obtain the SIPC advance, or whether the claim

will be disallowed and why.⁴⁷ If a customer claim is allowed, that customer will receive a notice of determination, together with a SIPC release and subrogation form to be completed and returned.⁴⁸ The trustee's determination letter will advise BLMIS customers of their rights.⁴⁹ If a customer does not agree with the trustee's determination, the customer can oppose it by making an objection.⁵⁰ The bankruptcy court judge will then decide whether the claim should be allowed or disallowed.⁵¹

CONCLUSION

In the ensuing months, SIPC will continue to make advancements to BLMIS customers and Picard will continue to take steps to collect the available assets of BLMIS and Madoff to further satisfy customer claims. The Madoff Ponzi scheme has certainly cast more of a spotlight on SIPC, an agency many may not have been familiar with before the Madoff affair became front-page news.

FOOTNOTES

1. Madoff Trustee Web site (last visited March 23, 2009).
2. *Id.*
3. See Trustee Irving Picard, Statement at the First Meeting of Creditors (Feb. 20, 2009).
4. Madoff Trustee Web site, *supra* note 1.
5. See 15 U.S.C. §78aaa et seq.
6. See FINRA.org, Your Rights Under SIPC Protection (last visited March 23, 2009).
7. See SIPC.org, SIPC Brochure (last visited March 23, 2009).
8. See SIPC.org, SIPC Statute and Rules (last visited March 23, 2009).
9. See SIPC Brochure, *supra* note 7.
10. See Your Rights Under SIPC Protection, *supra* note 6.
11. See SIPC.org, Answers to the 7 Most Asked Questions (last visited March 23, 2009).
12. See SIPC Statute and Rules, *supra* note 8.
13. See Assessing the Madoff Ponzi Scheme and the Need for Regulatory Reform: Hearing before the House Financial Services Committee, 110th Cong. (Jan. 5, 2009) (testimony of Stephen Harbeck, President, SIPC) (hereinafter Harbeck House Testimony).
14. See *id.*
15. See *id.*
16. SIPC Press Release, SIPC to Reinstitute Assessments of Member Firms' Operating Revenues (Mar. 2, 2009) (last visited March 23, 2009).
17. See *id.*
18. See SIPC.org, The SIPC Mission (last visited March 23, 2009).
19. See Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing of the Senate Banking Committee, 110th Cong. (Jan. 27, 2009) (testimony of Stephen Harbeck, President, SIPC) (hereinafter Harbeck Senate Testimony).
20. See SIPC.org, What SIPC Covers ... What it Does Not (last visited March 23, 2009).
21. See SIPC Brochure, *supra* note 7.
22. See What SIPC Covers ... What it Does Not, *supra* note 20.
23. See Your Rights Under SIPC Protection, *supra* note 6.
24. See Answers to the 7 Most Asked Questions, *supra* note 11.
25. See SIPC Brochure, *supra* note 7.
26. SIPC Press Release, Liquidation Proceeding for Bernard L. Madoff Investment Securities LLC Undertaken by Securities Investment Protection Corporation (Dec. 15, 2008) (last visited March 23, 2009).
27. See *id.*
28. See SIPC Brochure, *supra* note 7.
29. See *id.*
30. See *id.*
31. See *id.*
32. See Harbeck Senate Testimony, *supra* note 19.
33. See Harbeck House Testimony, *supra* note 13.
34. See SIPC.org, Why We Are Not the FDIC (last visited March 23, 2009).
35. See FDIC.gov, Insuring Your Deposits (last visited March 23, 2009).
36. See SIPC Brochure, *supra* note 7.
37. See *id.*
38. See *id.*
39. See *id.*
40. See *id.*
41. See Picard, *supra* note 3.
42. See SIPC Brochure, *supra* note 7.
43. See SIPC Press Release, Madoff Liquidation Trustee Mails More Than 8,000 Customer Claim Forms, Publishes Notice in Major Newspapers (Jan. 5, 2009) (last visited March 23, 2009).
44. See *id.*
45. See *id.*
46. See Picard, *supra* note 3.
47. See *id.*
48. See *id.*
49. See *id.*
50. See Order Approving Form and Manner of Publication and Mailing of Notices, Specifying Procedures for Filing, Determination, and Adjudication of Claims (Dec. 23, 2008).
51. See *id.*