Substance and Semblance in Investor Protection

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I. INTRODUCTION

The D.C. Circuit recently dealt a powerful blow to the Securities and Exchange Commission (SEC) in its unprecedented attempt to compel the Securities Investor Protection Corporation (SIPC) to liquidate—and thereby provide modest restitution for investors in—a multibillion dollar Ponzi scheme. Whether *SEC v. SIPC* is a blow for or against investor protection, however, depends on one's perspective.[1] On the one hand, victims of broker–dealer securities fraud (such as the Ponzi schemes perpetrated by Bernie Madoff and Allen Stanford) understandably resent efforts to limit claims to the SIPC Fund; their resentment is undoubtedly stoked by a "gantlet of legal technicalities" barring relief

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1. SEC v. Sec. Investor Prot. Corp., 758 F.3d 357, 359 (D.C. Cir. 2014).

"that would challenge even those knowledgeable in securities law."[2] On the other hand, multibillion dollar claims on SIPC could impair its ability to facilitate the transfer and resolution of securities accounts in a time of crisis: a well-capitalized SIPC Fund arguably contributed to the efficient liquidation of Lehman Brothers and MF Global—and could play an even more constructive role as its purview is effectively extended to other types of instrument.

These dueling perspectives reflect the dilemma SIPC poses for policymakers in the aftermath of the recent financial crisis. Congress created SIPC under the Securities Investor Protection Act of 1970 (SIPA) as part of its mission to remediate and prevent financial failures of stockbrokers nearly half a century ago.[3] By financing the prompt return of customer property in the event of a broker–dealer's insolvency, SIPC was intended "to reinforce the flagging confidence in the securities market by providing an extra margin of protection for the small investor."[4] That "extra margin," however, has grown wider over the years as SIPC has faced unrelenting pressure to cover an ever broader range of relationships, entities, and products far afield of its original mandate.

As with any scheme of public insurance, the availability of SIPC advances to customers in the event of their broker's insolvency creates significant moral hazard for brokers and their customers.[5] Just as important, however, is the moral hazard created by separating SIPC's restitutionary function from the prophylactic regulation exercised by the SEC, the securities self-regulatory organizations (SROs) and other financial regulators. The SEC's decision to press the cause of the Stanford victims in spite of its longstanding interpretation of SIPA illustrates the danger.[6] In response to the multibillion dollar losses suffered by these investors, the public may view SIPC as a convenient industry-funded source of restitution when policymakers and regulators fail to protect investors against foreseeable fraud or misconduct by broker–dealers.

The onslaught of SIPC proceedings and legislative, regulatory and judicial responses following the recent financial crisis presents a valuable opportunity to reflect on the strains

2. Gretchen Morgenson, *INVESTOR BEWARE; Many Holes Weaken Safety Net for Victims of Failed Brokerages*, N.Y. TIMES (Sept. 25, 2000), http://www.nytimes.com/2000/09/25/business/investor-beware-many-holes-weaken-safety-net-for-victims-of-failed-brokerages.html.

3. *See, e.g.*, Harold S. Bloomenthal & Donald Salcito, *Customer Protection From Brokerage Failures: The Securities Investor Protection Corporation and the SEC*, 54 U. COLO. L. REV. 161, 162–65 (1983) (discussing the history behind legislative and regulatory efforts to protect customers of insolvent broker–dealers); Michael E. Don & Josephine Wang, *Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers*, 12 CARDOZO L. REV. 509, 510–12 (1990) (discussing the passage of the Securities Investor Protection Act in response to the 1960s Paperwork Crisis); Egon Guttman, *Broker–Dealer Bankruptcies*, 48 N.Y.U. L. REV. 887, 905–07 (1973) (discussing the creation of SIPC as a response to the inadequacy and discretionary administration of the exchanges' special trust funds); Thomas W. Joo, *Who Watches the Watchers?: The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1080–87 (1999) (attributing the crisis in investor confidence to "mismanagement and misconduct" and the "failure of self-regulation").

4. SEC v. Packer, Wilbur & Co., 498 F.2d 978, 980 (2d Cir. 1974).

5. Joo, *supra* note 3, at 1129–35.

6. *Compare Analysis of Securities Investor Protection Act Coverage for Stanford Group Company*, SEC (June 15, 2011), http://www.sec.gov/rules/other/2011/stanford-sipa-analysis.pdf, *with* Brief of Former SEC Officials and Professors of Law as Amici Curiae in Support of Appellee and Affirmance, SEC v. Sec. Investor Prot. Corp., 2013 WL 1702043, at *24–25 (D.C. Cir. Apr. 19, 2013) (arguing that "[a]s recently as 2011, the SEC advanced a litigating position of 'customer' that is, in fact, diametrically opposed to the expansive interpretation it advances in this case") [hereinafter Stanford Amici Brief].

SIPC endures in carrying out the dual role of resolving insolvent broker–dealers and promoting investor confidence in the brokerage industry. As the size and systemic import of major brokerage insolvencies grows, policymakers must ask whether SIPC's resources should be deployed with a focus on improving the efficiency of liquidation proceedings that could potentially result in a fair and orderly outcome (at the expense of customers trapped in proceedings too toxic to handle), or with a focus on treating investors as equitably as possible to remediate the losses they suffer due to outrageous misconduct or mismanagement. An emphasis on the former might better integrate SIPC with a variety of account regimes and industry mechanisms, while scaling back its role as a compensation fund for aggrieved investors. An emphasis on the latter might require better integration of SIPC with enforcement authorities to recover funds for defrauded customers and a better-developed claims process to manage public expectations.

Part II of this Article provides an overview of SIPC and SIPA's relationship to the financial responsibility rules of the Securities Exchange Act of 1934 (Exchange Act) and the U.S. Bankruptcy Code. Part III considers four case studies—the collapse of Lehman Brothers and MF Global, and the Madoff and Stanford Ponzi schemes—and the questions they raise regarding the adequacy and legitimacy of the SIPC regime. Part IV considers the challenges policymakers face when defining the scope of investor protection under SIPA, both from the perspective of delimiting entitlement to protection and fashioning appropriate evidentiary, methodological, and eligibility rules to channel reasonable expectations. Finally, Part V considers two possible evolutionary paths to clarifying SIPC's role in our financial markets.

II. SIPC IN BRIEF

SIPC was created as part of a series of financial responsibility reforms stemming from the "back-office" crisis in the 1960s securities market. The post-war boom fueled an era of heady speculation on Wall Street and with it, a perfect storm of highly leveraged trading, inadequate recordkeeping, and negligent or opportunistic management.[7] Upstart broker–dealers were able to support highly leveraged proprietary positions using customer funds and securities as collateral.[8] At the same time, the volume of increasingly automated trading on stock exchanges outpaced the largely manual process of comparing, clearing and settling transactions.[9] As the technological gap between "front office" trading and "back office" processing grew, brokerage firms became increasingly prone to fraud, theft,

7. *See, e.g.*, Guttman, *supra* note 3, at 888 (citing, inter alia, H.R. DOC. NO. 92–231 (1st Sess. 1971)).

8. JOEL SELIGMAN, TRANSFORMATION OF WALL STREET 450–66 (3d ed. 2003) (describing the SEC's reaction to the "back-office" crisis from 1967–1970 and the perceived inefficacy of exchange capital requirements). Broker–dealers exploited alternative sources of short-term credit as well. Steven L. Molinari & Nelson S. Kibler, *Broker/Dealers' Financial Responsibility Under the Uniform Net Capital Rule—A Case for Liquidity*, 72 GEO. L.J. 1, 26–32 (1983); *see also* SELIGMAN, *supra*, at 458 (noting that impermanent forms of capital such as "subordinated loans or secured demand notes from customers or partners . . . as of 1970, made up 40 percent of the capital of all [New York Stock] Exchange member partnerships and 34 percent of the capital of all Exchange member corporations"); Nicholas Wolfson & Egon Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603, 625–26, 636 (1972) (describing theoretical concerns with counting subordinated loans toward net capital).

9. For example, prior to the 1975 amendments to the Securities Exchange Act, many customer securities were held in certificated form, which required physical delivery in connection with the settlement of securities transactions.

and loss of customer funds.[10] When the bubble burst in 1969, many firms were forced into liquidation[11] and, in the process, nearly exhausted industry guaranty funds maintained by exchanges.[12]

The Congressional response was to revive investor confidence in the securities brokerage industry by providing immediate protection for their customers. In 1970, Congress created SIPC to administer SIPA's liquidation regime and to establish an industry-financed fund for the protection of customer funds and securities held by securities brokers.[13] In 1975, Congress acted on additional recommendations of Congressional hearings on unsafe and unsound practices in the brokerage industry[14] and amended the Exchange Act to grant the SEC greater authority to impose uniform financial responsibility rules on broker–dealers.[15]

SIPC's organizational structure suggests a superficial similarity to the Federal Deposit Insurance Corporation (FDIC) and the variety of self-regulatory organizations registered under the Exchange Act, but the limitations on SIPC's governance structure and powers belie any real comparison.[16] SIPC is organized as a "membership corporation" whose membership includes by law all broker–dealers registered under the Exchange Act, excepting only certain niche and offshore broker–dealers.[17] Only a small fraction of its members hold customer funds and securities in a custodial capacity ("carrying brokers"); most of the remainder are "introducing brokers" that provide sales and execution services, but rely on carrying brokers to perform custodial services.[18] Introducing brokers are

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10. Joo, *supra* note 3, at 1076–77; SELIGMAN, *supra* note 8, at 450–61.

11. S. REP. NO. 94-75, at 4 (1975) ("1975 Amendments Legislative History").

12. *See, e.g.*, H.R. REP. NO. 91-1613 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5257 (noting that, at the time of SIPA's enactment, the special trust fund of the New York Stock Exchange was "virtually exhausted, having been required to commit approximately $55 million, which includes $30 million transferred from the Exchange's building fund in the spring of this year").

13. 15 U.S.C. §§ 78ccc (2012) (organizing SIPC), 78ddd (empowering SIPC to establish the "SIPC Fund").

14. SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 92–231, at 42–45 (2d Sess. 1971) [hereinafter UNSAFE AND UNSOUND PRACTICES REPORT].

15. 15 U.S.C. § 78o(c)(3) (2012), as amended by section 11(3) of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 121; *see* Part II.B *infra* (outlining the SEC rules regarding the financial responsibility of broker–dealers).

16. SIPC members exercise little self-governance in SIPC's statutory mission. Although SIPC is not "an agency or establishment of the United States Government," 15 U.S.C. § 78ccc(a)(1) (2012), the President, the Board of Governors of the Federal Reserve System (the FRB or Board), and the Secretary of the Treasury appoint its seven-member board of directors. *Id.* § 78ccc(c). As with traditional SROs, SIPC is subject to SEC reporting, compliance inspection and audit requirements, and must subject proposed rule changes and by-law amendments to the SEC for review after public notice and comment. *Id.* § 78ccc(e). Unlike SROs, however, SIPC has no formal supervisory authority over its members; instead it must rely on the SEC and self-regulatory organizations not only to examine its members' financial condition, but also to obtain information about their operations as necessary for liquidation. *Id.* § 78iii(c)–(f); U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO/GGD-92-109, SECURITIES INVESTOR PROTECTION: THE REGULATORY FRAMEWORK HAS MINIMIZED SIPC'S LOSSES 57–60 (1992), *available at* http://www.gao.gov/assets/160/152371.pdf [hereinafter 1992 GAO REPORT].

17. 15 U.S.C. § 78ccc(a)(2)(A) (2012). Broker–dealers "whose principal business . . . taking into account business of affiliated entities, is conducted outside the United States and its territories and possessions" are not required to be SIPC members. *Id.* § 78ccc(a)(2)(A)(i). In addition, SIPC membership generally excludes broker–dealers whose business relates exclusively to mutual funds, variable annuities, insurance, or security futures products. *Id.* § 78ccc(a)(2)(A)(ii)–(iii).

18. For example, while SIPC reported a membership of 5654 broker–dealer firms in its 2006 Annual Report, the SEC estimated that only 216 were subject to the reserve requirement of the Customer Protection Rule

required to be SIPC members to the extent that customer securities may come to be "received, acquired, or held" by the broker as intermediary between customers and carrying brokers.[19] An understanding of SIPC's role requires a brief recitation of how SIPC liquidation proceedings provide for the distribution of customer funds and securities in a broker–dealer liquidation, how the Exchange Act's financial responsibility rules dovetail with SIPC's customer protection regime, and how the SIPC Fund bridges the gap between the two.

A. SIPC and Member Liquidation Proceedings

SIPC liquidation proceedings are designed to protect the claims of custodial customers of a SIPC member with respect to the distribution of customer property. The highly speculative nature of traditional investment banking and brokerage activities—such as underwriting, market making, and dealing—makes it impracticable to insure all of a broker–dealer's contractual obligations to its creditors and counterparties.[20] Instead, SIPC's narrow mandate is to streamline the return of customer funds and securities held in a broker–dealer's custody as the broker–dealer approaches insolvency.[21]

SIPC may, upon notice to a member, file an application for a protective decree in federal district court,[22] if the broker–dealer "has failed or is in danger of failing to meet its obligations to customers," and triggers one or more additional conditions suggesting

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in that year. Amendments to Financial Responsibility Rules for Broker–Dealers, Exchange Act Release No. 55431, 72 Fed. Reg. 12862, 12881 (Mar. 19, 2007); *see also* 1992 GAO REPORT, *supra* note 16, at 14 (noting that, as of December 31, 1991, SIPC had 8153 members, of whom only 954 were carrying firms). Other SIPC members include firms that trade exclusively for proprietary accounts.

19. 15 U.S.C. § 78*lll*(2)(A) (2012). SIPC takes the position that a person whose accounts are cleared by a carrying broker on a fully disclosed basis for one or more introducing brokers or dealers is a customer of the carrying broker, and not the introducing broker, for purposes of determining the scope of SIPC protection. 17 C.F.R. § 300.200; *see also* Joo, *supra* note 3, at 1089 (arguing that "[w]hen an introducing firm fails, all of the customers' property should reside safely with the clearing firm" and therefore that "a properly run introducing firm should never be the subject of a SIPA proceeding"). Nevertheless, courts have concluded that such persons may also be deemed "customers" of an introducing broker if they "had no reason to know that they were not dealing with" the introducing broker or if the introducing broker misappropriates or otherwise acquires control over customer funds or securities. *In re* Old Naples Sec., Inc., 223 F.3d 1296, 1303–04 (11th Cir. 2000); *see also In re* Primeline Sec. Corp., 295 F.3d 1100, 1107 (10th Cir. 2002) ("Whether a claimant deposited funds 'with the debtor' does not depend simply on to whom claimants made their checks payable. The relevant inquiry is whether the brokerage firm actually received, acquired or possessed Claimants' property.").

20. *See* 2 MICHAEL MALLOY, BANKING LAW AND REGULATION § 7.02 (1994 & Supp. 2002-2).

21. As described in the House Report on the SIPA bill, "The primary purpose of the reported bill is to provide protection for investors if the broker–dealer with whom they are doing business encounters financial troubles. In these circumstances public customers sometimes encounter difficulty in obtaining their cash balances or securities from the broker–dealers. Sometimes it is just a matter of time until the liquidation is completed, but, unfortunately, in some situations the customer never fully recovers that to which he is entitled. The proposed legislation would provide for the establishment of a fund to be used to make it possible for the public customers in the event of the financial insolvency of their broker, to recover that to which they are entitled." H.R. Rep. 91-1613; *see also* Joo, *supra* note 3, at 1098–99 (noting that the financial responsibility rules are almost entirely about ensuring that broker–dealers can "self-liquidate" in the event of failure).

22. Under the Bankruptcy Code, stock–brokers generally may not reorganize under Chapter 11. 11 U.S.C. § 109(d) (2012). Instead, they must either liquidate under Chapter 7 or, upon SIPC's application, in a liquidation proceeding under SIPA. David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 BROOK. J. CORP. FIN. & COM. L. 1, 4 (2009). As Skeel notes, the holding company of a broker–dealer may nevertheless apply for Chapter 11 reorganization for itself and its non-broker–dealer affiliates. *Id.* at 14; Part III.A *infra*.

financial distress.[23] SIPC has the discretion not to intervene, or to delay intervention:[24] while the SEC may seek a judicial order "requiring SIPC to discharge its obligations,"[25] customers of a broker–dealer have no private right of action to compel intervention.[26] If the statutory conditions are met or the member does not contest the matter, the district court must issue a protective decree, appoint a disinterested trustee for the liquidation of the broker–dealer's business as specified by SIPC,[27] and remove the proceeding to bankruptcy court.[28]

The primary goal of a SIPC liquidation proceeding is to distribute "customer property" and otherwise satisfy "net equity" claims of "customers" (each as defined below) as promptly as possible, before liquidating the broker–dealer's general estate.[29] As part of the liquidation process, the SIPC trustee must gain control over the broker–dealer's offices and branches, freeze customer accounts, locate customer property, and review and process customer claims.[30] Securities held of record in the customer's name must generally be returned to the customer.[31] All other customers are entitled to receive a prorated share of the customer property recovered by the SIPC trustee, as described in Part IV.B below.[32] The trustee is authorized to satisfy customer claims for securities through the delivery of

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23. 15 U.S.C. §§ 78eee(a)(3)(A), (b)(1) (2012) (specifically, insolvency, receivership or certain similar federal or state law proceedings, or noncompliance or inability to comply with applicable SEC or SRO financial responsibility requirements). In addition, SIPC members must generally obtain SIPC's consent to enter into any federal or state insolvency, receivership, or bankruptcy proceeding (except in proceedings that the FDIC initiates under its orderly liquidation authority under the Dodd–Frank Act). 15 U.S.C. § 78eee(a)(3)(B).

24. As noted in the text accompanying note 16 above, a SIPC liquidation proceeding for an introducing broker who handles accounts on a fully disclosed basis would generally be warranted only in the event of fraud or the theft of customer funds or securities. *See* 1992 GAO REPORT, *supra* note 16, at 22.

25. 15 U.S.C. § 78ggg(b) (2012). The insolvency of the Stanford Financial Group is the only insolvency proceeding with respect to which the SEC has exercised this statutory authority. SEC v. Sec. Inv. Prot. Corp., 758 F.3d 357, 359 (D.C. Cir. 2014).

26. Sec. Inv. Prot. Corp. v. Barbour, 421 U.S. 412, 425 (1975).

27. 15 U.S.C. § 78eee(b)(1), (3).

28. *Id.* § 78eee(b)(4). SIPC is deemed a party in interest, and the SEC may, on its own motion, file notice of its appearance and participate as a party as well. *Id.* § 78eee(c), (d). The proceeding is conducted "in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7" of the Bankruptcy Code. *Id.* § 78fff(b) (2012).

29. *Id.* § 78fff(a).

30. 1992 GAO REPORT, *supra* note 16, at 57.

31. 15 U.S.C. § 78fff-2(c)(2). Prior to the 1978 amendments to SIPA, the SIPC trustee was required to return all "specifically identifiable customer property" to customers before allocating the remaining pool of customer property among claimants in proportion to their net equity claims. Following the SEC's 1975 mandate to create a central depository system, the overwhelming majority of customer securities positions in the United States have come to be held in book-entry form under Article 8 of the Uniform Commercial Code. Some commentators contend that more recent revisions to Article 8 expose securities customers and SIPC to greater risk in the event of the insolvency of a securities intermediary. *See* Francis J. Facciolo, *Father Knows Best: Revised Article 8 and the Individual Investor*, 27 FLA. ST. U. L. REV. 615, 693–94 (2000) (suggesting that Article 8 may have "severely restricted" the category of customer property available for distribution under SIPC because "[t]he corpus of customer property under SIPA . . . can be diminished by unilateral action by a securities intermediary"); Russell A. Hakes, *UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?*, 35 LOY. L.A. L. REV. 661, 729–41 (2002) (observing that Article 8's priority rules for financial assets favor secured creditors over customers that hold security entitlements vis-à-vis a broker–dealer).

32. 15 U.S.C. § 78fff-2(c)(1)(B).

such securities if "ascertainable from the books and records of the debtor or . . . otherwise established to the satisfaction of the trustee."[33]

If the SIPC trustee succeeds in locating one or more SIPC broker–dealers to bid on the defunct member's customer accounts, the trustee may sell or transfer all or any part of the account of a customer to such bidders without the consent of any customer.[34] Bulk transfers of securities accounts to a willing bidder can restore access to frozen customer accounts within days or weeks and are therefore the preferred form of resolution.[35] In some cases, a bidder may not appear—for example, if the defunct member trades in specialty stocks or has engaged in substantial fraud, or if there are other substantial irregularities in bookkeeping.[36] In such cases, the SIPC trustee must review and settle customer claims on an account-by-account basis before liquidating the remainder of the broker–dealer's estate. This process may often take months, particularly if there are disputes as to "customer" status and the calculation of "net equity" claims.[37]

For smaller broker–dealers, SIPC may expedite liquidation by paying off customer claims directly (the "direct payment procedure") in lieu of delaying payments pending the recovery of customer property.[38] Otherwise, depending on the broker–dealer's size, SIPC may either manage the liquidation proceeding directly or seek appointment of a trustee and an attorney.[39] The trustee's expenses are charged against the SIPC member's general estate (but not customer property),[40] which in theory gives the member's general creditors and counterparties an ongoing incentive to monitor the member's solvency.[41] For larger firms, the trustee has the discretion to make one or more interim distributions of customer

33. *Id.* § 78fff-2(b)(2). The trustee is also empowered to apply customer funds to acquire such securities for delivery to the extent that the securities can be purchased in a fair and orderly market. *Id.* § 78fff-2(d). Nevertheless, a customer is exposed to the risk of a decline in the market value of customer securities between the filing date and the settlement date. 1992 GAO REPORT, *supra* note 16, at 32. By contrast, the default provisions of the Bankruptcy Code governing stockbroker and commodities broker proceedings generally require prompt liquidation of all customer assets and cash settlement as of the filing date. 11 U.S.C. § 741–61 (2012).

34. 15 U.S.C. § 78fff-2(f).

35. 1992 GAO REPORT, *supra* note 16, at 32. Bulk transfers are particularly desirable to the extent that they protect all of a broker's securities customers, and not just those who file a net equity claim with SIPC or the trustee. *See, e.g.*, SIPC, 2013 ANNUAL REPORT 38 (2014), *available at* http://www.sipc.org/Content/media/annual-reports/2013-annual-report.PDF [hereinafter 2013 SIPC ANNUAL REPORT] (stating that "[t]he number of Customers Receiving Distributions can exceed Responses Received when trustee transfers accounts in bulk"); Sheila Cheston, *Investor Protection Under the SIPA: A Reassessment and Recommendations for Future Change*, 19 COLUM. J.L. & SOC. PROBS. 69, 88–89 (1985) (evaluating the bulk transfer procedure's success and making suggestions for its improvement).

36. 1992 GAO REPORT, *supra* note 16, at 32–34.

37. *See, e.g.*, *infra* Part III.B (stating that in the MF Global liquidation, general creditors of the broker–dealer's estate advanced funds for distribution to customers of the broker–dealer to expedite liquidation).

38. 15 U.S.C. § 78fff-4 (aggregate claims of less than $250,000). The SIPC Task Force has recommended raising the threshold for direct payment procedures to $5,000,000. REPORT AND RECOMMENDATIONS OF THE SIPC MODERNIZATION TASK FORCE 16–17 (Feb. 2012), *available at* http://www.sipc.org/Content/media/news-releases/Final%20Report%202012.pdf [hereinafter SIPC TASK FORCE REPORT].

39. 15 U.S.C. § 78eee(b)(3) (2012). SIPC has the sole discretion to appoint itself or an employee as trustee only if liabilities of the debtor to unsecured general creditors and to subordinated lenders appear to aggregate less than $750,000 and if there appear to be fewer than 500 customers of such debtor. *Id.*

40. *Id.* § 78eee(b)(5)(E). If the general estate is insufficient to pay allowances in whole or in part, SIPC advances funds as necessary for such payment. *Id.*

41. 1992 GAO REPORT, *supra* note 16, at 36. The SIPC trustee's expenses are considered "costs and expenses of administration" with a priority claim against the general estate of the debtor. 15 U.S.C. § 78fff(e).

property before the final distribution, as customer property is recovered and disputes over customer status, recoverable customer property, and the calculation of net equity claims are resolved.[42]

The discretion afforded to the trustee is controversial because it is difficult to predict the extent to which efforts to litigate claims or recover the estate's assets will be successful in relation to the expenses incurred. SIPC's judgment in the selection, oversight, and compensation of trustees and their attorneys is subject to limited judicial scrutiny,[43] but may nevertheless stoke public indignation when the trustee's compensation and legal fees are significant in relation to the amounts advanced by SIPC to customers.[44] While the U.S. Government Accountability Office (GAO) has generally found no reason to question the experience and integrity of SIPC's selected trustees, it has cautioned SIPC to improve the transparency of the selection process and to consider a broader pool of applicants to preserve quality while reducing cost.[45]

B. SIPA and the Exchange Act's Financial Responsibility Rules

The SEC's uniform financial responsibility rules for broker–dealers dovetail with SIPA's investor protection regime by ensuring that a broker–dealer maintains adequate funds and securities for distribution to customers in the event of the broker–dealer's insolvency. The SEC seeks to achieve these objectives chiefly through: (i) a Customer Protection Rule that requires segregation of adequate securities and net customer credit balances of the broker–dealer's customers;[46] and (ii) a Net Capital Rule designed to ensure the availability of additional funds or marketable assets to liquidate the business of a broker–dealer in an orderly manner in the event of distress.[47]

42. *See, e.g.*, *Distributions*, THE MADOFF RECOVERY INITIATIVE, http://www.madofftrustee.com/distributions-16.html [hereinafter THE MADOFF RECOVERY INITIATIVE] (last visited Mar. 29, 2015) (discussing how four prorated interim distributions have taken place in the Madoff liquidation from 2011 through 2014, as the trustee continues to recover funds from various sources).

43. 15 U.S.C. § 78eee(b)(5)(C) ("In determining the amount of allowances in all other cases, the court shall give due consideration to the nature, extent, and value of the services rendered, and shall place considerable reliance on the recommendation of SIPC."); *see* OFFICE OF AUDITS, U.S. SEC. AND EXCHANGE COMM'N, REPORT NO. 495, SEC'S OVERSIGHT OF THE SECURITIES INVESTOR PROTECTION CORPORATION'S ACTIVITIES 26 & n.161 (Mar. 30, 2011) (recommending that SEC staff consider whether to request Congress to modify SIPA to allow bankruptcy judges "to assess the reasonableness of administrative fees" in SIPC proceedings).

44. *See, e.g.*, Morgenson, *supra* note 2 (criticizing SIPC for being slow, inefficient, and unresponsive to the needs of investors); S. 1725, 113th Cong. (2013) (proposing to eliminate SIPC's discretion to select trustee and to subject trustee compensation to judicial approval); H.R. 1987, 112th Cong. (2011) (proposing to eliminate restrictions on judicial oversight of trustee compensation and to require audit of trustees with respect to liquidation proceedings for which SIPC "does not have a reasonable expectation of recoupment of the advances made by SIPC"). SIPC routinely maintains that such compensation and fees are justified in relation to the property recovered by the trustees and returned to customers. See *infra* notes 77 and 123 (discussing SIPC's and GAO's assessment of the performance of SIPC trustees in relation to such recoverable property).

45. U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-12-414, SECURITIES INVESTOR PROTECTION CORPORATION: INTERIM REPORT ON THE MADOFF LIQUIDATION PROCEEDING 9–16 (Mar. 2012) [hereinafter 2012 GAO INTERIM REPORT].

46. 17 C.F.R. § 240.15c3-3 (2014); *see generally* Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069 (2002) (providing a general overview of the history, purpose and function of the Customer Protection Rule and issues relating to its implementation).

47. 17 C.F.R. § 240.15c3-1; *see generally* Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863 (1992) (providing a general overview of the history, purpose and function of the Net Capital Rule and issues relating to its implementation).

The Customer Protection Rule implements the SEC's statutory mandate to impose safeguards for the "acceptance of custody and use of customers' securities, and the carrying and use of customers' deposits or credit balances."[48] First, to the extent that a customer has "fully paid" for securities in cash, the Rule requires that the broker–dealer maintain possession and control over such securities.[49] By contrast, if a customer has financed its securities positions with credit extended by the broker–dealer,[50] the broker–dealer may rehypothecate such securities as collateral to a third party.[51] The Rule nevertheless requires possession and control of excess securities collateral carried in the customer's account.[52] Broker–dealers are required to reduce such "fully paid" and "excess margin securities" to possession and control through one of several enumerated custody arrangements.[53]

48. 15 U.S.C. § 78o(c)(3)(A) (2012). The Customer Protection Rule operates in tandem with the rules of the Federal Reserve Board governing securities credit. *Id.* § 78g(c) (2012). The Board's rules for broker–dealers principally distinguish "cash" transactions (in which the customer agrees to pay the full purchase price of a security within the relevant settlement period) from "margin" transactions (in which the customer may borrow a specified percentage of the purchase price of a security). *Compare* 12 C.F.R. § 220.4 (2014) (margin accounts) and *id.* § 220.8 (cash accounts).

49. The term "fully paid securities" generally includes "all securities carried for the account of a customer in a special cash account" as defined in Regulation T as well as "fully paid" securities and securities with no loan value under Regulation T that are carried for the account of a customer in a general (margin) account or special account. 17 C.F.R. § 240.15c3-3(a)(3).

50. Such extensions of credit, by default, would take place in a customer's "margin account" under the Board's margin rules. 12 C.F.R. § 220.4 (2014).

51. When customers purchase securities through a broker–dealer on credit, the broker–dealer typically finances such positions by borrowing from a third-party lender, such as a bank or another broker–dealer. The broker–dealer thus stands as "a creditor vis-à-vis his customer and a debtor vis-à-vis the financier, if any be involved." Guttman, *supra* note 3, at 889. Brokers therefore seek to retain the right to rehypothecate customer margin securities to a third party. In lieu of requiring "dominion and control over the assets in the [customer's] margin account," *id.*, the SEC requires each broker–dealer to include monies borrowed against customer securities in the calculation of its aggregate customer credit balances (as described in the next paragraph). Related rules meanwhile impose restrictions on the commingling and rehypothecation of margin securities. *See* 15 U.S.C. § 78h(a) (2012) (granting the SEC authority to regulate the hypothecation of customer securities by broker–dealers); *see also* 17 C.F.R. § 240.8c-1 (2014) (regulating the hypothecation of customers' securities), as well as on the type and amount of securities that broker–dealers may take and use as collateral. *See* 12 C.F.R. § 220.12 (2014) (establishing minimum initial margin requirements for stocks bought on margin in a margin account carried by a broker–dealer); *see also* Financial Industry Regulatory Authority (FINRA) Rule 4210(b) and (c), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/industry/p122203.pdf (imposing initial and maintenance margin requirements for certain "long" and "short" positions carried in a margin account, subject to various exemptions); New York Stock Exchange (NYSE) Rule 431(b) and (c), *available at* http://www1.nyse.com/nysenotices/nyse/rule-interpretations/pdf.action;jsessionid=14B98A048D6984179BAB49F2049DBF0E?number=191 (same); *see also infra* note 168 (contrasting such rules with CFTC rules governing commodities accounts). Congress eliminated limitations on permissible non-bank sources of credit for broker–dealers in 1996. Securities Exchange Act of 1934, § 8(a), 48 Stat. 888, 888 (1934), *repealed by* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 104(b), 110 Stat. 3416, 3423 (1996).

52. The term "excess margin securities" includes, *inter alia*, margin securities carried in a customer account "having a market value in excess of 140 percent of the total of the debit balances in the customer's account." 17 C.F.R. § 240.15c3-3(a)(5) (2014).

53. *Id.* § 240.15c3-3(b), (c). In a related vein, the Customer Protection Rule establishes minimum collateral requirements when a broker–dealer borrows "fully paid" or "excess margin" securities from a customer, or retains custody of securities that are the subject of a repurchase agreement between the broker or dealer and a counterparty that is a customer. *Id.* § 240.15c3-3(b)(3), (4); Jamroz, *supra* note 46, at 1089–95.

The Customer Protection Rule further requires broker–dealers to maintain a special reserve account for the benefit of customers. The reserve formula is calculated based upon the difference between aggregate amounts owed to customers ("customer credits") and aggregate amounts owed by customers ("customer debits").[54] Under the Rule, broker–dealers must calculate the reserve requirement on a weekly or monthly basis and deposit the required amount in the reserve account.[55] A broker–dealer must immediately notify the SEC and its designated examining authority in the event of failure to make a required deposit.[56] Taken together, the reserve account, securities held in custody, and collection of customer debits secured by margin securities should mirror the custodial claims of a broker–dealer's customers in the event of the broker's insolvency.

The SEC's uniform Net Capital Rule provides a further equity cushion to facilitate resolution of customer claims. The Net Capital Rule's standard formula imposes a liquid net worth requirement on registered broker–dealers[57] and additional minimum capital requirements for firms depending upon the nature of their business activities.[58] The Net Capital Rules of the SEC and the exchanges were historically intended not only to protect the broker–dealer's customers against the broker–dealer's insolvency, but to allow for orderly resolution of claims of the broker–dealer's creditors and counterparties as well.[59] Following the adoption of the Customer Protection Rule, however, the securities industry lobbied against the imposition of an "inefficient and costly commitment of capital . . . where such a commitment is not necessary for customer protection."[60]

As a result, the SEC amended the Net Capital Rule to permit firms to employ an alternative net capital formula linked solely to the size of customer debit balances calculated under the customer reserve requirement.[61] The alternative net capital formula "presupposes that the [customer] debits in the Reserve Formula are collectible" and "that they will be applied to pay off customer claims in a liquidation."[62] The minimum net capital requirement under the alternative formula thus serves as a "cushion . . . [to] be

54. 17 C.F.R. § 240.15c3-3a (2014). Customer credits include free credit balances in customer accounts, monies borrowed by the broker that are collateralized by customer securities, and monies payable against loans of customer securities. Customer debits include debit balances in customers' cash and margin accounts. *Id.*

55. *Id.* § 240.15c3-3(e). The timing of the reserve computation and deposit creates some risk that broker–dealer insolvency could result in a shortfall in "customer property." *See, e.g.*, Upton v. SEC, 75 F.3d 92, 93 (2d Cir. 1996) (describing a pattern of borrowing activity designed to minimize customer reserve computation).

56. 17 C.F.R. § 240.15c3-3(i).

57. *Id.* § 240.15c3-1(a)(1)(i) (requiring 15:1 ratio of "aggregate indebtedness" to "net capital" under the standard formula). Net capital is calculated by calculating net worth under U.S. generally accepted accounting principles and deducting illiquid items and certain "haircuts" from securities and other proprietary positions based on their relative riskiness. Jamroz, *supra* note 47, at 868–92.

58. 17 C.F.R. § 240.15c3-1(a)(2) (2014). For example, an introducing broker that operates on a fully disclosed basis and receives but does not hold customer securities must maintain net capital of not less than $50,000. *Id.* § 240.15c3-1(a)(2)(iv).

59. Jamroz, *supra* note 47, at 863–65 (asserting that the "primary purpose of the Net Capital Rule is to protect the customers and creditors of registered broker–dealers from monetary losses and delays that can occur when a registered broker–dealer fails" by promoting "orderly self-liquidations of financially distressed broker–dealers" and thereby reducing the likelihood of a SIPA liquidation).

60. Exchange Act Release No. 11497, 40 Fed. Reg. at 29798. As recent events have borne out, the Net Capital Rule also plays a role in curbing systemic risk in the "highly cyclical nature" of the securities industry. Molinari & Kibler, *supra* note 8, at 22–33.

61. 17 C.F.R. § 240.15c3-1(a)(1)(ii) (2014); Molinari & Kibler, *supra* note 8, at 26 n.154 (discussing the relative merits of the basic and alternative methods).

62. Molinari & Kibler, *supra* note 8, at 16–17.

applied against administrative costs" of collecting customer debits and distributing customer funds and securities in a SIPC proceeding,[63] without maintaining substantial additional capital for the protection of the insolvent firm's other creditors.

C. The SIPC Fund

The SIPC Fund is the crux of the SIPA framework. To ensure the prompt discharge of the broker–dealer's obligations to its customers, the SIPC trustee must deliver securities or make payments to or for the account of such customer "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee," regardless whether there has been "any showing or determination that there are sufficient funds of the debtor available to satisfy such claims."[64] To facilitate discharge, SIPC may advance funds to the trustee for the "prompt payment and satisfaction of net equity claims of customers."[65] Similarly, to facilitate a bulk transfer, SIPC may indemnify a transferee broker against shortages in customer accounts sold or transferred.[66] Under current law, the amount of the advance or indemnification may not exceed $500,000 per customer for securities claims and $250,000 for cash claims.[67]

SIPC maintains the SIPC Fund through periodic assessments upon its members based on their net operating revenues.[68] It is difficult to identify a "quantifiable measure" for the appropriate size of the SIPC Fund,[69] because SIPC primarily protects customers against compliance risk (the risk that the broker–dealer will mismanage custody of the customer's

63. *Id.* The SEC briefly created yet another (now discontinued) method of calculating net capital that was geared toward multi-national "bulge bracket" investment banks: under the "consolidated supervised entity" approach, the SEC would permit large investment banks to calculate net capital on a group-wide basis (rather than at the level of individual broker–dealer subsidiaries) under Basel II net capital standards in exchange for consenting to consolidated SEC oversight of all of their operations (including operations of the affiliates of the U.S. broker–dealer). 17 C.F.R. § 15c3-1 app. E & G (2009); *see* Alternative Net Capital Requirements for Broker–Dealers that Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49830, 69 Fed. Reg. 34428 (June 21, 2004). This program was discontinued in 2008. Press Release 2008-230, Chairman Cox Announces End of Consolidated Supervised Entities Program, SEC (Sept. 26, 2008).

64. 15 U.S.C. § 78fff-2(b)(1) (2012).

65. *Id.* § 78fff-3(a). If customer claims exceed the available customer property and funds held by the broker–dealer, SIPC is subrogated to the claims of such customers with respect to any residual customer property, or if customer property is inadequate, the estate of the broker–dealer. *Id.*

66. *Id.* § 78fff-2(f); *see* Cheston, *supra* note 35, at 88 (describing the efficacy of bulk transfers and impediments to more frequent use, such as "the reluctance of broker–dealers to accept transferred accounts").

67. These amounts will be adjusted for inflation. 15 U.S.C. § 78fff-3(e). The SIPC Task Force recently recommended raising the statutory maximum for customer advances to $1.3 million to account for inflation (with periodic adjustments thereafter), SIPC TASK FORCE REPORT, *supra* note 38, at 5–7, and eliminating the distinction between cash and securities claims. *Id.* A few, typically larger brokerage firms have obtained third-party insurance to cover amounts over the SIPC threshold: many insurance companies reportedly stopped offering such coverage after 2003 (and insurance industry losses on Enron-related surety bonds), in light of the paucity of excess coverage claims and the corresponding "complexity of quantifying their maximum probable loss." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-03-811, SECURITIES INVESTOR PROTECTION: UPDATE ON MATTERS RELATED TO THE SECURITIES INVESTOR PROTECTION CORPORATION 20–28 (2003) [hereinafter 2003 GAO REPORT].

68. BYLAWS OF THE SEC. INVESTOR PROT. CORP. art. 6(1)(g), *available at* http://www.sipc.org/about-sipc/statute-and-rules/bylaws (defining "net operating revenues"); *see* 15 U.S.C. § 78ddd(c) (2012). The self-regulatory organization that acts as the designated examining authority for each SIPC member (for most broker–dealers, FINRA) acts as collection agent for SIPC and is responsible for collecting and filing with SIPC such as information as is necessary to determine the member's assessment. *Id.* § 78hhh.

69. 1992 GAO REPORT, *supra* note 16, at 19.

assets) rather than credit risk (the risk that the broker–dealer will default on its obligations).[70] The GAO has expressed skepticism about setting the size of the Fund based on the amount of customer assets held by SIPC members, for lack of any demonstrable correlation between the amount of customer assets held at a broker–dealer and compliance risk.[71] For want of a better metric, SIPC has historically maintained the fund at a level equal to the amount deemed necessary to facilitate the liquidation of its largest member.[72]

As of December 31, 2013, the SIPC Fund stood at $1,900,180,093.[73] The amount committed to manage the Madoff liquidation, both due to sums advanced and the trustee's costs, is expected to dwarf that amount.[74] While SIPC has the power to borrow up to $2.5 billion from the U.S. Treasury,[75] there is no other public support for the SIPC Fund. As a result, to finance its expected obligations and prepare for future proceedings, SIPC has resolved to raise the target level of the SIPC Fund to $2.5 billion and raise its assessment rate with the goal of collecting $400 million in assessments per year.[76]

III. SIPC IN THE CRUCIBLE

SIPC believes that it has generally met the expectations of customers of SIPC members without significant cost to the securities industry or the U.S. Treasury.[77] Nevertheless, disputes over eligibility for "customer" status and the scope of "protection" have long left many empty-handed investors and their advocates with the impression that SIPC is a "total failure and fraud."[78] Congressional hearings and GAO studies of SIPC

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70. *Cf.* Basel II, pt. 2, para. 644–63, at 144–49 (requiring banks to hold "capital for operational risk" based on one of several formulas tied to annual gross income from and the risk of individual business lines).

71. 1992 GAO REPORT, *supra* note 16, at 40–42 (finding no correlation between probability of liquidation and the risk of broker–dealer activities or the amount of SIPC-protected property).

72. *Id.*, at 43.

73. *The SIPC Fund*, SIPC, http://www.sipc.org/about-sipc/the-sipc-fund (last visited Jan. 19, 2015).

74. SECURITIES INVESTOR PROTECTION CORPORATION, 2013 ANNUAL REPORT 22 (2013) (estimating that the total charges to SIPC in the BLMIS case, including administrative costs, will be approximately $2.6 billion); *see infra* notes 121–122 (discussing advances committed by SIPC and fees billed by SIPC's trustee to date).

75. 15 U.S.C. § 78ddd(f) (2012) (providing for such borrowing with the SEC's approval and upon a showing that the loan is "necessary for the protection of customers of brokers or dealers and the maintenance of confidence in the United States securities markets"). SIPC has never drawn upon its line of credit with the U.S. Treasury, but at SIPC's urging, Congress raised SIPC's line of credit from $1 billion to $2.5 billion. *See Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before the S. Comm. on Banking Housing and Urban Affairs*, 111th Cong. (2009) (testimony of Stephen Harbeck, President, SIPC), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction =Files.View&FileStore_id=509f5d8b-e79d-47fb-91b9-858c03a656ef ("The failures of Lehman Brothers and Madoff call into question the sufficiency of SIPC's statutory line of credit with the United States Treasury. This credit line of $1 billion has not changed since 1970.").

76. BYLAWS OF THE SEC. INVESTOR PROT. CORP. art. 6, § 1(a), *available at* http://www.sipc.org/about-sipc/statute-and-rules/bylaws.

77. According to SIPC, from 1970 to 2013, SIPC "advanced $2.1 billion in order to make possible the recovery of $133 billion in assets for an estimated 772,000 investors." *History*, SIPC.ORG, http://sipc.org/about-sipc/history (last visited Jan. 19, 2015). SIPC further asserts that, as of 2013, "no fewer than 99 percent of persons who are eligible get their investments back with the help of SIPC." *SIPC's Role & Responsibilities*, SIPC, http://www.stanford-antigua-sec-lawsuit.com/SIPCs-Role.aspx (last visited Dec. 6, 2013).

78. *The Securities Investor Protection Corporation: Past, Present, and Future, Hearing Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 214 (2012) (testimony of Ron Stein, President, Network for Investor Action and Protection), *available at*

during this period have periodically raised questions about SIPC's operational readiness to manage the liquidation of a large broker–dealer,[79] but policymakers rarely dwell on the balance of costs and benefits struck in SIPA except in the wake of a major broker–dealer failure.[80]

In part, such confidence—or complacency—stems from a longstanding belief that market forces are sufficient to avoid triggering a costly liquidation for most well run firms. Because the costs of a SIPC liquidation are borne by claimants on the broker–dealer's general estate, financial institutions and sophisticated customers interconnected with a broker–dealer, in theory, have a compelling incentive to monitor its activities.[81] The SEC and SIPC have consistently maintained that larger firms have better internal controls and hold more liquid securities for their customers, which reduces the risk of insolvency and customer loss in the event of a liquidation proceeding.[82]

As centralized clearance and settlement reduced the risk of custodial negligence in the 1980s, commentators sounded concerns that SIPC and securities regulators stood complacent in the face of new risks facing the brokerage industry.[83] Liquidation proceedings involving outright theft of customer assets or firm assets by officers and employees of broker–dealers became increasingly notable, although the firms at issue were comparatively small in size in relation to the nation's largest carrying brokers.[84] U.S. registered broker–dealers also became increasingly exposed to the risks undertaken by their parent companies and non-broker–dealer affiliates as the size of investment banking groups increased and their funding mechanisms became increasingly complex.[85] Few, however, could have foreseen that the recent financial crisis would expose SIPC to these threats in rapid succession, and how dismally market forces and regulatory bodies would perform even with respect to well-connected firms subject to both ongoing regulatory and public oversight. The following case studies are illustrative.

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http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg75077/pdf/CHRG-112hhrg75077.pdf [hereinafter *Stein Testimony*] (representing views of a not-for-profit group founded by former BLMIS investors to promote regulatory reform); *see also In re* Investors Center, Inc., 129 B.R. 339, 353 (Bankr. E.D.N.Y. 1991) (observing that "[f]or many of the victims . . . the Securities Investment [*sic*] Protection Act has proved to be grossly misnamed").

79. For example, in 1989–1990, Drexel Burnham Lambert, Inc. and Thomson Securities narrowly avoided SIPC liquidation at the eleventh hour when bidders were secured for their customer accounts. Joo, *supra* note 3, at 1116.

80. *See, e.g.*, 1992 GAO REPORT, *supra* note 16, at 37–38 (warning that "SEC officials and SIPC cannot afford to become complacent" in the face of broker–dealers' greater reliance on "new and technically sophisticated" and "riskier" activities for more of their revenue).

81. *Id.* at 36. These counterparties may include banks that finance proprietary and customer securities positions and broker–dealers and other counterparties that enter into funding or derivative transactions. *Id.*

82. *Id.* at 45.

83. Joo, *supra* note 3, at 1087–91.

84. 1992 GAO REPORT, *supra* note 16, at 29–31. Such activities include, for example, intercepting funds or securities transferred between a customer and the clearing broker; concealment of violations of the Customer Protection Rule or the net capital requirement; or causing the broker–dealer to make excessive loans against worthless collateral. *Id.*

85. Joo, *supra* note 3, at 1091–93.

A. Lehman Brothers

The Lehman Brothers bankruptcy, the largest bankruptcy in U.S. history, represents the potential complexity and strain that a major investment bank or broker–dealer insolvency can pose on the SIPA framework. Lehman suffered a liquidity crisis after traditional sources of short-term financing dried up in the wake of the failures of Bear Stearns and Merrill Lynch.[86] Unlike those firms, Lehman was unable to arrange a satisfactory acquisition in time to avoid filing for bankruptcy.[87] Lehman Brothers Holdings, Inc. (LBHI), Lehman's holding company, and its non-brokerage affiliates voluntarily filed a Chapter 11 proceeding on September 15, 2008.[88] Lehman's collapse spawned over 75 insolvency proceedings in 16 jurisdictions worldwide, including the liquidation of two major operational subsidiaries that carried substantial customer accounts—Lehman Brothers, Inc., the U.S. broker–dealer subsidiary (LBI), and Lehman Brothers International Ltd. (Europe), the U.K. broker–dealer subsidiary (LBIE).[89]

As a securities and commodities broker, LBI was not eligible for reorganization as part of LBHI's Chapter 11 proceeding. Instead, LBI prearranged a sale of its securities and commodities businesses to Barclays Capital, Inc., and coordinated the entry of a protective decree by SIPC to allow "the [negotiated] transfer of [securities] assets and customer accounts of LBI to close in a timely manner" under SIPC's auspices.[90] This maneuver allowed Lehman to transfer approximately 110,000 securities customer accounts containing $92 billion in assets within days of the filing of the protective decree.[91]

The amount of customer assets carried by LBI ($110 billion), along with the variety of LBI's custodial and contractual arrangements with affiliates and third parties, threatened prolonged litigation. For example, the SIPC trustee challenged $10 billion in claims LBIE submitted on behalf of certain customer and proprietary accounts it maintained at LBI on

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86. Like its peers, Lehman was excessively reliant on short-term sources of financing, such as overnight repurchase agreements. FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 324–43 (2011) [hereinafter FCIC REPORT]; *see also infra* note 159 (discussing the liquidity crisis experienced by investment banks in 2008).

87. ANDREW ROSS SORKIN, TOO BIG TO FAIL 340–69 (2009) (describing the role of the Federal Reserve Board, the Treasury Department, and the SEC in pressuring Lehman to file for bankruptcy despite Lehman's eleventh-hour efforts to negotiate an acquisition with Barclays).

88. Form B1, Voluntary Petition of Lehman Brothers Holdings, Inc., (Sept. 14, 2008) *available at* http://online.wsj.com/public/resources/documents/lehmanfiling916208.pdf.

89. Stephen J. Lubben & Sarah Pei Woo, *Reconceptualizing Lehman*, 49 TEX. INT'L L.J. 297, 301–02, 309 (2014).

90. Press Release, Securities Investor Protection Corporation, SIPC Issues Statement on Lehman Brothers Inc.: Liquidation Proceeding Now Anticipated (Sept. 18, 2008), *available at* http://www.sipc.org/news-and-media/news-releases/20080918 [hereinafter SIPC Lehman Press Release].

91. *Id.*; *see* Thomas W. Joo, *A Comparison of Liquidation Regimes: Dodd–Frank's Orderly Liquidation Authority and the Securities Investor Protection Act*, 6 BROOK. J. CORP. FIN. & COM. L. 47, 52–53 (2011) (explaining the strategy employed by Lehman and other insolvent broker–dealers in the past to navigate the exclusion from chapter 11); Skeel, *supra* note 22, at 4–6 (describing Lehman's maneuver and its coordination with the SEC and SIPC); Statement of the Office of the Trustee of Lehman Brothers Inc. (LBI), *Settlement to Finalize Private Investment Management (PIM) Account Transfers; Over $92 Billion Transferred to 110,000 Former LBI Customers Since SIPA Liquidation Commenced* (Dec. 10, 2008), *available at* http://www.prnewswire.com/news-releases/statement-of-the-office-of-the-trustee-of-lehman-brothers-inc-lbi-settlement-to-finalize-private-investment-management-pim-account-transfers-over-92-billion-transferred-to-110000-former-lbi-customers-since-sipa-liquidatio-78995282.html (announcing the Bankruptcy Court's approval of the agreement with Barclays).

the grounds that they did not qualify as "customers" under SIPA.[92] Various LBI creditors—such as counterparties to certain "to be announced" transactions in mortgage-backed securities and institutional clients with claims to soft-dollar commissions—also sought "customer" status in order to gain a share of customer property.[93] Thanks in large part to the bulk transfer of accounts to Barclays and the amicable settlement of an array of claims among LBHI's affiliates and creditors, the SIPC trustee succeeded in fully satisfying eligible customer claims from recovered property without drawing upon the SIPC Fund.[94]

B. MF Global

The MF Global bankruptcy highlights the problems posed by SIPC intervention in the liquidation of a broker–dealer with multiple classes of business. MF Global, Inc., a subsidiary of MF Global Holdings, Inc., was registered as both a securities and futures broker.[95] In October 2011, MF Global reported a $952 million deficiency in customer funds that were required to be segregated for its futures customers, in addition to shortfalls in other secured or segregated customer accounts held abroad.[96] The trustee's investigation revealed that MF Global employees had entered into increasingly desperate intra-day transfers of funds among various accounts maintained by the firm's affiliates (including segregated customer trust accounts for its futures customers) in an effort to cover the firm's failing proprietary positions in repurchase agreements on European sovereign debt.[97] Although efforts were made to sell various holdings of the firm, MF Global Holdings, Inc. was unable to find willing purchasers and filed for bankruptcy on October 31, 2011.[98]

MF Global represented the largest liquidation of a futures broker in U.S. history (and the eighth largest U.S. bankruptcy).[99] While the vast majority of MF Global, Inc.'s customer accounts were futures accounts (approximately 36,000 in number), SIPC sought a protective decree for several hundred securities customers.[100] In the absence of a SIPC-

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92. *The Securities Investor Protection Corporation: Past, Present and Future, Hearing Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Fin. Serv. Comm.*, 112th Cong. 3 (2012) (testimony of Ira D. Hammerman, Senior Managing Director and General Counsel, Sec. Indus. Fin. Mkts. Assoc.), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-112-ba-wstate-ihammerman-20120307.pdf [hereinafter *SIFMA Testimony*].

93. *See, e.g.*, *In re* Lehman Bros. Inc., 462 B.R. 53, 56 (Bankr. S.D.N.Y. 2011) (denying "customer" status with respect to claims relating to "to be announced" transactions); *In re* Lehman Bros. Inc., 474 B.R. 139, 141 (Bankr. S.D.N.Y. 2012) (denying "customer" status with respect to claims for soft dollar commissions).

94. Press Release, Securities Investor Protection Corporation, SIPC Applauds Lehman Trustee on Milestone 100 Percent Return of Securities Customers' Property (June 7, 2013), *available at* http://www.sipc.org/news-and-media/news-releases/20130607.

95. It was also subject to the oversight of the Federal Reserve Board in its capacity as a primary dealer of U.S. government securities.

96. Report of Investigation of Louis J. Freeh, Chapter 11 Trustee of MF Global Holdings Ltd., et al. at 69–73, *In re* MF Global Holdings Ltd. et al., No. 11-15059 (MG) (Bankr. S.D.N.Y. Apr. 4, 2013), *available at* http://online.wsj.com/public/resources/documents/FreehReportonMFG.pdf [hereinafter Freeh Report].

97. *Id.*

98. *Id.* (finding that MF Global Holdings Ltd. and MF Global Finance USA, Inc. filed for bankruptcy after a potential sale collapsed).

99. *See, e.g.*, Laura Goldsmith, Note, *The Collapse of MF Global and Peregrine Financial Group: The Response from the Futures Industry, Regulators, and Customers*, 32 REV. BANKING & FIN. L. 25, 25 (2012).

100. *In re* MF Global Inc., No. 11-civ-07750 (PAE) (S.D.N.Y. Oct. 31, 2011) (issuance of protective decree), *available at* http://docs.justia.com/cases/federal/district-courts/new-york/nysdce/1:2011cv07750/386874/3.

like guarantee fund for futures accounts,[101] the CME Group (operator of the preeminent futures exchanges in the United States, including the Chicago Mercantile Exchange and the Chicago Board of Trade) stepped in to guarantee the bulk transfer of the firm's commodities accounts for up to $550 million, and committed the full capital of the CME trust to making MF Global's futures customers whole.[102] In April 2014, with the cooperation of the general creditors of the firm's estate,[103] the trustee announced a final distribution to satisfy 100% of all claims of former public customers of the U.S. broker–dealer, with the return of a total of $6.7 billion to over 26,000 customers.[104]

MF Global's liquidation proceedings prompted policymakers and commentators to question the preparedness of the SEC and the Commodity Futures Trading Commission (CFTC) to handle the liquidation of a dually registered securities and futures broker.[105] In particular, leading futures market participants expressed displeasure that SIPC's appointment of a trustee in the liquidation proceeding limited their ability to participate in the resolution of MF Global's estate.[106] Because MF Global was also the first liquidation of a futures broker involving a deficit in segregated funds due to theft, SIPC's intervention raised broader questions as to whether the classification of customer claims and distribution of customer property among securities and futures accounts under current law is equitable, if futures customers suffer delays and greater risk of loss while securities customers are paid in full relatively quickly.[107]

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101. *See infra* note 248 and accompanying text (stating that former CFTC Commissioner Bart Chilton and others have advocated the creation of a similar guaranty fund for commodities accounts).

102. Press Release, CME, CME Group Increases Guarantee to $550M to Accelerate Return of 75 Percent of MF Global Inc. Segregated Funds to All Customers (Nov. 22, 2011), *available at* http://cmegroup.mediaroom.com/index.php?s=43&item=3215.

103. In particular, general creditors of the broker–dealer's estate voluntarily advanced funds for distribution to customers of the broker–dealer in order to expedite liquidation. *In re* MF Global Inc., 505 B.R. 623, 623 (Bankr. S.D.N.Y. 2014).

104. Press Release, SIPC, SIPC Commends MF Global Trustee for Achieving Milestone 100 Percent Return of MF Global Customer Property with Final Distribution (Apr. 3, 2014), *available at* http://www.sipc.org/news-and-media/news-releases/20140403.

105. *See, e.g.*, JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION 39–43 (2009), *available at* http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf [hereinafter JOINT HARMONIZATION REPORT] (analyzing differences in account structures, segregation requirements, and processes for liquidating insolvent broker–dealers and futures commission merchants under SEC and CFTC rules and the difficulties such differences present for dually registered firms, as illustrated by the collapse of Lehman Brothers); *Joint SEC and CFTC Hearing on Harmonizing Market Regulation* 4 (2009) (testimony of Larry Leibowitz, Group Executive Vice President, NYSE Euronext, Inc.), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/jointmeeting090209_leibowitz.pdf (viewing it "essential that the SEC and CFTC develop procedures to guide a trustee . . . when a joint BD/FCM becomes insolvent").

106. *See In re* MF Global Inc., 462 B.R. 36, 39 (Bankr. S.D.N.Y. 2011), *corrected* (Nov. 28, 2011) (denying motion requesting the appointment of an official committee of commodity broker customers, over opposition of the SIPC trustee); *see also Client Alert*, *Entering Uncharted Waters: MF Global Liquidation Presents Unprecedented Test of U.S. Insolvency Regime for Dual Registrants*, TEIGLAND-HUNT LLP 4, (Nov. 22, 2011) *available at* http://teiglandhunt.com/wp-content/uploads/2013/09/75.pdf [hereinafter *Client Alert*] (noting that MF Global had "approximately 50,000 futures customer accounts and just 400 securities customer accounts," and questioning whether an SIPC-appointed trustee will "be able to apply the commodity broker insolvency regime 'consistent with' SIPA as a practical matter").

107. *See Client Alert*, *supra* note 106, at 4 (noting that current processes fail to accommodate for differences in futures customers and securities customers, which could lead to inequitable results); *see also In re* MF Global,

C. Bernard L. Madoff Investment Securities

Bernard L. Madoff Investment Securities LLC (BLMIS) was a broker–dealer registered under the Exchange Act and a leading Nasdaq market maker.[108] Alongside its market-making and proprietary trading activities, BLMIS operated an investment advisory business.[109] This business did not carry customer accounts or directly receive or disburse customer funds; instead, its investment advisory clients transmitted and received funds through an independent custodian.[110] BLMIS represented that it generated consistently high returns for investment advisory clients using a split-strike conversion trading strategy. In reality, BLMIS fabricated customer statements to create the appearance of trading activity.[111]

Despite numerous "red flags," SEC and FINRA investigations failed to adequately investigate the integrity of the custodial and auditing arrangements Madoff used to hide his fraudulent activity.[112] The scheme unraveled when unprecedented withdrawals during the financial meltdown of 2008 left Madoff unable to raise enough new money to cash out investors.[113] Although BLMIS's assets were not subject to the SEC's Customer Protection Rule or FINRA oversight, SIPC sought a protective decree for BLMIS on December 15, 2008. The SIPC trustee received more than 16,000 investor submissions "reflect[ing] $73.1 billion in fictional net investments and related gains."[114]

Through a series of deeply unpopular decisions, the trustee allowed just over 2500 claims totaling $11.4 billion.[115] On the one hand, the trustee allowed claims from all claimants that had a direct customer relationship with BLMIS, despite the fact that BLMIS did not hold any customer assets in securities accounts, on the grounds that they had

491 B.R. 355, 361–63 (Bankr. S.D.N.Y. 2013) (unsuccessfully challenging trustee's classification of claims as commodities claims ineligible for SIPC relief, rather than securities claims); *In re* MF Global Inc., 467 B.R. 726, 731, 734 (Bankr. S.D.N.Y. 2012) (denying SIPA protection to warehouse receipts held in a commodities account at debtor, notwithstanding accountholder's claim of "REASONABLE RELIANCE, that SIPC was protecting his brokerage account").

108. *See, e.g.*, Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 951–57 (2009) (noting that BLMIS's founder, Bernard Madoff, had earned the "respect and trust of the SEC" due to his "efforts in the 1970s and 1980s to establish competitive regional exchanges and to increase the influence of the NASDAQ").

109. *See In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 127 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011) (outlining the different business units that made up BLMIS). BLMIS's investment advisory business was physically segregated from its other activities and was not registered with the SEC as an investment adviser until 2006. BLMIS's investment advisory business was not subject to the jurisdiction of FINRA (or its predecessor, the NASD). *Id.*

110. *See, e.g.*, Levinson v. Westport Nat'l Bank, 900 F. Supp. 2d 143, 152–55 (D. Conn. 2012) (describing Madoff's custodial arrangements with Westport National Bank), *order vacated in part on reconsideration*, 2013 WL 1294473 (D. Conn. 2013).

111. *In re* Bernard L. Madoff Investment Securities, LLC, 654 F.3d 229, 231–33 (2d Cir. 2011).

112. SEC INSPECTOR GENERAL, CASE NO. OIG-509, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME 20–41 (2009) [hereinafter OIG MADOFF REPORT]. Many competitors and former and prospective BLMIS customers repeatedly warned the SEC and FINRA that Madoff could not have conducted the volume of options trading he claimed without affecting prices on options exchanges or taxing the capacity of the over-the-counter institutional options market. *Id.*

113. Hurt, *supra* note 108, at 955–56.

114. *In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 124 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011).

115. THE MADOFF RECOVERY INITIATIVE, *supra* note 42.

deposited funds with BLMIS for the purchase of securities.[116] On the other hand, because the vast majority of claimants were indirect investors—including, for example, beneficiaries of pension funds invested with Madoff and investors in hedge funds operating as "feeder funds"—their claims were disallowed.[117] The Department of Justice, meanwhile, separately created a parallel Madoff Victims Fund for the distribution of four billion dollars in forfeited assets recovered from Madoff affiliates.[118]

In addition to limiting the number of claims, the trustee calculated each customer's net equity claim based on its "net investment" in Madoff's scheme, rather than the final balances on customer statements mailed to customers,[119] and sought to recover withdrawals by various "net winners" through the exercise of avoidance powers.[120] As of December 22, 2014, SIPC had committed approximately $700 million in advances to the BLMIS liquidation, and the trustee had collected $10.5 billion from settlements and judgments and distributed $6.1 billion to Madoff clients.[121] Meanwhile, the trustee's administrative costs have already exceeded $1.01 billion[122]—nearly double the cost of all previous SIPC liquidations.[123]

D. Stanford Financial Group

Allen Stanford orchestrated a Ponzi scheme through several affiliated companies within the Stanford Financial Group. Stanford Capital Management (a registered investment adviser) induced customers to purchase certificates of deposit issued by the Stanford International Bank Ltd. (SIBL) that carried "improbable, if not impossible" rates

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116. *In re* Bernard L. Madoff Inv. Sec., LLC, 654 F.3d 229, 235–36 (2d Cir. 2011) (upholding the status of Madoff investors as "trading customers" of BLMIS).

117. *In re* Bernard L. Madoff Inv. Sec. LLC, 708 F.3d 422, 426–28 (2d Cir. 2013).

118. *Madoff Victim Fund*: *Department of Justice Asset Forfeiture Distribution Program*, RCB SERVICES, http://www.madoffvictimfund.com (last updated Fall 2014).

119. *See infra* Part IV.B.2 (discussing the methodological approaches taken by SIPC trustees).

120. *See infra* Part IV.B.3 (discussing how defenses to the trustee's exercise of avoidance powers in a SIPC proceeding may depend on a customer's sophistication).

121. THE MADOFF RECOVERY INITIATIVE, *supra* note 42. According to SIPC, aggregate distributions of more than $7.2 billion have been paid out to eligible customers (including $823.7 million in committed advances from SIPC), and all allowed claims totaling $976,592 or less have been fully satisfied. Press Release, Irving Picard, Fifth Pro Rata Interim Distribution of Recovered Funds to Madoff Claims Holders Commenced; Totals Approximately $355.8 Million (Feb. 9, 2015), *available at* http://www.madofftrustee.com/statements-07.html#557; Press Release, SIPC, Distributions to Madoff Customers Now Covering 54 Percent of Losses (Feb. 9, 2015), *available at* http://www.sipc.org/news-and-media/news-releases/20150209 (noting that "total amount distributed in the Madoff liquidation proceeding to date exceeds $7.2 billion" including "$823.7 million in committed advances" from SIPC).

122. *See* Jonathan Stempel, *Payout to Madoff Victims Tops $7.2 Billion*, REUTERS (Feb. 9, 2015, 12:04 PM), *available at* http://www.reuters.com/article/2015/02/09/us-madoff-payout-idUSKBN0LD1XQ20150209 (reporting that "through Sept. 30, 2014, law firms, consultants and other professionals had billed $1.01 billion in fees and expenses" to recoup money for Madoff's victims" and that the bankruptcy court has "so far approved more than $601 million of payments, largely comprising fees," to the SIPC trustee and its counsel).

123. 2012 GAO INTERIM REPORT, *supra* note 45, at 32 (noting that the combined cost of all prior SIPC liquidations amounted to $512.6 million). The GAO noted, however, that the ratio of administrative costs to net equity claims remained consistent with prior liquidation proceedings. *Id.* In part, this reflects the significant cost of recovering funds from Madoff and his affiliates: because much of the money Madoff converted had been siphoned to personal accounts, the SIPC trustee petitioned the court to combine BLMIS's liquidation proceeding with bankruptcy proceedings involving Madoff's personal estate.

of return.[124] Customers purchased the CDs directly from SIBL, either by writing checks deposited into SIBL accounts or by wiring funds to SIBL.[125] Most, if not all, of the CDs were offered under disclosures that they were not protected under SIPC or insured by the FDIC or a similar deposit insurance scheme.[126] The CDs were distributed to "accredited investors" throughout the United States—mostly concentrated in Texas, Louisiana, and Alabama—in purported private placements exempt from registration under the Securities Act.[127] More problematically, the CDs were not sold or held in custodial accounts at Stanford's broker–dealer; instead, many of the CDs were held at third party clearing brokers.[128]

SEC examiners became aware that Stanford might be perpetrating a Ponzi scheme as early as 1997. The SEC's enforcement action against Stanford did not begin in earnest until 2005, however.[129] By the time criminal and civil enforcement actions were instituted, Stanford Capital Management had placed nearly $7.2 billion in certificates of deposit with investors worldwide.[130] SIPC refused to institute liquidation proceedings for the benefit of Stanford CD holders on the grounds that it was not authorized to protect monies invested with offshore banks or other firms that are not SIPC members or to protect investors against a loss in value of a security, whether because of mismanagement or fraud.[131]

The SEC sought an order to compel SIPC to liquidate Stanford Group Company (Stanford's broker–dealer affiliate and a SIPC member) and thereby assume responsibility for protecting "customers" of the consolidated group. The district court denied the SEC's application and held that the CD holders were not custodial "customers" of SGC because SGC "never physically possessed the investors' funds at the time that the investors made their purchases."[132] In affirming the district court, the D.C. Circuit concluded that the CD holders were, at best, "lenders" to SIBL.[133] The Court also rejected the SEC's petition for

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124. SEC OFFICE OF THE INSPECTOR GENERAL, INVESTIGATION OF THE SEC'S RESPONSE TO CONCERNS REGARDING ROBERT ALLEN STANFORD'S ALLEGED PONZI SCHEME, Case No. OIG-526, at vii, 102 (Mar. 31, 2010) (quoting SEC complaint), *available at* http://www.sec.gov/news/studies/2010/oig-526.pdf [hereinafter OIG STANFORD REPORT].

125. SEC v. Sec. Investor Prot. Corp., 758 F.3d 357, 360 (D.C. Cir. 2014).

126. *Id.* Because the CDs were not considered "covered securities" under U.S. securities law, the Supreme Court held that the Securities Litigation Uniform Standards Act did not preclude private class action litigation in state court. Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1071 (2014).

127. OIG STANFORD REPORT, *supra* note 124, at 107 (noting that the CDs were purportedly offered pursuant to Regulation D and that the staff found no evidence that the certificates of deposit had been sold to non-accredited investors in the United States).

128. SEC v. Sec. Investor Prot. Corp., 872 F. Supp. 2d 1, 7–8 (D.D.C. 2012), *aff'd*, 758 F.3d 357 (D.C. Cir. 2014). Arbitration proceedings brought by Stanford investors against carrying brokers for fraud, misrepresentation, and breach of fiduciary duty in connection with their custodial relationship with Stanford have not fared well. *See, e.g.*, *In re* the Arbitration between Kieblach v. Pershing LLC, FINRA Dispute Resolution Case No. 13-01692 (Nov. 3, 2014) (denying claimants' request for relief in its entirety).

129. OIG STANFORD REPORT, *supra* note 124, at 17–29 (attributing the failure, in part, to the difficulty and novelty of the case and the obstacles entailed in compelling the production of evidence from SIBL through Antiguan regulators).

130. Second Amended Complaint at 1, SEC v. Stanford International Bank, Ltd., et al., Case No. 3-09CV0298-N (N.D. Tex. June 19, 2009), *available at* https://www.sec.gov/litigation/complaints/2009/stanford-second-amended-061909.pdf.

131. Press Release, SIPC, SIPC to Defend Itself Against SEC Lawsuit Over Stanford Antiguan Bank Losses (Dec. 12, 2011), *available at* http://www.sipc.org/news-and-media/news-releases/20111212.

132. SEC v. Sec. Investor Prot. Corp., 872 F. Supp. 2d 1, 8–12 (D.D.C. 2012).

133. SEC v. Sec. Investor Prot. Corp., 758 F.3d 357, 365–67 (D.C. Cir. 2014).

"substantive consolidation" of SIBL and SGC because claims on the capital of the consolidated entity would in any event be excluded from the scope of SIPC protection along with other creditors and stockholders of Stanford's affiliates.[134]

IV. THE PARAMETERS OF INVESTOR PROTECTION

The foregoing case studies punctuate the longstanding tension between investors' "legitimate expectations" and "market reality" in applying the SIPA framework.[135] SIPC was designed to boost customer confidence in broker–dealers and securities markets in the face of a specific crisis that loomed over securities markets at a specific point in time over 45 years ago. As a result, SIPC hews narrowly to its original mandate in the face of novel investor claims stemming from a variety of foreseeable and unforeseeable crises. Meanwhile, investor advocates have used regulatory failures at the SEC and self-regulatory organizations, such as FINRA, as justification for demanding an expansion of SIPC coverage to provide restitution of their customer balances—including expected gains—stemming from such crises, in the absence of any means of effective redress against the federal agencies themselves.[136] What is perhaps most troubling is that policymakers and regulators are joining in the chorus, rather than making the hard decisions necessary to reconcile investor expectations with the costs and benefits of heightening regulation and increasing the industry's (and ultimately, its customers') exposure to drawdowns on the SIPC Fund.[137]

Any private or industry-funded regime will fold fairly quickly if limitations on relief cannot be articulated and adequately communicated to manage public expectations in relation to the levies raised to sustain it.[138] The viability of an "investor protection" regime such as SIPC therefore turns on two core policy decisions: (1) the scope of "investors"

134. *Id.* at 367–68. For the same reason, the D.C. Circuit sidestepped the SEC's argument that SGC should be deemed to have misappropriated funds received from customers on the theory that customers could have believed that they were depositing cash with SGC for the purchase of the Stanford CDs. *Id.* at 368–69.

135. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 496 B.R. 744, 755 (Bankr. S.D.N.Y. 2013) (citing *In re New Times*).

136. Courts have held that the SEC is immune from liability (at least to affected investors) for failure to fulfill its statutory obligation to "immediately notify SIPC" if it becomes aware that a SIPC member is approaching financial difficulty. *See, e.g.*, Zelaya v. United States, No. 11-62644-CIV, 2013 WL 4068754 (S.D. Fla. Aug. 12, 2013) (dismissing a claim that the SEC breached "a non-discretionary obligation 'to notify' the Securities Investor Protection Corporation" of Stanford Financial Group's financial distress for lack of subject matter jurisdiction under the Federal Tort Claims Act); *see also* 15 U.S.C. § 78eee(a)(1) (2012). Likewise, SIPA provides that SRO assistance to a SIPC member broker–dealer in the voluntary liquidation or reduction of its business cannot result in a claim that the regulator has assumed or adopted any obligations of the member to its customers. 15 U.S.C. § 78eee(a)(2).

137. Stanford Amici Brief, *supra* note 6, at 18 (arguing that treating Stanford victims as SIPC customers "would radically transform SIPA and threaten SIPC's ability to function as Congress intended" and there is "no indication that the SEC engaged in the rigorous economic analysis necessary to take such a momentous step in the nature of the SIPC Fund's duties"); *SIFMA Testimony*, *supra* note 92, at *2 (questioning whether the SIPC Task Force's proposed recommendations to increase SIPC protection were taken with "any real consideration of their cost to SIPC," which would be "funded by the members of SIPC and, ultimately, by the investing public").

138. *See, e.g.*, UNSAFE AND UNSOUND PRACTICES REPORT, *supra* note 14, at 29–30 (remarking that the "funds which are available in the event they are needed to accomplish the goals of SIPC are not an inexhaustible amount and also, as public funds, require protection"). It is true, as discussed in Part V.B below, that Congress could authorize public funds (or raise levies on securities market participants and intermediaries) to fund such a scheme, though the political feasibility of such relief is questionable.

reasonably entitled to protection; and (2) the scope of "protection" that investors ought to expect. With respect to the scope of "investors," policymakers must consider how broadly securities regulators should regulate the financial responsibility and business conduct of broker–dealers and their affiliates with a view to limiting recourse to the SIPC Fund, and how much exposure the fund (and thus the securities industry) should face with respect to unregulated or under-regulated transactions or accounts. With respect to the scope of protection, policymakers must consider, from a cost-benefit perspective, the extent to which evidentiary, methodological, and eligibility rules may be fashioned to create an administrable framework for processing investor claims that limits moral hazard while providing more than token relief. This Part surveys the positions that policymakers, courts, and SIPC have taken with respect to determining who ought to be entitled to investor protection and what considerations should play into determining the scope of investor protection.

A. Who is Entitled to "Investor" Protection?

To qualify for SIPC protection, an investor must be a "customer" of a SIPC member. As described in Part II of this Article, "customer" status carries with it several important privileges. First, the investor is entitled to receive a prorated share of any "customer property" segregated or otherwise recovered for the benefit of customers. Customer status therefore confers priority over other claimants and interest holders in bankruptcy, who can only look to the general estate of the defunct member. Second, "customers" are generally entitled to receive a SIPC advance toward their net equity claims to expedite the return of their property, pending the trustee's recovery efforts. For example, a SIPC customer with a $1,000,000 claim for securities might receive a $500,000 advance from SIPC, and thereafter receive a prorated share of any customer property the trustee recovers until its claim is paid in full.[139] Non-customers, by contrast, may not receive any interim distributions until sufficient property has been recovered to satisfy priority claims, which may take the better part of a decade in complex cases and with little prospect of recovery.

SIPA generally defines a customer as:

> [A]ny person . . . who has a claim on account of securities received, acquired, or held by the [member] in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral, security, or for purposes of effecting transfer.[140]

SIPA expressly includes in the definition of "customer" persons who deposit cash with a member "for the purpose of purchasing securities," or who have a claim for cash "arising out of sales or conversions of such securities."[141] The statutory definition

139. Not all SIPC "customers" are entitled to receive SIPC advances: SIPA precludes advances to satisfy the net equity claims of the following categories of customer, although such persons remain entitled to receive a prorated share of any "customer property" recovered by the trustee: a general partner, officer, or director of the debtor; certain five percent beneficial owners of any class of equity security or limited partnership interest; or any broker–dealer or bank (unless the claim arose out of transactions for customers of the broker–dealer or bank). 15 U.S.C. § 78fff-3(a) (2012).

140. *Id.* § 78*lll*(2)(A).

141. *Id.* § 78*lll*(2)(B)(i), (iii). As discussed below, Dodd–Frank further amended the definition of customer to include certain portfolio margining accounts. *Id.* § 78*lll*(2)(B)(ii).

expressly excludes claims on the capital of the member, as well as claims arising out of transactions with a member's foreign subsidiaries.[142]

Because SIPC customers are afforded special status in SIPC liquidation proceedings, courts "have consistently taken a restrictive view of the definition of a 'customer' under SIPA."[143] Generally speaking, courts have interpreted this definition to extend SIPC protection only to investors who have "entrusted" cash or securities to a broker–dealer, while denying customer status with respect to funds or securities transferred to the broker–dealer as investments in the broker–dealer (whether as loans, subordinated loans, or equity contributions)[144] or as collateral in connection with extensions of credit to or from the broker–dealer (e.g., in funding or derivative transactions).[145] Courts have also denied customer status to the broker–dealer's obligations to customers arising out of expectations of profit from transactions entered into with the broker–dealer as a party (such as certain "to be announced" or "delivery-versus-payment" transactions litigated in the Lehman and MF Global proceedings),[146] or claims that sound in contract or tort other than conversion or misappropriation (such as traditional claims of fraudulent sales practices, unsuitable securities or transactions, or failure to execute sell orders).[147]

The statutory intent behind such classification is generally to ensure that the scope of customer claims under SIPC mirrors the scope of customer property protected under the SEC and SROs' financial responsibility rules. Nevertheless, policymakers, courts and regulators have all permitted gaps and inconsistencies to fester between the SEC's financial responsibility rules and SIPA's remedial mandate. Such gaps and inconsistencies can be attributed to several dynamics: first, the SEC may lack the incentive to bring its rules into conformity with judicial decisions under SIPA, even when it has the authority to do so. Likewise, Congress may incrementally expand the scope of SIPA's remedial mandate without concomitantly harmonizing or extending regulatory protections to limit or compensate for SIPC's potential liability. Finally, SIPC and the courts may extend

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142. *Id.* § 78*lll*(2)(C).

143. *In re* Klein, Maus & Shire, Inc., 301 B.R. 408, 418 (Bankr. S.D.N.Y. 2003); *see also* Stafford v. Giddens (*In re* New Times Sec. Servs., Inc.), 463 F.3d 125, 127 (2d Cir. 2006) ("Judicial interpretations of 'customer' status support a narrow interpretation of the SIPA's provisions."); *In re* Bernard L. Madoff Inv. Sec. LLC, 708 F.3d 422, 426 (2d Cir. 2013) ("This court has ruled that '[j]udicial interpretations of 'customer' status support a narrow interpretation of the SIPA's provisions," quoting *In re New Times Sec. Servs., Inc.*, 463 F.3d at 127 (internal quotation marks omitted)). For example, courts have generally required claimants to demonstrate that they qualify as a "customer" on a transaction-by-transaction basis, even if they would otherwise qualify as customers of the broker–dealer for purposes of other transactions or applicable business conduct rules. Sec. Investor Prot. Corp. v. Stratton Oakmont, Inc., 229 B.R. 273, 277 (Bankr. S.D.N.Y. 1999), *aff'd sub nom*., Arford v. Miller (*In re* Stratton Oakmont, Inc.), 210 F.3d 420 (2d Cir. 2000) ("[A]n investor can be a customer vis-à-vis certain transactions but not others.").

144. *See, e.g.*, SEC v. Sec. Investor Prot. Corp., 758 F.3d 357, 363–67 (D.C. Cir. 2014).

145. *In re* Lehman Bros. Inc., 506 B.R. 346, 354–55 (S.D.N.Y. 2014); *In re* MF Global, 492 B.R. 407, 415 (Bankr. S.D.N.Y. 2011); *see also In re* Bevill, Bresler & Schulman Asset Mgmt. Corp., 67 B.R. 557, 600 (D.N.J. 1986) (looking to the "fiduciary" character of the relationship in determining whether counterparties to repurchase agreements and reverse repurchase agreements qualify as customers under SIPA).

146. *In re MF Global*, 492 B.R. at 411–12; *In re* Lehman Bros. Inc., 462 B.R. 53, 63 (Bankr. S.D.N.Y. 2011).

147. *See, e.g.*, Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 496 B.R. 744, 759 (Bankr. S.D.N.Y. 2013) (noting that "SIPA provides no protection for any other losses caused by 'conversion, fraud, or other broker wrongdoing'"); *see generally* Daniel A. Klein, *Construction and Application of Term "Customer" in Securities Investor Protection Act (SIPA)*, 52 A.L.R. FED. 2d 491 (2011) (collecting cases on the scope of the "customer" definition).

"customer" status to individuals whose claims arise out of conduct that cannot be efficiently or equitably distinguished from traditional claims.

1. The SEC's Institutional Incentives

In some respects, flaws in the SIPC scheme may be attributed to the SEC's institutional inability to conform its financial responsibility rules to the scope of SIPC's customer protection regime. The definition of "customer" under the SEC's rules and the definition of "customer" under SIPA are construed under different processes: the Customer Protection Rule is construed by the SEC's rulemaking and interpretation, while SIPA's scope is shaped by SIPC's litigation strategy and judicial decisionmaking.[148] Despite the highly technical nature of SIPA's statutory definitions, courts have been reluctant to grant *Chevron* deference to either the SEC or SIPC in interpreting SIPA's provisions.[149] This naturally frustrates regulatory efforts to tailor SIPA's definition of "customer" in a manner that manages public expectations.

As a result, the only way for the SEC to reduce discrepancies between the two regimes is to adapt the definition of "customer" under its financial responsibility rules to match the breadth of SIPC coverage. The exercise of such authority comes at a political price, however, because it increases the ongoing cost of capital, custody and reserve requirements on all broker–dealers in the service of preventing the remote possibility of a draw on the SIPC Fund.[150] Moreover, in an era of heightened judicial skepticism toward regulation, agencies such as the SEC may be reluctant to embark on rulemaking exercises subject to intense judicial second-guessing under the guise of cost-benefit analysis.[151]

Two longstanding examples illustrate the contours of this problem: (1) the classification of proprietary accounts of introducing brokers; and (2) the classification of repurchase agreements under SIPA. Consider first the classification of accounts held by a

148. The Customer Protection Rule's definition of customer includes "any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person," regardless of the purpose for which the funds or securities are held. 17 C.F.R. 240.15c3-3(a)(1) (2014). However, the Rule's definition of "customer"—unlike SIPA—expressly excludes most proprietary accounts of broker–dealers. *Id.*

149. For example, in *In re New Times*, the Second Circuit declined to grant *Chevron* deference to SIPC, notwithstanding its "history of knowledgeable and conscientious performance" of its statutory mandate, on the grounds that it is not an independent agency and does not have the power to adopt, amend, and repeal necessary bylaws, rules, and regulations without SEC oversight. *In re* New Times Sec. Servs., Inc., 371 F.3d 68, 78–80 (2d Cir. 2004) (quoting Sec. Investor Prot. Corp. v. Charisma Sec. Corp., 506 F.2d 1191, 1196 (2d Cir. 1974)). The Second Circuit further concluded that the mandatory deference envisioned by *Chevron* to the SEC's interpretation of section 9(a) of SIPA would be "inappropriate" in light of the lack of any SEC rulemaking or interpretive guidance or previous articulation of a position on the question at bar, as well as—somewhat circularly—"SIPC's arguably greater familiarity with the provisions of SIPA." *Id.* at 80–82. The Court nevertheless granted *Skidmore* deference to the SEC in light of "the agency's expertise, the care it took in reaching its conclusions, the formality with which it promulgates its interpretations, the consistency of its views over time, and the ultimate persuasiveness of its arguments." *Id.* at 83 (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 138 (1944)).

150. *See, e.g.*, Jamroz, *supra* note 46, at 1119 (discussing the "difficult position" of the SEC in determining whether to use its authority to require reserves against repo transactions).

151. *See* SEC, Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf; *see also* Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 325–36 (2013) (describing the historical context for the development of the SEC's 2012 guidance as well as the public response thereto).

carrying broker for the proprietary trading activity of an introducing broker (a "PAIB account").[152] Because the SIPA definition of "customer" does not completely exclude brokers and dealers from SIPC coverage, introducing brokers may submit net equity claims for proprietary accounts held by a defunct carrying broker and share pro rata in customer property recovered by SIPC. [153] The SEC has accordingly faced the choice of imposing a customer segregation and reserve requirement for PAIB accounts or exposing SIPC to the risk that the claims of such accounts might unfairly deplete customer property in the event of the collapse of a major clearing broker, and thereby delay or reduce distributions to the defunct broker's public customers.

Efforts to close the gap advanced incrementally, and only in the wake of highly publicized failures. For example, in 1998, following the collapse of a series of introducing and clearing brokers, the SEC staff used interpretive guidance to impose a reserve requirement on carrying brokers for PAIB accounts of U.S.-registered introducing brokers under the SEC's financial responsibility rules.[154] Addressing the disparity with respect to non-U.S. broker–dealers, however, required Commission rulemaking.[155] The Commission could not muster the political will to close the gap until nearly two decades later,[156] and only after the prospect that a court might grant claims asserted by Lehman's non-U.S. affiliates on LBI's customer assets in the United States exposed the dangers of leaving the gap unattended.[157]

Repurchase agreements (and reverse repurchase agreements) pose similar problems. Broker–dealers and other financial intermediaries frequently use "repo" agreements to

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152. *See supra* notes 18–19 and accompanying text (discussing the difference between introducing and carrying brokers).

153. Consider the following example: assume that A and B are broker–dealers, and that A (an introducing broker) holds an account at B (a carrying broker). For purposes of the Customer Protection Rule, A is not considered a customer of B because A is a broker. For purposes of SIPA, however, A may be considered a "customer" of B, although A is not entitled to receive SIPC advances, but just a prorated share of customer property. Therefore, the Consumer Protection Rule does not require that B segregate fully paid funds and securities carried for A, but A is entitled to share in such segregated funds and securities alongside B's other customers in a SIPC liquidation.

154. *See* New York Stock Exchange, Inc., SEC No-Action Letter (Nov. 3, 1998) (requesting clarification of the SEC staff's position as to the treatment of assets in a PAIB account under the Net Capital Rule); NASD Notice to Members 98–99: SEC Issues No-Action Letter on Proprietary Accounts of Introducing Broker/Dealers (Dec. 1998) (stating that "introducing brokers" might not be able to count unsegregated funds and securities toward the minimum net capital required under the "Net Capital Rule"); *see also* Jamroz, *supra* note 46, at 1115–18 (explaining that the SEC has never required reduction of "fully paid" securities in PAIB accounts to possession and control).

155. Because non-U.S. introducing broker–dealers are not subject to the Net Capital Rule, the SEC staff could not use the prospect of noncompliance with the Net Capital Rule to encourage U.S. carrying brokers to maintain a reserve account for the benefit of non-U.S. PAIBs.

156. Financial Responsibility Rules for Broker–Dealers, Exchange Act Release No. 70072, 78 Fed. Reg. 51824 (Aug. 21, 2013).

157. *See, e.g.*, *SIFMA Testimony*, *supra* note 92, at *3 (noting that if LBIE's proprietary claims were "ultimately allowed as customer claims, the gap between SIPA and the Customer Protection Rule may cause a sizeable shortfall in the customer property available for distribution to LBI's customers"). The SEC nevertheless acknowledged the right of foreign broker–dealers to subordinate their proprietary claims to the claims of other creditors of the broker–dealer to withdraw from the definition of "customer" under SIPA and thus obviate the reserve requirement. 17 C.F.R. § 240.15c3-3(a)(16) (2014).

obtain liquid funds against securities while retaining the economic risk of the latter.[158] Despite concerns about excessive reliance on short-term "repo" financing,[159] regulators traditionally considered the application of custody and reserve requirements to repurchase agreements to be onerous in relation to the risk posed to individual counterparties,[160] particularly to the extent that larger firms often maintain "matched books" to arrange financing between counterparties.[161] Nevertheless, courts have occasionally honored the net equity claims of repo counterparties based on the economic equivalence of repurchase agreements to margin loans, the intent of the parties, and whether the broker rehypothecated securities received or instead held them in custody.[162] As a result, repo counterparties continue to submit customer claims in SIPC liquidation proceedings—including the SIPC proceeding in Lehman—in the hope of obtaining a favorable judgment or settlement.[163]

Nearly all commentators who opine on the issue—including the SIPC Task Force—encourage a greater effort to reconcile inconsistencies between the SEC's financial responsibility rules and the SIPA regime.[164] The question is, by whom? Congress could bring SIPA into conformity with the policy behind SEC rules, for example, by carving out broker–dealers from SIPA's definition of "customer," but there is little incentive to engage in such housekeeping amendments, particularly if they would affect thousands of introducing brokers nationwide for the benefit of relatively few carrying brokers.

Some commentators suggest granting the SEC the authority to define the term "customer" under SIPA.[165] From a public policy perspective, such authority might

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158. For a discussion of repurchase agreements and the importance of the repo market, see Frank J. Fabozzi & Steven V. Mann, *Private Money Market Instruments*, *in* THE HANDBOOK OF FIXED INCOME SECURITIES 345–51 (Frank J. Fabozzi, ed., 8th ed. 2012).

159. Scholars have thoroughly chronicled the excessive reliance of investment banks on repurchase transactions to finance their activities. *See* GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 at 47–50, 133–35 (2010) (noting that the unavailability or increased cost of repo financing contributed to the liquidity crisis faced by banks in the 2008 financial crisis); Peter Eavis, *Boston Fed Chief Warns of Dangers to Repo Market*, N.Y. TIMES DEALBOOK (Aug. 13, 2014), http://dealbook.nytimes.com/2014/08/13/boston-fed-chief-rosengren-calls-for-overhaul-of-repo-market/?_r=0 (noting that repurchase agreements and similar types of borrowings still accounted for 52% of broker–dealer obligations in 2013, according to Eric S. Rosengren, president of the Federal Reserve Bank of Boston).

160. Both SIPC and the SEC acknowledge repurchase agreements as a sale, however, rather than the deposit of a margin security held for the counterparty's account. *See* 17 C.F.R. §240.15c3-3(b)(4)(i)(C) (requiring broker–dealers to notify non-broker counterparties that transfer securities to a broker in connection with a "hold-in-custody" repurchase agreement that "SIPC has taken the position that the provisions of the Securities Investor Protection Act of 1970 do not protect the counterparty"); Jamroz, *supra* note 46, at 1092–95.

161. *See, e.g.*, Fabozzi & Mann, *supra* note 158, at 349 (describing "matched books"); Jamroz, *supra* note 46, at 1118–19 (asserting that "[t]o treat repo counter parties as customers would require large investment banks that have government securities dealing activities to include receivables and payables that exceed the many billions of dollars associated with their so-called 'matched books' in the Reserve Formula").

162. *See* Matter of Bevill, Bresler & Schulman Asset Mgmt. Corp., 67 B.R. 557, 598–602 (D.N.J. 1986) (concluding that certain repo and reverse repo counterparties were "customers" within the meaning of SIPA); *see also* Don & Wang, *supra* note 3, at 538–40 (discussing the holding in *Bevill*, *Bresler*).

163. *In re* Lehman Bros., 506 B.R. 346, 355–57 (S.D.N.Y. 2014) (rejecting the argument that repos with Lehman created a customer relationship).

164. SIPC TASK FORCE REPORT, *supra* note 38, at 35.

165. *SIFMA Testimony*, *supra* note 92, at *2 (believing it "essential to ensure consistency between SIPA and the SEC's Customer Protection Rule"); *see also* S. 1725, 113th Cong. (2013) (proposing to amend the definition of "customer" to include any person that the SEC, "in its discretion and without any need for court approval, deems a customer").

nevertheless put the SEC in the position of dictating the scope of relief under SIPA—and thus the power to increase SIPC's liability unilaterally. As the Madoff liquidation and the Stanford litigation illustrate, there is significant risk that the SEC might be pressured to expand the scope of SIPC coverage (for example, under intense lobbying from legislators or victims of insolvencies) while delaying corresponding changes to its rules (under pressure from Wall Street to avoid raising the costs of business in the short term), and thereby precipitate future funding shortfalls in the event of a major broker–dealer failure.

2. Institutional Design

The quest to expand SIPC coverage may also find political champions who are willing to expand the scope of SIPA's remedial protection liberally without making the effort to bring prophylactic regulation into line. For some, SIPC coverage is often a convenient proxy for holding "Wall Street" responsible for the misconduct of insolvent institutions or the lassitude of their regulators. In response to the Madoff and Stanford schemes, for example, a variety of legislative proposals would expressly expand the definition of "customer" to include direct and indirect victims of Ponzi schemes, victims of fraudulent or unethical conduct by broker–dealers, and other persons aggrieved by broker–dealer misconduct.[166] The open-ended and unpredictable liability such a scheme would create, and the political difficulty of securing short-term financing from the Treasury or long-term funding from the securities industry, creates significant political challenges to their adoption.

More interesting cases turn on Wall Street's vested interest in expanding SIPC coverage—e.g., as a way to remove regulatory impediments to consolidating customer accounts. For example, the combined trading of securities and futures products in a single account has posed problems in the absence of a uniform set of financial responsibility rules. Accounts for trading in futures products are generally subject to a rigorous segregation regime under the Commodity Exchange Act,[167] but with no SIPC-like fund to resolve or guarantee accounts in liquidation.[168] Meanwhile, CFTC rules govern the liquidation of futures brokers and other regulated entities that carry financial or commodity futures, swaps, and related derivatives.[169]

As a result, something as straightforward as hedging a broad-based index future (such as the S&P 500 index future) against one or more broad-based index options or exchange-

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166. *See, e.g.*, S. 1725, 113th Cong. (2013) (proposing to amend the definition of "customer" under SIPA to include "any person that had cash or securities that were converted or misappropriated" by the defunct broker–dealer or its affiliates); H.R. 1987, 112th Cong. (2011) (proposing to require SIPC to satisfy the securities and cash claims of certain "indirect Ponzi scheme investors" up to specified thresholds).

167. Commodity Exchange Act, 7 U.S.C. § 1 et seq. (2012).

168. *See generally* THOMAS L. HAZEN & JERRY W. MARKHAM, BROKER–DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW, § 5.8 (2011) (discussing the CFTC's customer protection regime for futures accounts); *see also supra* note 105 (citing sources analyzing differences in account structures, segregation requirements, and processes for liquidating insolvent broker–dealers and futures commission merchants under SEC and CFTC rules).

169. CFTC rules require prompt liquidation or transfer of most open contracts and prorated distribution of customer property across specified account classes. 17 C.F.R. §§ 190.02(f), 190.08 (2014); *see also id.* § 190.01(a)(1) (defining "account class" to include "futures accounts, foreign futures accounts, leverage accounts, delivery accounts . . . and cleared swaps accounts"); *cf.* 17 C.F.R. § 300.400 (2014) (requiring the trustee to immediately liquidate standardized positions on filing and generally prohibiting the trustee from purchasing standardized options for customer accounts).

traded funds poses logistical challenges, because index futures are subject to the CEA account structure while index options and funds are securities subject to the Exchange Act's account structure. To resolve the decades-old impasse,[170] Dodd–Frank amended SIPA to permit the SEC to extend SIPC protection to all futures and related options products carried in a portfolio margining account.[171] Nevertheless, Congress left it to the SEC and CFTC to compromise on account structures, risk-based methodologies, and other regulations necessary to create a "unified account regime."[172]

Dodd–Frank created further uncertainties as to how SIPC would operate with respect to off-exchange derivative transactions ("swaps") linked to securities ("security-based swaps") and other underlying assets or instruments ("non-security-based swaps").[173] By recognizing "security-based swaps" as "securities" under the Exchange Act (including the well-publicized "credit default swaps" that felled AIG), Dodd–Frank creates the possibility that SIPC might be responsible for providing advances against positions in all security-based swaps held at a broker–dealer.[174] Moreover, because SIPA does not provide for proration of customer property within asset classes,[175] securities customers of all stripes may have to share in customer property with sophisticated swap participants if the same carrying broker holds their accounts.[176]

These flaws in institutional design open SIPC to potential criticism from an even broader spectrum of the financial community if another significant dually-registered brokerage firm should fail in the future. It may seem inequitable to offer SIPC protection to derivatives approved for trading in certain institutional or high-net-worth securities

170. Regulators remained at an impasse, among other reasons, because they were reluctant to permit trading of securities in a futures account without the benefit of SIPC coverage, or to permit trading of futures in securities accounts without full segregation or SIPC coverage. JOINT HARMONIZATION REPORT, *supra* note 105, at 41–43.

171. Specifically, Dodd–Frank amended SIPC's definition of "net equity" to include the value of futures contracts and related positions held pursuant to a "portfolio margining program" approved by the SEC, while simultaneously extending the definition of "customer property" to include futures and related positions held on behalf of customers. 15 U.S.C. §§ 78*lll*(4)(D), 78*lll*(11)(A)(ii) (2012). Recent amendments to the Customer Protection Rule further require such futures and options positions to be incorporated into the broker–dealer's reserve formula calculation. 17 C.F.R. § 240.15c3-3(a)(8)–(9) (2014).

172. JOINT HARMONIZATION REPORT, *supra* note 105, at 41–43. Amendments to the Customer Protection Rule in 2013 clarify to a degree the treatment of futures positions, cash settlement from futures transactions, and the value of options positions in commodities accounts carried for portfolio margining customers under the Customer Protection Rule. Financial Responsibility Rules for Broker–Dealers, Exchange Act Release No. 70072, 78 Fed. Reg. 51824, 51844–46 (Aug. 21, 2013) (observing that while the Dodd–Frank amendments to SIPA may have made amendments to the Rule unnecessary, the adopted amendments "complement the amendments to SIPA and provide additional protections to customers").

173. Prior to Dodd–Frank, any amounts owed or obligation to return collateral tendered under such derivatives contracts would have been treated as claims on the general estate of the broker–dealer, subject to the special close-out provisions of the Bankruptcy Code. Skeel, *supra* note 22, at 10–13.

174. This may increase SIPC's liability in two ways: first, if the customer deposits collateral in connection with a security-based swap, SIPC might be responsible for the return of excess collateral held by the broker–dealer (even if the broker–dealer is not required to segregate any such collateral from its proprietary assets); second, if the customer is entitled to receive a payment from the broker–dealer, the SIPC trustee might be required to provide advances against any such payments that are due as of the filing date. *SIFMA Testimony*, *supra* note 92, at *3–5.

175. SIFMA has advocated such rules for such accounts, and has proposed that the SEC allow opt-outs similar to those for foreign PAIBs. *See id.* (citing the testimony of Ira D. Hammerman); *supra* note 157.

176. By contrast, the CFTC distinguishes cleared swaps from uncleared swaps for purposes of Part 190, and recognizes cleared swaps as a separate customer account class. 17 C.F.R. § 190.01(a)(1) (2014).

accounts, but not to retail investors in traditional futures accounts, when all account types are handled in a single liquidation proceeding.[177] Most of the largest futures brokers in the United States, for example, are also registered as securities brokers with the SEC.[178] However rigorous the segregation requirements for futures brokers, the lack of an ex ante system of guaranteeing bulk transfers of futures and commodities accounts slows down the bulk transfer process considerably, as illustrated by the MF Global liquidation process.[179]

Customers of a dually-registered firm might also bemoan that "customer property" is not shared equitably among SIPC-protected securities accounts and the various classes of unprotected futures accounts under the Commodity Exchange Act—particularly when there are shortfalls in certain account classes, but not others. For example, decisions about how assets are recovered and allocated through the trustee's various powers in a bankruptcy proceeding—particularly to the extent that the trustee may use those powers to expand the scope of customer property—can create tensions among different customer classes.[180] One institutional solution to this problem would be to consolidate securities and futures trading under a single regulator.[181] However, in the meantime, half-measures to extend SIPC coverage are likely to sow greater investor confusion and leave courts and regulators with

177. Because exchange-traded futures and options are contractual obligations vis-à-vis a clearinghouse, rather than certificated instruments, regulation of custodial arrangements with futures brokers and other CFTC-regulated intermediaries focuses on the protection of funds, securities and other property deposited with an intermediary as collateral for the settlement of obligations with the relevant clearinghouse.

178. Operation, in the Ordinary Course, of a Commodity Broker in Bankruptcy, 75 Fed. Reg. 44890, 44891 n.10 (July 30, 2010) (citing the Futures Industry Association's observation that "43 of the 50 largest FCMs are also registered broker–dealers").

179. The CFTC has previously considered whether to recommend an insurance scheme for futures accounts, although at the time the risk of futures account defaults was considered negligible. U.S. COMMODITY FUTURES TRADING COMMISSION, REPORT TO CONGRESS CONCERNING COMMODITY FUTURES ACCOUNT INSURANCE (1976). Commissioner Chilton and others have revived interest in this issue in light of the MF Global insolvency, as discussed at note 248 below.

180. CFTC Rule 190.08 provides that "customer property" available for distribution in the liquidation of a commodities broker includes "[a]ll cash, securities, or other property" that "[i]s property of the debtor's estate recovered by the Commission in any proceeding brought against the principals, agents, or employees of the debtor" or "[i]s cash, securities or other property of the debtor's estate, including the debtor's trading or operating accounts and commodities of the debtor held in inventory, but only to the extent that" certain enumerated categories of customer property are "insufficient to satisfy in full all claims of public customers." 17 C.F.R. § 190.08(a)(1)(ii)(H), (J) (2014). Meanwhile, assets recovered through the exercise of avoidance powers will only be considered "customer property" under SIPA if, "except for such transfer," the property "would have been customer property." 15 U.S.C. § 78fff-2(c)(3) (2012).

181. Similar to the model employed in other jurisdictions, a single regulator could be empowered to oversee all exchange-traded and over-the-counter securities and derivatives products, and—to the extent available—oversee a single investor protection fund to address insolvency-related claims across products. *See, e.g.*, DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE, 106–26 (Mar. 2008) (hereinafter BLUEPRINT) (proposing convergence in the regulation of securities and futures markets and the eventual merger of the SEC and CFTC); John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 473–81 (1995) (arguing for consolidation of the SEC and CFTC). Such a move would also harmonize U.S. account structures with those in other jurisdictions. However overdue, harmonization or consolidation of SEC and CFTC rules remains politically difficult. BLUEPRINT, *supra*, at 106–26 (advocating such a merger); see also Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 552 (2009) (noting that the principal obstacles to a merger of the SEC and the CFTC are the "allocation of jurisdiction for such a merged entity among competing congressional committees" and the "challenges in combining the often-conflicting cultures of the agencies").

the thankless task of working out a reasonable framework ex post for mapping protected customers to segregated assets.

3. Equity and Efficiency

SIPC trustees and the courts may feel compelled to honor otherwise ineligible claims for reasons of equity or efficiency, even as such expansion disrupts the balancing of claims and customer property envisioned by SIPA. Such claims often arise because a customer claims to enjoy SIPC protection by virtue of a de facto customer relationship with the broker–dealer, even though the customer's formal relationship was with a non-broker–dealer affiliate or through another financial or legal intermediary. Because the SEC or other financial regulators may have no authority over such affiliates or intermediaries—or in any event no policy interest in subjecting the latters' client relationships to heightened regulatory scrutiny or substantive regulation—there is no effective way to protect SIPC against unregulated exposure if a court recharacterizes those relationships as meeting SIPA's definition of "customer" after the fact.

For example, when a financial services firm holds itself out as offering a variety of services—such as banking, securities, insurance, and investment advisory services—the capacity in which the firm or its associated persons act will dictate, as a technical matter, the protections available to any funds or financial instruments entrusted to the firm.[182] Customers interfacing with such firms or their representatives might believe that they are entitled to protection equivalent to that provided by SIPC in the event of insolvency of one or more affiliated entities, particularly if the firm uses common promotional materials, dual-hatted representatives, or offers multiple services to the same individual.[183] An "entity-centric" approach to defining who is entitled to SIPC relief thus invites the "prospect of an enterprise's piecemeal use of SIPC membership as window dressing."[184]

SIPC, the SEC, and other regulators have attempted to improve investor education in this regard—for example, by exhorting customers to ensure that the affiliate they are dealing with is a SIPC member. However, such efforts often prove ineffective as financial services are increasingly provided under one roof,[185] and multiple financial guarantee programs (such as FDIC deposit insurance or state insurance guarantee associations) stand behind different categories of product or entity.[186] These problems are compounded when

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182. U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES INVESTOR PROTECTION: STEPS NEEDED TO BETTER DISCLOSE SIPC POLICIES TO INVESTORS, REP. NO. GAO-01-653, 43–52 (May 2001),, *available at* http://www.gao.gov/new.items/d01653.pdf [hereinafter 2001 GAO REPORT]; 1992 GAO REPORT, *supra* note 16, at 70–72.

183. For example, the SEC argued before the D.C. Circuit that investors could have been led to believe that they were purchasing SIBL CDs through Stanford's broker–dealer affiliate (SGC) if they had accounts at SGC, dealt solely with SGC representatives, or paid for their CDs in accordance with SGC's instructions (even if SGC never handled the funds). The fact that investors and SGC employees referred generally to "Stanford" or that checks deposited to purchase CDs were payable to "Stanford" further evidenced investor confusion. SEC v. Sec. Investor Prot. Corp., 758 F.3d 357, 368 (D.C. Cir. 2014).

184. Anita K. Krug, *Escaping Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039, 2087 (2013).

185. 2001 GAO REPORT, *supra* note 182, at 43–52; 1992 GAO REPORT, *supra* note 16, at 70–72.

186. 2001 GAO REPORT, *supra* note 182, at 60–71.

firms fail to maintain adequate records or even engage in deliberate fraud.[187] In such cases, it is often difficult to establish—let alone defend—a basis for denying protection due to the formal separation of affiliates without provoking public resentment.[188]

A second example is the status of individuals who have derivative claims on a SIPC member firm. When investment managers engage in discretionary investment activity on behalf of a fund—such as a mutual fund, pension fund, or hedge fund—investors in the fund are traditionally considered equityholders in or beneficiaries of the fund, rather than custodial customers of the broker–dealer holding the fund's account.[189] In the Madoff liquidation, several limited partnerships and other investment companies that invested in Madoff's scheme failed to persuade the court that their limited partners and other investors should be considered "customers" of BLMIS for these purposes, particularly because they were not identified or reflected as such in BLMIS's accounts.[190]

The practical consequence is that such indirect accountholders are entitled to receive their share of the fund's SIPC advance and prorated "customer property," but are not separately entitled to receive a full SIPC advance up to the statutory limit.[191] Depending on the sophistication of the investors,[192] equity may defy SIPA's logic. In the Madoff case, for example, courts upheld the trustee's disallowance of the individual claims of beneficiaries of an ERISA pension plan as required by SIPA.[193] Recognizing the equities of their claims, however, the SIPC Task Force has recommended that Congress amend SIPA to extend SIPC coverage to beneficiaries of ERISA plans with respect to certain indirect claims.[194]

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187. *See, e.g.*, *In re* Old Naples Sec., 223 F.3d 1296, 1303–04 (11th Cir. 2000) (granting customer status to investors who sent funds to agent of broker for purchase of bonds through broker, even though investors had been fraudulently induced to wire funds to a "financial services" company under common ownership with the brokerage firm).

188. *See, e.g.*, S. 1725, 113th Cong. (2013) (proposing to revise the term "customer" to include any person whose cash or securities were "converted or otherwise misappropriated by the [broker–dealer] *(or any person who controls, is controlled by, or is under common control with the debtor, if such person was operating through the debtor)*") (emphasis added).

189. *See, e.g.*, *In re* First Ohio Sec., No. 93-3313, 1994 WL 599433, at *1 (6th Cir. 1994) (holding that pension fund participants are not individual "customers" of a broker–dealer); Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co., 533 F.2d 1314, 1317–21 (2d Cir. 1976) (trustees of a pension plan are not separate "customers" of a broker–dealer). By contrast, when a broker–dealer maintains a customer account at a SIPC member on behalf of its customers, "each such customer of such broker or dealer or bank shall be deemed a separate customer of the [member]." 15 U.S.C. § 78fff-3(a)(5) (2012).

190. *In re* Bernard L. Madoff Inv. Sec., 708 F.3d 422, 426–27 (2d Cir. 2013). The court focused on the narrow issue that such indirect investors did not maintain a custodial relationship with Madoff's broker–dealer—e.g., the deposit of customer funds or securities for the account of the customer—and thus lacked a direct fiduciary relationship with Madoff. *Id.* at 426.

191. For example, a private fund with ten investors might receive a single advance of up to $500,000 for securities claims (in addition to the prorated return of any customer property), which would be apportioned among the investors, rather than separate advances of $500,000 per investor.

192. Investors eligible to participate in private equity funds and hedge funds must meet certain qualification or accreditation thresholds, on the basis of which they should be able to appreciate the risk entailed in forgoing SIPC coverage, among other investment risks. Moreover, private funds have a significant interest in keeping the composition and identity of their investors confidential, which complicates the ability of regulators to assess SIPC's potential exposure in the event of the implosion of a fund's broker–dealer.

193. Sec. Investor Prot. Corp. v. Jacqueline Green Rollover Account, No. 12 Civ. 1039 (DLC), 2012 WL 3042986, at *1, *9 (S.D.N.Y. 2012).

194. SIPC TASK FORCE REPORT, *supra* note 38, at 12–14.

B. What Is Investor "Protection"?

As discussed in Part II.A, the statutory goal of a SIPA liquidation proceeding is to distribute "customer property" to each customer to satisfy its "net equity" claim, before the remainder of the member's estate is distributed to other claimants and interestholders. The "net equity" claim of a customer account is generally determined by calculating the amount that would have been owed to the customer if all of its securities positions were liquidated on the filing date, less any indebtedness of the customer to the broker on the filing date.[195] If a SIPC member broker–dealer is in compliance with applicable financial responsibility rules,[196] adequate "customer property" should be available to satisfy customer claims upon liquidation or transfer of customer accounts.

Such a parsimonious view of "net equity" might seem at odds with the idea of investor protection, given the myriad ways that customers may suffer losses at the hands of unscrupulous or incompetent brokers. Accordingly, Congress contemplated that SIPC might be called upon to make customers whole for more expansive shortfalls in customer property, for example, whether due to failures in internal controls[197] or if securities are "lost, improperly hypothecated, misappropriated, never purchased, or stolen."[198] It also contemplated that SIPC would use its authority not only to make the customer whole for amounts invested but to honor expected profits on securities positions as well.[199] Such additional relief may be justified not only by the desire to offer investors more comprehensive protection, but also by the equally compelling objective of minimizing the potential litigation expense and liability faced by transferee brokers with whom the SIPC trustee negotiates a bulk transfer of accounts. In a similar vein, SIPC generally requires the trustee of a broker–dealer's estate to close out certain open contractual commitments with public customers of *another* broker–dealer in the ordinary course of business for the protection of such other customers.[200]

Difficult policy questions arise when the toxicity of a defunct broker's business eliminates the possibility of orderly liquidation or bulk transfer of accounts. In such cases, the trustee's task is no longer to achieve an equitable allocation of customer property among investors, but rather to process claims against the SIPC Fund in accordance with

195. 15 U.S.C. § 78*lll*(11) (2012).

196. The "customer property" available for distribution to customers in a SIPA liquidation proceeding includes most cash and securities received, acquired or held by, or for the account of, the defunct broker from or for the securities accounts of a customer, including resources from the realization of customer debt balances and debit-related items. The definition of "customer property" also includes, *inter alia*, "any other 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, unless the trustee determines that including such property within the meaning of such term would not significantly increase customer property." 15 U.S.C. § 78*lll*(4)(E) (2012).

197. Inherent limitations in enforcing continuous compliance with the Customer Protection Rule might result in the inadequate segregation of funds and securities for the benefit of customers, for example, because of the lag between the reserve computation and the deposit of funds into the reserve account or intraday fluctuations in the inventory of securities under possession and control. *Supra* note 55 and accompanying text.

198. S. REP. NO. 96-763, at 2 (1978); H.R. REP. NO. 95-746, at 21 (1977). *See* 100110 ABI-CLC 265. In some cases, the classification of protected and unprotected transactions may well turn on the available documentation.

199. *See supra* note 33 and accompanying text (explaining that the trustee is empowered to apply customer funds to acquire securities for delivery to the extent that they can be purchased in a fair and orderly market).

200. 15 U.S.C. § 78fff-2(e) (2012); 17 C.F.R § 300.301 (2014).

judicially imposed parameters on recoverable losses.[201] Courts must therefore decide how to administer SIPC's obligations in light of an increasingly obsolescent statutory regime.[202] Some problems are evidentiary in nature, such as whether to recognize losses or honor expected profits from hypothetical positions resulting from unexecuted, unauthorized, fraudulent, or unethical transactions. Others are methodological, such as choosing the appropriate formula for equitably distributing a limited pool of customer property or deploying the SIPC Fund to cover customer claims. Still others may require inquiries into the sophistication and means of customers, such as in connection with the exercise of traditional avoidance powers in bankruptcy. I discuss each in turn.

1. Evidentiary Considerations

One set of problems stems from the difficulty of developing evidentiary rules for assessing claims based on the broker's mishandling of a customer's account—such as failures to execute trades, execution of unauthorized trades, suitability of transactions, or claims of fraud or other misconduct. Unlike claims for the recovery of property held in a securities account on behalf of the customer, claims based on trading authority and execution are broadly classified as unsecured contract claims against the broker's general estate. They are often relegated to this status alongside other contractual counterparties because the customer effectively seeks to recover expected gains or avoid losses resulting from a breach of instruction.[203] In a similar vein, judgments or arbitration awards resulting from claims of securities fraud or other actionable breaches of a broker–dealer's ethical obligations to its customers are generally classified as unsecured tort claims in bankruptcy on par with other judgment creditors of a broker's estate.[204]

From the perspective of public investors, however, there may be little distinction between protection for funds and securities converted through theft or mismanagement (which SIPA clearly covers) and those dissipated through fraud or breach of contract (which SIPA should not cover). Congress opened the door for ambiguity in SIPA's legislative history. For example—in the context of trading instructions—Congress envisioned SIPC coverage for "never purchased" securities. This decision seems understandable in light of the paperwork crisis prevailing at the time: if a broker–dealer confirmed the purchase of specific securities but the broker–dealer neglected to purchase them, the customer could claim entitlement to any appreciation in the value of the securities

201. Of course, courts have little difficulty rejecting claims when investors are complicit in fraud or themselves engage in securities law violations. *See, e.g.*, SEC v. Packer, Wilbur & Co., 498 F.2d 978, 984–85 (2d Cir. 1974) (examining how an "active and sophisticated" investor abused requirements for trading in cash account under Regulation T).

202. *Cf.* Donald Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 687–704 (1987) (discussing generally the efforts of federal courts to interpret the Glass–Steagall framework in light of the evolving business activities of banks).

203. *See, e.g.*, *In re* John Dawson & Assocs., Inc., 271 B.R. 561, 568 (Bankr. N.D. Ill. 2001) (holding that "a decision to allow the investor to retain the benefits of every profitable unauthorized trade while forcing SIPC . . . to insure and compensate such an investor for any unauthorized trade which proved unprofitable would run contrary to the stated purposes of SIPA"); *In re* Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) (holding that "[t]he failure to execute an order to buy securities gives rise to a breach of contract claim for damages, but is not a customer claim protected by the SIPA.").

204. *See, e.g.*, *In re* MV Sec., 48 B.R. 156, 160–61 (Bankr. S.D.N.Y. 1985) (noting that claims of fraud or overreaching "are not covered by SIPA and therefore not entitled to SIPC protection"); *see infra* Part V.B (discussing restitution funds).

that should have been purchased.[205] Congress never provided statutory guidance, however, as to how courts should distinguish cases worthy of SIPC coverage from those relegated to the general estate of the broker–dealer.

For example, extending SIPC coverage to instances of unauthorized trading poses an evidentiary conundrum because customers may be inclined to abuse the privilege of affirming or rejecting transactions in hindsight.[206] In such cases, SIPC has generally restored customer funds and securities positions to the status quo ante upon a showing of appropriate documentation that the customer promptly contested the unauthorized transaction.[207] Problems have nevertheless arisen when the SEC and SROs have given customers contradictory advice as to how to document unauthorized trading or when trustees have imposed more stringent evidentiary requirements through the claims process.[208]

Parallel compensation schemes, of course, may recognize an even broader variety of non-custodial claims. Florida's guaranty fund, for example, compensates claimants who are unable to collect on a judgment or arbitration award against a broker–dealer for fraudulent or unethical conduct in connection with the sale of a security.[209] The U.K.'s Financial Services Compensation Scheme (FSCS) similarly provides protection against losses arising from bad investment advice or poor investment management or misrepresentation when the firm is unable to pay claims against it.[210] Such funds are viable, in no small part, because they impose a variety of restrictions designed to minimize the amount and scope of relief, including lower caps on payouts and limitations on the range of investments covered, the scope of investors protected, and the type of losses claimed.[211]

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205. For example, SIPC Rule 501 provides that a customer has a "claim for securities" if the member firm has completed the transaction or, alternatively, has "sent written confirmation to the customer that the securities in question have been purchased for or sold to the customer's account." 17 C.F.R. § 300.501(a)(1), (2).

206. Such "cherry-picking" claims typically involve the purchase of a security that subsequently declines in value or the sale of a security that subsequently appreciates in value.

207. 17 C.F.R. §§ 300.500–.503 (covering claims for cash, securities, and voidable security transactions).

208. 2001 GAO REPORT, *supra* note 182, at 25–42 (discussing opportunities to improve the disclosure of SIPC's policies in liquidations involving unauthorized trading). For example, SIPC trustees have generally not considered instructions to trade or telephonic confirmation of trades to be sufficient, absent a written confirmation. SEC v. JNT Investors, Inc., No. 72 CIV. 681, 1978 WL 1137, at *1–2 (S.D.N.Y. Feb. 9, 1978) (citing *SEC v. S.J. Salmon & Co.*, 72 Civ. 560 (S.D.N.Y. 1973) and *SEC v. Howard Lawrence & Co.*, 4 CBC 1 (S.D.N.Y. 1975)) (explaining that failure to execute a sell order as instructed was insufficient to constitute a "customer claim"); *see also In re* A.R. Baron Co., 226 B.R. 790, 796–97 (Bankr. S.D.N.Y. 1998) (explaining that there is no "customer claim" without written confirmation of sale or a completed executory contract).

209. Florida Securities Act § 517.141 (2014).

210. UK FINANCIAL CONDUCT AUTHORITY, FCA HANDBOOK, COMP 5.5 (2013), *available at* http://fshandbook.info [hereinafter FCA HANDBOOK]; *see also* FINANCIAL SERVICES COMPENSATION SCHEME, PROTECTING YOUR MONEY: A GUIDE TO MAKING A CLAIM WITH THE FINANCIAL SERVICES COMPENSATION SCHEME (2013), *available at* http://www.fscs.org.uk/what-we-cover/publications/ (describing claims covered by the FSCS).

211. *See, e.g.*, Florida Securities Act § 517.141(1)–(2) (limiting payment to $10,000 per claim and no more than $100,000 aggregate for claims against any single broker–dealer). The UK FSCS similarly limits claims to £50,000. FCA HANDBOOK, COMP 10.2.3. Moreover, with respect to claims involving the management of investments, the UK FSCS covers only stocks and shares, unit trusts, futures and options, personal pension plans and certain long-term investments ("designated investment business" and "designated investments," as defined in the FCA Handbook Glossary); and generally limits protection to retail investors, small businesses, and charities. *Id.*, COMP 4.2.1 and 4.2.2. In addition, it does not pay compensation for expected profits. *Id.*, COMP 12.4.3. *See also* Florida Securities Act, § 517.141(1) (limiting claims to actual or compensatory losses).

Such schemes, however, present the difficulty of assessing claims of fraud and suitability, which require deeper analysis of factual context. Inquiries into the fiduciary character of the relationship between a broker–dealer and its customer may generate significant litigation costs.[212] For example, there may be little incentive for an insolvent broker–dealer to contest a civil claim, and every incentive to collude with its customer, if a compensation scheme will make the investor whole. Under these circumstances, SIPC relief may effectively become "a type of subsidy to firms that systematically engage in or allow their individual brokers to engage in risky or unethical behavior."[213] Unless adequate resources are committed to the detection of fraud and abuse, this, in turn, would have the effect of slowing the distribution of funds.

2. Methodological Considerations

A second set of issues relates to the methodology by which an investor's net equity is calculated, particularly in cases where honoring customer claims at face value "would give rise to an absurd result."[214] For example, in the course of a SIPC proceeding, customers might submit net equity claims for the value of fictitious transactions (and in some cases, fictitious securities), based on customer statements fabricated by the broker–dealer. In contrast with unauthorized trades or fraudulent securities, customer records in such cases do not remotely correspond to actual funds or securities held by the broker–dealer. As a result, the only practicable goal of a SIPC liquidation proceeding is to process claims against the SIPC Fund and to recover and distribute as fairly as possible any additional funds siphoned by the fraudster and its affiliates.[215]

The problem in such cases, of course, is that the expected profits are entirely arbitrary. Because the broker–dealer itself dictates the amount that appears on each customer's statement, such an approach would give the broker–dealer carte blanche to dictate the prorated *allocation* of recovered customer property among investors, regardless of their actual investment or interim withdrawals.[216] As a threshold matter, it may be inequitable to honor a customer's claims of profit at all if the customer could not reasonably believe

212. *See, e.g.*, *supra* note 145 (discussing issues litigated in the context of repurchase agreements).

213. Joo, *supra* note 3, at 1109.

214. *In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 135 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011).

215. Moreover, because SIPC imposes different limits on "cash" and "securities" claims, the methodology by which net equity claims are classified is just as important as how they are calculated. Congress adopted the differential guarantee structure for SIPC claims in large part because of the difficulty of explaining the role and purpose of SIPC coverage as compared to FDIC insurance for banks. Nevertheless, classifying transactions as "claims for securities" or "claims for cash" is a tricky exercise, which the SIPC Task Force believes has outlived its purpose. SIPC TASK FORCE REPORT, *supra* note 38, at 8–11. For example, if a broker–dealer confirms the purchase of a security for a customer account, but fails to execute the purchase, the customer would normally be entitled to a "claim for securities" equal to the value of the securities that should have been purchased. Customers have succeeded in persuading courts to extend that logic to purchases of fictitious securities based on the customers' expectation of the higher amount of SIPC coverage. *In re* New Times Sec. Servs. Inc., 371 F.3d 68, 68 (2d Cir. 2004). *But see In re* First Ohio Sec. Co., 39 F.3d 1181, 1181 (6th Cir. 1994) (ruling that certain claims involving fictitious securities should be treated as claims for cash).

216. Steven M. Sheffrin, *Restitution for Ponzi Scheme Victims: The Symbiotic Relationship of Tax and Securities Law*, 10 RUTGERS BUS. L.J. 21, 53 (2013). For example, assume customers A and B each invest $1,000,000 in a Ponzi scheme in 2010, but receive customer statements that report a final balance of $4,000,000 and $2,000,000 respectively on their investments in 2013. Under the financial statement method, any customer property recovered would be prorated among A and B's claims in a 2:1 ratio.

the scheme was viable.[217] Nevertheless, for smaller liquidations, SIPC trustees may generally find it expedient to honor customer claims based on cash and securities positions described in customer statements (the "financial statement method"), particularly when the cost of extending SIPC coverage to such positions may be negligible, the cost of litigating is wasteful, or equivalent securities may be sourced from the broker's proprietary inventory or public markets.

In liquidations involving Ponzi schemes, however, SIPC trustees have opted to calculate "net equity" using records of cash transfers between the customer and the broker. Indeed, courts have opined that the tally of cash deposits and withdrawals under this "net investment method" might well be the only "verifiable amounts that are manifest from the books and records."[218] Among other virtues, courts have argued that the net investment method is "harmonious" with the avoidance provisions of the Bankruptcy Code and "avoids placing some claims unfairly ahead of others," particularly when SIPC advances cannot make up the difference.[219] More generally, it is consistent with the traditional philosophy of loss compensation undergirding securities litigation and the spirit of restitution under traditional common law fraud.[220] The "net investment method" is of course unpopular with investors because the customer's net investment is likely to be substantially lower than the inflated balances on its customer statements.[221]

Granting the SIPC trustee discretion to select from among methodological choices, however, places courts in the difficult position of making decisions about investors' "legitimate expectations" in the absence of statutory guidance.[222] For example, in the case

217. *In re* New Times Sec. Servs. Inc., 463 F.3d 125, 130 (2d Cir. 2006) (quoted by *In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 135 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011)). *See, e.g.*, *In re* Old Naples Sec., 311 B.R. 607, 607, 613–15 (M.D. Fla. 2002) (rejecting customer status for broker's willful ignorance as to the ability of bond transactions to generate "extraordinarily high rates of return" promised by defunct broker); *In re* Adler, Coleman Clearing Corp., 277 B.R. 520, 559–63 (Bankr. S.D.N.Y. 2002) (granting no relief to a customer who was willfully blind to broker's wrongful conduct and tried to conceal aspects of the transaction in his testimony).

218. *In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 135 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011).

219. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 499 B.R. 416, 428 (S.D.N.Y. 2013).

220. *Id.* at 422 (discussing non-SIPA claims).

221. In this vein, for example, investors may argue that they will have filed tax returns reporting profits based on such fictitious income and entered into other financial arrangements based on "legitimate expectations" to such income. The IRS's treatment of losses in Revenue Ruling 2009-09 and Revenue Procedure 2009-20, to a degree, strives to complement the "net investment method" by allowing investors to fully recoup taxes paid on fictitious income. Rev. Rul. 2009-09 I.R.B. 2009-14, *available at* www.irs.gov/pub/irs-drop/rr-09-09.pdf; Rev. Proc. 2009-20 I.R.B. 2009-14, *available at* www.irs.gov/pub/irs-drop/rp-09-20.pdf. In particular, the Revenue Procedure permits "qualified investors" to deduct as a "theft loss" a substantial percentage of the total amount of net income with respect to certain "specified fraudulent arrangements" that, "consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year," less any actual recovery or payment from SIPC. *Id.* at 7–8; *see* Sheffrin, *supra* note 216, at 36 (observing that the "keys to the IRS's treatment of Madoff-like Ponzi schemes are: 1) the taxpayer's loss is characterized as a theft loss, not a capital loss, and (2) the theft loss that was incurred was characterized as a transaction entered into for profit").

222. *See, e.g.*, *In re* New Times Sec. Serv., Inc., 371 F.3d 68, 87 (2d Cir. 2004) (discussing competing arguments advanced by the SEC and SIPC as to the "legitimate expectations" of investors with respect to "non-existent securities"); *see also In re* Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229, 236 (2d Cir. 2011) (considering BLMIS customers' "legitimate expectations" with respect to recovery of the balances reported on their customer statements in light of the methodological approach prescribed by SIPA).

of long-lived frauds, the net investment method may not account for inflation or the time value of money. As a result, the SEC and other commentators have suggested that trustees consider either adjusting cash flows for inflation (a "constant dollar" approach) or applying a "low, safe interest rate" to compensate longer-term investors.[223] Courts have nevertheless rejected the task of selecting from among such methodologies as "irrational and unworkable" in the absence of statutory guidance.[224] Critics meanwhile surmise that SIPC encourages trustees to minimize SIPC's liability (and thus the need to raise assessments or borrow funds) by selecting methodologies that result in the least cost to SIPC.[225]

3. Relevance of Sophistication and Means

SIPA, on its face, does not discriminate among customers based on size or status. Nevertheless, a SIPC trustee may be able to treat customers differently based upon an assessment of their conduct and in light of their relative sophistication and means. Consider, for example, the problem of clawing back returns received by early investors in a Ponzi scheme: when net equity claims are calculated on the basis of net cash flows, there may be "net winners" (investors who have withdrawn more than they have invested) in addition to "net losers" (investors who have invested more than they have withdrawn). In such cases, a SIPC trustee might seek to use its avoidance powers in bankruptcy to claw back some or all of amounts paid out to early investors to enforce fair treatment of all investors.[226] The exercise of such powers, however, may require (or permit) the trustee to disproportionately claw back funds from some investors while leaving others relatively unscathed.

In general, avoidance powers permit the trustee of the estate of a debtor to recover payments from transferees in a variety of circumstances:[227] for example, if the firm made

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223. 2012 GAO INTERIM REPORT, *supra* note 45, at 28–31 (noting that the SEC voted to support the "constant dollar" method, but determined to revote after discovery that the SEC's then-General Counsel was subject to a conflict of interest). Steve Sheffrin, for example, suggests that an inflation-adjusted net investment method might, from a welfare analysis perspective, be the approach that is fairest and easiest to administer. Sheffrin, *supra* note 216, at 53.

224. *See, e.g.*, *In re* New Times Sec. Serv., Inc., 371 F.3d 68, 88 (2d Cir. 2004) (rejecting proposal to restore purported dividend reinvestments in fictitious mutual funds on the grounds that the amounts would be arbitrary and leave the SIPC Fund unacceptably exposed). Likewise, in *In re BLMIS*, the court held that building in a guaranteed return for investors would "eliminate the market risks that are inherent in securities" and "yield an outcome for which the [investors] never bargained and [which] SIPA never intended to protect." Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 496 B.R. 744, 756–61 (Bankr. S.D.N.Y. 2013).

225. *See, e.g.*, *id.* at 754–61 (finding that the "[t]rustee's Net Investment Method unadjusted for Time–Based Damages is legally sound in light of the plain language, purpose, framework and distribution scheme of SIPA, as well as Second Circuit precedent"); *supra* note 45 and accompanying text.

226. SIPA provides that, in the event of a shortfall in customer property, "the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of [the Bankruptcy Code]." 15 U.S.C. § 78fff-2(c)(3) (2012).

227. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-12-991, SECURITIES INVESTOR PROTECTION CORPORATION: CUSTOMER OUTCOMES IN THE MADOFF LIQUIDATION PROCEEDING 58–65 (2012) [hereinafter 2012 GAO OUTCOMES REPORT] (discussing how the avoidance powers of a trustee operate in the context of a Ponzi scheme); Mallory A. Sullivan, *When the Bezzle Bursts: Restitutionary Distribution of Assets After Ponzi Schemes Enter Bankruptcy*, 68 WASH. & LEE L. REV. 1589, 1610–15 (2011) (same); *see generally* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998) (same).

the payment shortly before a bankruptcy filing ("preferential transfers"),[228] if the firm made the payment with actual intent to hinder, delay or defraud its creditors ("actual fraudulent transfers"),[229] or if the firm made the payment in exchange for less than "reasonably equivalent value" ("constructive fraudulent transfers").[230] In the case of Ponzi schemes, courts have generally presumed that Ponzi scheme payouts are actually fraudulent and that transfers beyond the return of the investor's principal lack value, making those transfers recoverable as both actual and constructive fraudulent transfers.[231]

A trustee's ability to recover not only payments of fictitious profits but also repayments of principal from an investor in a Ponzi scheme nevertheless generally turns on whether the investor can successfully assert the "good faith" defense available under the Code.[232] For example, transfers up to the amount of the investor's principal may be protected against avoidance if the investor can establish that "there were no facts surrounding his dealings with the debtor to put him on inquiry notice of the debtor's fraud or insolvency."[233] In assessing the objective good faith of an investor in an ordinary bankruptcy proceeding, courts may look to a number of factors, such as "the investor's level of business knowledge and experience (including education), other investments made, the returns earned on such investments, and the nature of the investigation conducted by the investor in making such investments."[234]

In the Madoff liquidation, by contrast, the district court allowed the SIPC trustee to claw back transfers in excess of the principal invested within the two years that preceded the issuance of the SIPC protective decree,[235] but prohibited the avoidance of transfers representing the return of such principal unless such payments were received in "willful blindness" of the operation of Madoff's scheme.[236] The court justified applying a "subjective standard" in lieu of inquiry notice because fraud, in the context of federal

228. 11 U.S.C. § 547 (2012) (permitting avoidance of transfers up to 90 days prior to the bankruptcy filing, and one year for certain insiders).

229. *Id.* § 548(a)(1)(A) (permitting avoidance of actual fraudulent transfers up to two years prior to filing).

230. *Id.* § 548(a)(1)(B) (permitting avoidance of constructive fraudulent transfers up to two years prior to filing).

231. *See, e.g.*, Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 476 B.R. 715, 725 (S.D.N.Y. 2012) (concluding that transfers from Madoff Securities to defendants that exceeded the return of defendants' principal, i.e., that constituted profits, were not "for value"); 2012 GAO OUTCOMES REPORT, supra note 227, at 60–61 (discussing the treatment of Ponzi schemes).

232. Under the provisions of the Code governing actual fraudulent transfers, a transferee may retain the interest transferred, notwithstanding the debtor's intent to defraud its creditors, only if she "takes for value and in good faith" to the extent of the value given to the broker. 11 U.S.C. § 548(c) (2012). The trustee may generally avoid payments representing the return of principal that qualify as "preferential transfers" as well. 2012 GAO OUTCOMES REPORT, *supra* note 227, at 59–60.

233. McDermott, *supra* note 227, at 176–77.

234. *Id.* at 178–79. According to McDermott, "courts have held that the investor has the burden of proof and that the good faith inquiry is an objective one—the duty of care that the investor must exercise is that of a reasonable person." *Id.* at 176.

235. While a broader range of fraudulent transfers might have been avoided under New York state law, Judge Rakoff invoked a safe harbor for certain securities settlement transfers to limit the scope of avoidance to actually fraudulent transfers under the Bankruptcy Code. *Id.* § 546(e). Nancy Rapoport suggests that application of the section 546(e) safe harbor might properly have been deemed a question of fact, as intimated by Judge Wood's prior opinion. Nancy B. Rapoport, *Black Swans, Ostriches, and Ponzi Schemes*, 42 GOLDEN GATE U. L. REV. 627, 629 (2012).

236. Picard v. Katz, 462 B.R. 447, 454 (S.D.N.Y. 2011), *abrogated on limited grounds by* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 513 B.R. 437 (S.D.N.Y. 2014).

securities law and thus a SIPC liquidation proceeding, "demands proof of scienter."[237] As a result, the court effectively placed the burden on the trustee to establish the point at which "red flags" were so prevalent that, in Nancy Rapoport's words, "investors should have known that they should have been asking Madoff a few questions."[238]

While clawbacks may be viewed as a tool for favoring the "haves" over the "have nots,"[239] requiring a SIPC trustee to make allegations of relative culpability or deliberate indifference to claw back payments might nevertheless lead investors to perceive the trustee's avoidance tools as an "instrument of investor oppression and harm," rather than investor protection.[240] Arguably, sophisticated investors who attest to "accredited" status and understand the importance of formal account relationships must appreciate that they take calculated risks when they participate in schemes that offer consistent, above-average returns.[241] From the perspective of investors, however, it is difficult to stomach clawbacks based on allegations of relative culpability or deliberate indifference when regulators fail to detect (or worse, fail to act on) many of the same "red flags" that investors are accused of ignoring.[242]

The trustee's inability to pursue other culpable parties only fuels this perception. For example, the SIPC trustee (as representative of the broker–dealer's estate) may be equitably estopped from asserting "claims against third parties for participating in a fraud that [the broker–dealer] orchestrated"—such as unjust enrichment, breach of fiduciary duty, aiding and abetting fraud, conversion, or negligence.[243] Investors subjected to clawbacks may therefore be perplexed as to why the trustee does not actively pursue such aiders and abettors, instead of aggrieved investors such as themselves who have already suffered paper losses, to recover assets for the benefit of the broker–dealer's estate.

V. BALANCING SUBSTANCE AND SEMBLANCE

However flawed Congress's approach in designing SIPC may seem in hindsight, commentators routinely caution that the political and social costs of changing investor expectations may be "too great even though the [current] approach is no longer appropriate

237. *Id.* at 455 (observing that the difference between the trustee's proposed "inquiry notice" approach and the "willful blindness" approach applied by the court "is essentially the difference between an objective standard and a subjective standard").

238. Rapoport, *supra* note 235, at 639.

239. *Id.*

240. *Stein Testimony*, *supra* note 78, at 214.

241. *See, e.g.*, McDermott, *supra* note 227, at 178 (noting that courts consider "the disparity between prevailing market rates of return and the rates of return promised by the debtor on investments in its scheme" as a factor in assessing the application of the "good faith" defense).

242. *See* Sullivan, *supra* note 227, at 1621 (suggesting that the practice of routinely denying knowledgeable investors the "good faith" defense is "problematic" insofar as "savvy investors are presumably held to a higher standard than governmental monitoring agencies"). Proposals for legislative reform, for example, condition clawbacks from non-professional intermediaries on actual knowledge or complicity, while holding broker–dealers, investment advisers, and other fiduciaries to a higher negligence standard. *See, e.g.*, S. 1725, 113th Cong. (2013).

243. *In re* Bernard L. Madoff Inv. Sec. LLC., 721 F.3d 54, 64 (2d Cir. 2013) (applying the in pari delicto doctrine under New York law). Moreover, to reach the assets of affiliates, SIPC must invoke bankruptcy doctrines of uncertain application—such as "substantive consolidation." *See, e.g.*, SEC v. Sec. Investor Prot. Corp., 758 F.3d 357, 364–65 (D.C. Cir. 2014) (avoiding the issue of "substantive consolidation" of Stanford Group Company with its affiliates).

for changed conditions."[244] SIPC, in particular, must navigate three contentious relationships: (1) a public relations relationship with securities investors, in which SIPC has difficulty articulating the limitations of its statutory mandate and resources; (2) a financial relationship with the brokerage industry, which balks at more costly internal controls and regulation to contain outlier events and higher assessments to fund unquantifiable demands; and (3) a regulatory relationship with the SEC and SROs, which call on SIPC to provide greater relief in the wake of their own inability or unwillingness to devote scarce recourses to compliance inspection and enforcement.

If SIPA is perceived a policy failure, any legislative solution must realign SIPC's relationship with securities investors, the securities industry, and securities regulators to bridge the gap between "legitimate expectations" and "market reality." This is no mean feat, not the least because any step in favor of one of these constituencies is likely to come at the expense of one or both of the others. Consider for example the advantages and disadvantages of the following two paradigms, each of which might well represent a viable evolutionary path for SIPC:

- A government-operated industry utility that exists primarily to facilitate inter-broker transfers of customer accounts by indemnifying bidders against shortfalls in customer property in the event of a broker's insolvency, without committing to provide advances directly to customers of an insolvent broker in the event of a large-scale liquidation in which no orderly transfer is possible; and
- A restitution fund that exists to provide partial compensation for out-of-pocket losses suffered by retail investors, through advances against sums recovered through criminal, civil and administrative proceedings and an industry-sponsored fund, following certain "specified fraudulent arrangements" committed by securities brokers.

In an ideal world, SIPC could achieve both: given the staggering and unpredictable liabilities to which SIPC might be subject, however, there may just be enough political will to achieve one of these aims if the volume of future claims grows disproportionately to SIPC's current funding structure.

A. Substance, Without Semblance?: SIPC as Bidder Indemnification Fund

One approach to reimagining SIPC's role is to reframe SIPC exclusively as an industry utility to facilitate the resolution of a securities or futures broker. Under such an approach, the SIPC Fund would play the modest but critical role of indemnifying the bulk transfer of customer accounts. If the trustee in bankruptcy is able to find a bidder willing to acquire some or all classes of customer accounts of the defunct broker–dealer, SIPC would top up any shortfall in the accounts up to the statutory limit.[245] If no bidder materializes—for example, in the case of brokers too toxic to handle, such as BLMIS and

244. Joo, *supra* note 3, at 1148–49.

245. For example, indemnification by the SIPC Fund might be mandated whenever the trustee for the estate of a broker–dealer enters into a definitive asset sale with a bidder who is willing to shoulder the risk of liability for a class of accounts specified by law. This would discourage SIPC trustees and bidders from cherry-picking accounts of a defunct broker. Joo, *supra* note 3, 1110–11. A secondary role would be to assure completion of open transactions for accounts in which one of the parties is a public customer for the mutual benefit of all broker–dealers. The fund would have to retain discretion to advance funds or provide greater indemnification when the benefits to the industry outweigh the costs. *Id.*

SGC—customer accounts would be liquidated in accordance with the stockbroker liquidation provisions of the Bankruptcy Act; customers of such broker–dealers would mostly get pennies on the dollar and no SIPC advance.[246]

The appeal of such a structure is that it might create a unique opportunity to harmonize the treatment of securities and futures accounts by allowing one fund to backstop all classes of transferable customer accounts.[247] Following the failures of futures brokers such as MF Global, participants in the futures industry have proposed the creation of guaranty funds similar to SIPC that would offer the benefits of speedy account transfers in the event of a futures broker's insolvency without the additional costs entailed in creating a full-scale public insurance scheme like SIPC.[248] Much like the funds maintained by existing securities and futures exchange clearinghouses, such a fund would exist largely for the protection of members that agree to the expeditious bulk transfer of customer accounts.[249]

The drawback of such an approach is that it would undoubtedly provoke a fairly significant short- to medium-term investor relations crisis for Congress and the SEC. There is no reason to believe that investors will perceive a shift in SIPC's role solely to "bidder indemnification" as anything less than a wholesale governmental retreat from investor protection.[250] As public awareness of SIPC's existence and role has ebbed, however, expansive SIPC coverage against all varieties of broker fraud may well be unnecessarily wasteful in light of the minimal role it plays in guaranteeing investor confidence.[251] Dodd–Frank has arguably usurped much of SIPC's discretion over the management of the estate

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246. For smaller liquidations, SIPC could continue to offer a nondiscretionary "direct payment procedure." *See* SIPC TASK FORCE REPORT, *supra* note 38 (noting that SIPC has proposed raising the threshold for application of the direct payment procedure to $5,000,000 in customer assets).

247. An even more ambitious proposal might have SIPC assume exclusive or concurrent responsibility for the examination of its members with respect to applicable financial responsibility rules—including with respect to both securities and commodities accounts—by giving it formal SRO status or combining its operations with an existing SRO such as FINRA. *See, e.g.*, 15 U.S.C. § 78q(d) (2012) (permitting such delegation to an SRO). As a result of the demutualization of most registered exchanges over the past few decades, virtually all SROs have delegated the responsibility to examine SIPC members for compliance with the SEC's financial responsibility rules to FINRA, as "designated examining authority," under Rule 17d-1. 17 C.F.R. § 240.17d-1 (2014). This development significantly reduces political and administrative impediments to such a reorganization.

248. *See, e.g.*, H.R. 3009, 113th Cong. (2013) (proposing a Futures Investor Protection Corporation); Laura Goldsmith, *The Collapse of MF Global and Peregrine Financial Group: The Response From the Futures Industry, Regulators, and Customers*, 32 REV. BANKING & FIN. L. 25, 33–37 (2012) (discussing various proposals); Futures Investor and Customer Protection Act Proposal (2012), http://commoditycustomercoalition.org/wp-content/uploads/2012/08/FICPA-3-Point-Proposal-PDF-2.pdf (proposing the creation of an investor guaranty fund); *see also* Bart Chilton, Commissioner, CFTC, The Plan, Stan—Moving Forward on a Futures Insurance Fund, Statement on the Futures Investor and Customer Protection Act (FICPA) Proposal (Aug. 9, 2012), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement080912.

249. Guttman, *supra* note 3, at 905–07; Hugh L Sowards & James. S. Mofsky, *The Securities Investor Protection Act of 1970*, 26 BUS. LAW. 1271, 1275–76 (1971).

250. OFFICE OF AUDITS, U.S. SEC. AND EXCHANGE COMM'N, REPORT NO. 495, SEC'S OVERSIGHT OF THE SECURITIES INVESTOR PROTECTION CORPORATION'S ACTIVITIES 28–32 (Mar. 2011) [hereinafter SEC REPORT NO. 495] (finding that "many investors still do not sufficiently understand certain limitations on the coverage SIPA provides and the protection against losses resulting from broker–dealer failures" despite the investor education efforts of the SEC, SIPC, and the self-regulatory organizations). This criticism has been echoed for over a decade. 2003 GAO REPORT, *supra* note 67, at 16–20; OFFICE OF AUDITS, U.S. SEC. AND EXCHANGE COMM'N, REPORT NO. 301, OVERSIGHT OF SECURITIES INVESTOR PROTECTION CORPORATION 7 (Mar. 2000).

251. SEC REPORT NO. 495*, supra* note 250, at 29 (finding that "most investors are unaware of SIPC and SIPA until they learn about their broker–dealer's liquidation or failure").

of systemically significant brokers by placing key decisions about asset sales and reorganization of the broker–dealer's business in the hands of the FDIC, the SEC, and other financial regulators.[252] In such cases, SIPC would seem to function as no more than an instrument for satisfying customer claims out of customer property.[253]

A larger question is whether SIPC, so managed, could resist the temptation to become an industry pawn—e.g., oversubsidizing transactions that have positive externalities for other firms while undersubsidizing transactions that do not.[254] Today, SIPC is arguably indifferent to resolution of a defunct broker–dealer's customer estate by liquidation or transfer of its customer accounts because customers always have recourse to the SIPC Fund. For firms that are not too-big-to-fail or too-small-to-notice, the trustee might resist providing sufficiently generous terms to a potential bidder to warrant a transfer of assets—in the absence of a compelling industry interest in bailing out the firm's customers—out of a desire to conserve SIPC resources.[255] One possible solution is to place appointment of the trustee in the hands (or subject to the approval of) a publicly accountable agency such as the SEC or CFTC (or both, in the case of a dually registered firm).[256]

B. Semblance, but How Much Substance?: SIPC as Public Restitution Fund

A more populist approach to reforming SIPC would transform it into a utility of the SEC and other enforcement agencies for compensating investor losses resulting from broker–dealer misconduct. Two features of the SIPA liquidation regime arguably make it attractive to investors with claims grounded in fraud or misconduct: (1) the familiarity of the SIPC claims process; and (2) the prospect of obtaining a SIPC advance to compensate for investment losses. For broker–dealer liquidations involving criminal, civil or administrative antifraud actions, the SEC or Department of Justice might thus empower SIPC to administer a restitution fund, with the expectation that SIPC could provide limited advances from the SIPC Fund to compensate customers for investment losses pending the

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252. For example, a determination to appoint the FDIC as receiver for certain covered financial entities must be made by a supermajority vote of the FDIC and the Federal Reserve Board, or in the case of a broker–dealer or a firm whose largest subsidiary is a broker–dealer, the SEC and the Federal Reserve Board. 12 U.S.C. § 5383(a)(1) (2012).

253. 12 U.S.C. § 5385(b) (2012) (limiting SIPC's powers "with respect to assets and liabilities transferred by [the FDIC] from the covered broker or dealer to any bridge financial company" and prohibiting SIPC from taking any action "to impair or impede the exercise of the powers and duties" of the FDIC with respect to certain statutory actions). The FDIC may not, however, exercise its powers in a manner that would "adversely affect the rights of a customer to customer property or customer name securities," "diminish the amount or timely payment of net equity claims of customers," or "otherwise impair the recoveries provided to a customer" under SIPA. 12 U.S.C. § 5385(d)–(f).

254. *Cf.* H.R. Rep. 91-1613, *reprinted at* 1970 U.S.C.C.A.N. 5254, 5257 (noting, at the time of SIPA's enactment, that the New York Stock Exchange justified its refusal to deploy its trust fund to protect the customers of certain of member firms based on "the voluntary nature of the trust fund"); Guttman, *supra* note 3, at 906–07 (describing the Exchange's resistance to binding itself to indemnifying customers of failed members).

255. While the trustee presumably would not have the discretion to offer less than the statutory amount of coverage, the discretion to exceed statutory limits (which trustees enjoy today and which would probably be necessary as a matter of efficiency) or to put account classes up for bid in different configurations might affect the desirability of acquiring a package of accounts through a bulk transfer.

256. *See, e.g.*, S. 1725, 113th Cong. (2013) (proposing that the trustee for a broker's estate in bankruptcy be appointed from a list maintained by the SEC). Conversely, such appointment might lead to the opposite result of oversubsidizing transfers to avoid public blame.

completion of enforcement proceedings.[257] This model might be further enhanced by requiring claim submitters to assign private rights of action relating to the alleged fraud to the fund administrator with a view to obtaining more relief through public enforcement, or alternatively, consolidating private antifraud litigation in a single "public class counsel."[258]

In recent years, scholars have examined the effectiveness of federal and state enforcement officials in developing protocols for compensating investor losses stemming from securities fraud, whether as a complement to or substitute for private litigation.[259] Since the 1990s, the SEC and other administrative agencies have sought to set aside a portion of civil money penalties or disgorgement payments for the benefit of investors harmed by the violation.[260] The fair funds provisions of the Sarbanes–Oxley (SOX) Act further legitimated the practice of directing civil penalties to compensate victims of securities fraud.[261] While many commentators express skepticism about the wisdom of pursuing criminal, civil or administrative penalties against issuers, regulators' ability to seek penalties against control persons, aiders and abettors, and other secondary violators may make such restitution funds a preferable alternative to revisiting the scope of private rights of action.[262]

SIPC's established role as an investor protection fund may help institutionalize the allocation of such fair funds to compensate customers of securities firms. Some commentators argue, for example, that regulators have failed to develop "many of the well-developed procedures for compensating victims that characterize large-scale private litigation," such as procedures designed "to ensure that victims are heard, to formulate

257. *See, e.g.*, H.R. 827, 113th Cong. (2013) (proposing to amend SIPA to provide "one-time payment[s] from the SIPC Fund" for customers pending a liquidation proceeding in an amount equal to the lesser of the customer's net equity claim and $500,000).

258. *Cf.* Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1109 (2008) (proposing the concept of a "public class counsel" as a "governmental actor . . . that undertakes actions on behalf of consumers or employees [and] obtains compensation for private parties"); *see, e.g.*, H.R. 1987, 112th Cong. (2011) (proposing to prohibit SIPC relief to an indirect Ponzi scheme investor that has filed a lawsuit against the Ponzi scheme investor, the Ponzi scheme, or the SIPC trustee). The CFTC already enjoys some such authority with respect to the recovery of customer property in commodities accounts. *See supra* note 180.

259. For example, as discussed below, the SEC believes that restitution funds can work in tandem with private litigation to redress securities fraud. Adam S. Zimmerman, *Distributing Justice*, 86 N.Y.U. L. REV. 500, 541 n.194 (2011).

260. *Id.* at 527–28. In criminal cases, courts are often empowered to order restitution to the victim of offenses against property (including offenses committed by fraud) or to remit property forfeited by a defendant to innocent persons. 18 U.S.C. § 3663A (2012). The impracticability of identifying victims and calculating their losses poses the same problems in the context of such proceedings. *Id.* § 3663A(c)(3); *see also* Hurt, *supra* note 108, at 968 (observing that, in the Madoff case, restitution was not feasible at sentencing and was directed to the DOJ as part of a remission of forfeiture proceeding).

261. SOX permits the SEC to add any civil penalty collected against an individual in a judicial or administrative action under federal securities law to any disgorgement fund for the benefit of victims. 15 U.S.C. § 7246 (2012). The SEC enjoys great flexibility in designing a plan of distribution with respect to any such fund. 17 C.F.R. § 201.1100 (2014).

262. *See, e.g.*, Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 335–36 (2008) (observing that "the SEC has important advantages over private plaintiffs" in recovering funds "because it is not encumbered by the restrictions . . . imposed on private plaintiffs in Rule 10b-5 actions," while expressing skepticism about the wisdom of this asymmetry); Winship, *supra* note 258, at 1132–33 (reasoning that "using the SEC to compensate investors makes sense only in limited circumstances," such as in aiding and abetting cases where "the only possible recovery is through an SEC action").

guidelines for payment, and to encourage effective judicial review."[263] By contrast, SIPC and SIPC trustees have significant experience in retrieving assets from defunct broker–dealers and developing procedures for, or calculating, allowed claims. Meanwhile, a SIPC-administered restitution fund might solve some of the procedural obstacles faced by SIPC trustees when recovering customer property on behalf of customers.[264] At the same time, DOJ and SEC oversight might provide greater assurance that the trustee's legal and administrative costs are justified in relation to assets expected to be recovered.

More important, such an approach would empower the SEC and SIPC to provide relief to a broader class of claimants—including nontraditional "customers"—by simultaneously tiering relief in relation to the type, sophistication, culpability, and means of claimants. If the public aim of SIPC coverage is to boost the confidence of small investors in securities markets, a SIPC-administered restitution fund might prioritize small claims through a more progressive structure than simple proration and a cap on advances.[265] After all, the relative sophistication of investors—and their ability to monitor a broker–dealer's operations—ought to play some role in determining how they are treated as part of a liquidation proceeding.[266] A more aggressive approach might even restrict coverage to publicly traded securities, registered mutual funds, and other retail investment products:[267] frauds involving private placed securities or confidential investment management strategies, for example, are comparably difficult for regulators to oversee relative to retail products.[268]

263. Zimmerman, *supra* note 259, at 505. Under the SEC's current rules of practice, for example, the SEC or hearing officer in a case must develop ad hoc plans for administration of fair funds or disgorgement funds to handle custody of funds, classification and notification of claimants, administration of the claims process, and other ministerial obligations. 17 C.F.R. § 201.1101 (2014) (SEC rules on fair funds and disgorgement plans).

264. *Supra* note 243 and accompanying text. In its nominal capacity as representative of the estate of a primary violator, the SIPC trustee may be estopped from asserting securities fraud or other claims against primary and secondary violators complicit in the broker–dealer's scheme, although customers could assign to SIPC any private right of action against additional primary violators. Sec. Investor Prot. Corp. v. Bernie L. Madoff Inv. Sec., LLC, 987 F. Supp. 2d 311, 316–20 (S.D.N.Y. 2013) (permitting assignment of claims, notwithstanding the fact that New York's in pari delicto doctrine would preclude the broker–dealer's estate from pursuing such a claim directly); *In re* MF Global, 505 B.R. 623, 632–33 (S.D.N.Y. 2014) (permitting assignment of claims). The resulting action, however, would be treated as a class action and would face the same procedural hurdles and heightened pleading burdens faced by private litigants in civil actions. *Bernie L. Madoff Inv. Sec., LLC*, 987 F. Supp. 2d at 316–20 (finding that the assigned claims would be treated as a class action for purposes of assessing state-law preclusion under the Securities Litigation Uniform Standards Act of 2008).

265. *See, e.g.*, H.R. 6695, 112th Cong. (2012) (requiring trustee to make a distribution based on a "fair and reasonable methodology" with consideration given to the "typical, non-professional investor," when allocations based on customer statements would otherwise be "unfair and inequitable to a substantial segment of customers" and "would not fully serve the remedial purposes" of SIPA); H.R. 1987, 112th Cong. (2011) (proposing to provide limited relief of up to $100,000 to indirect victims of Ponzi schemes, provided they were not "complicit" in the scheme and were not registered (or required to be registered) with the SEC).

266. The Network for Investor Protection and Action (NIAP), for example, has criticized the Madoff liquidation, among other reasons, because the majority of investors in the Madoff fund were individual investors, but roughly 75% to 90% of the customer property will be distributed to institutional entities. *Stein Testimony*, *supra* note 78, at 216.

267. *See supra* note 210 and accompanying text (discussing designated investments covered by the U.K.'s compensation scheme).

268. *Cf.* Jonathan D. Glater, *Hurdles of Different Heights for Securities Fraud Litigants of Different Types*, 2014 COLUM. BUS. L. REV. 47 (2014) (discussing how investors trading in public markets or purchasing shares in public offerings face more hurdles when claiming fraud than sophisticated investors in private placements, notably because of the heightened pleading requirements for securities fraud class actions). Moreover, investors

A fundamental premise of creating a public restitution fund is that enforcement officials and SIPC, working together, can develop clear ex ante evidentiary, methodological, and eligibility rules for advances and distributions that set legitimate expectations for investors without creating perverse incentives for broker–dealers, regulators, customers and counterparties. First, federal law often provides nebulous definitions of who may qualify as a "victim" for purposes of existing compensation funds: a narrower definition would be necessary to eliminate claims unrelated to the goal of promoting "investor confidence."[269] Moreover, a SIPC restitution fund might only be authorized in cases where civil or criminal proceedings have been initiated against a broker–dealer, akin to the IRS's "specified fraudulent arrangement" test.[270] In addition, the articulated goal of such a restitution fund should strictly be to compensate investors for loss (akin to the "net investment method" of calculating equity claims), rather than expected gains.[271] Standard protocols for submitting claims for restitution, likewise, may need to be tailored by enforcement officials, SIPC personnel, and representatives of affected classes of investors—subject to judicial review—to ensure fair treatment of investors in individual cases without routinely depleting the fund.[272]

Such a structure, while perhaps more palatable to investor advocates, might well open a Pandora's Box of issues. First, to the extent that SIPC's only source of funds is currently the annual member assessment, Congress would be forced to raise levies or broaden SIPC base to meet the expected claims resulting from such an expansion. Otherwise, aggrieved investors could only look forward to receiving token compensation for their losses to the extent that annual claims of broker–dealer fraud might regularly dwarf the balance currently maintained by SIPC many times over.[273] Risk-based assessments may take the edge off of such costs to a degree, even though they lack any demonstrable correlation with SIPC outlays.[274] Calls for more progressive levies would further exacerbate tensions

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ought to be aware of the enhanced risk of fraud from investments made based on exemptions from securities law or that require a representation that the purchaser is an "accredited investor" or "qualified purchaser" with respect to the investment.

269. The definition of "victim" under U.S. federal criminal law, for example, includes any "person directly and proximately harmed as a result of the commission of an offense for which restitution may be ordered." 18 U.S.C. § 3663 (2012).

270. *See supra* note 221 (discussing the IRS's "specified fraudulent arrangement" test). Moreover, the DOJ and SEC would retain the discretion to consider, as an enforcement matter, whether the relative size and variability of claims against a defunct broker–dealer are more efficiently handled through private class action litigation, rather than a restitution fund created through disgorgement or civil penalties. Zimmerman, *supra* note 259, at 505–07, 557–59.

271. *But see* S. 1725, 113th Cong. § 2(b) (2013) (proposing to require use of the financial statement method, unless the trustee determines that such allocations would be "unfair and inequitable to a substantial segment of customers and would not fully serve the remedial purposes of the Act"); H.R. 3482, 113th Cong. (2013) (same, unless the firm's books and records indicate the statement is inaccurate).

272. Zimmerman, *supra* note 259 at 530, 564 (discussing negotiated rulemaking process).

273. The FBI Financial Crimes Report in 2006 (prior to the recent financial crisis) estimated that claims for investment fraud in the United States amount to approximately $40 billion a year, [of which] six billion dollars in losses a year were due to market manipulation alone. FBI, FINANCIAL CRIMES REPORT TO THE PUBLIC 8 (2006), *available at* http://www.fbi.gov/stats-services/publications/fcs_report2006/financial-crimes-report-to-the-public-2006-pdf. As amici in *SEC v. SIPC* noted, this excludes the heightened administrative cost of processing increasingly complex customer claims. Stanford Amici Brief, *supra* note 6, at 21.

274. *See supra* Part II.C (discussing the SIPC Fund's role in the SIPA framework); *see also* CHICAGO MERCANTILE EXCHANGE RULEBOOK, Rule 816 (providing for risk-based contributions to the exchange's Base

between larger firms and smaller firms: for example, broker–dealers with an exclusively institutional clientele or who are engaged primarily in proprietary trading regularly balk at subsidizing an investor protection scheme for the primary benefit of retail customers.[275]

Moreover, it would be politically difficult to limit SIPC exposure to claims against broker–dealers if alternative sources of revenue—such as transaction taxes on stock trading or levies on reporting companies—were tapped. Why, after all, should special SIPC-administered restitution funds exist for customers of insolvent broker–dealers, but not creditors, counterparties or shareholders of insolvent broker–dealers or even public companies, such as Enron? There may already be significant temptation, for example, to transform garden-variety securities fraud claims (particularly in the context of private placements) into broker–dealer suitability and fraud claims in order to take advantage of less-rule-bound fora such as arbitration.[276]

VI. CONCLUSION

SIPC will likely survive the recent barrage of challenges to the scope of its coverage and claims: the Lehman and MF Global liquidations ultimately cost SIPC little, the Stanford liquidation remains outside of SIPC's mandate, and judicial interpretations have significantly contained SIPC's liability in the Madoff case. Meanwhile, legislative proposals to reform SIPC have gained little traction in either house of Congress. Nevertheless, SIPC members will be paying off obligations incurred as a result of the Madoff liquidation proceeding for years. More ominous, an argument can be made that the precedents created by the last few years will leave SIPC vulnerable to future financial crises or as yet undiscovered investment schemes.

If so, SIPC must continue to defend an increasingly outdated statute that does not reflect contemporary expectations of its role in the marketplace. A political solution to this problem requires some combination of lowering investor expectations, increasing funding, and improving the quality of regulation. At best, such a solution might lay the groundwork for improving other aspects of financial regulation, such as harmonizing securities and commodity futures regulation or building a viable framework for handling retail securities fraud claims. At worst, however, it could raise costs and compliance burdens without meaningfully reducing the risks and attendant losses of brokerage failures.

Guaranty Fund). For example, SIPA authorizes SIPC to set members' assessments, based upon, inter alia, "the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors." 15 U.S.C. § 78ddd(c) (2012); Joo *supra* note 3¸ at 1123 (noting that while SIPC has some discretion whether to bring liquidation proceedings, it generally treats all members equally in terms of assessments, advances, and claims processing—notwithstanding differences in operational and compliance risk across firms). Academic commentators have suggested that well-designed investor protection funds may not only supplement the remedial function of federal securities law, but also play a deterrent role if assessments can be scaled to operational or compliance risks. *Cf.* Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223 (2007) (suggesting a public investor compensation fund for securities fraud funded through levies on public companies linked to the strength of a "fraud risk rating" that reflects an issuer's corporate governance practices).

275. *See* 1992 GAO REPORT, *supra* note 16, at 50–51 (discussing adjustments in the calculation of "net operating revenue" to accommodate such concerns).

276. Jennifer J. Johnson, *Private Placements: Will FINRA Sink in the Sea Change?,* 82 U. CIN. L. REV. 465, 482–84 (2013) (discussing the explicit obligation for broker–dealers to engage in a "Reasonable Basis Suitability" analysis under FINRA rules when recommending a security to a customer and the potential impact for broker–dealer liability in private placements).