Statement
of
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before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

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Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the work of the Securities Investor Protection Corporation, known as SIPC. My name is Stephen Harbeck and I have been the President and Chief Executive Officer of SIPC for the past six years. I have worked at SIPC for 33 years and was General Counsel prior to my appointment as President and CEO.

SIPC was created under the Securities Investor Protection Act of 1970 ("SIPA") to provide specific financial protection to customers of failed securities broker-dealers. Although created under a federal statute, SIPC is not a government entity. It is a membership corporation, the members of which are, with very limited exceptions, all entities registered with the Securities and Exchange Commission ("SEC") as securities broker-dealers. Membership is not voluntary; it is required by law.

As a fundamental part of its statutory mandate, SIPC administers the SIPC Fund from which advances are made to satisfy claims of customers. The Fund is supported by assessments on SIPC member firms and its assets currently total $1.7 billion. In addition, SIPC maintains a commercial line of credit with an international consortium of banks, and, by statute, has a $1 billion line of credit with the United States Treasury.

SIPC has no authority to examine or investigate member firms. Those are the functions of the SEC and the Financial Industry Regulatory Authority which is a self-regulatory organization ("SRO") of the securities industry. When either of those entities or any other SRO informs SIPC that the customers of a brokerage firm are in need of the protections of SIPA, SIPC may initiate a customer protection proceeding to return to customers the contents of their securities accounts within specified limits. The proceedings are a specialized form of bankruptcy. A trustee and counsel are designated by SIPC, and appointed by the United States District Court, subject to a hearing on disinterestedness. The case is then referred to the appropriate Bankruptcy Court for all purposes.

To the extent securities or cash is missing from customer accounts, SIPC may use its funds, within limits, to restore customer accounts to the appropriate account balances. SIPC may advance up to $500,000 per customer on account of missing securities, of which up to $100,000 may be based upon a claim for cash. SIPC does not protect customers against market loss in an account. It is also important to note that customer property is never used to pay any of the administration expenses, such as fees of accountants, lawyers or even the trustee in a SIPA proceeding.

Through 2007, SIPC liquidated 317 brokerage firms, and returned over $15.7 billion in cash or securities to customers. Of that sum, SIPC used $322 million from the SIPC Fund to restore missing cash or securities. To date, SIPC has never used any government funds or borrowed under its commercial line of credit.

2008 was very different from anything in our past history. In addition to three smaller cases, SIPC has faced in recent months two unprecedented events: the initiation of liquidation proceedings for Lehman Brothers Inc. in September 2008, and the liquidation of Bernard L.

Madoff Investment Securities LLC, in December 2008. Both of those cases present significant challenges, but the two cases are very different.

Lehman Brothers Inc.

The Lehman Brothers Inc. ("LBI") liquidation was preceded by the Chapter 11 filing of Lehman Brothers Holdings Inc. on September 15, 2008. The Holding Company owned the SIPC member brokerage firm, LBI, which in turn held securities customer accounts. In order to facilitate the sale of brokerage assets, SIPC initiated a customer protection proceeding on Friday, September 19, 2008. On application by SIPC to the United States District Court for the Southern District of New York, LBI was placed in SIPA liquidation, James W. Giddens was appointed as trustee, and the law firm of Hughes Hubbard & Reed LLP was appointed as his counsel. That day, upon removal of the proceeding by the District Court, the United States Bankruptcy Court for the Southern District of New York held an extended hearing and approved the sale of assets of LBI to Barclays Bank.

Over the following weekend, the trustee for LBI transferred customer account positions, which contained $142 billion in customer assets, to two broker-dealers, one of which was the brokerage arm of Barclays. As a result, many of the customers of the defunct firm were able to exercise control over their respective portfolios in a seamless way. While much remains to be done in every aspect of the LBI matter, the initial stages have proceeded very well.

Bernard L. Madoff Investment Securities LLC

The failure of Lehman Brothers Inc. was linked to the complex, systemic failure of the subprime mortgage situation. The failure of Bernard L. Madoff Investment Securities LLC, a registered securities broker-dealer and SIPC member, involved a very different problem: the theft of customer assets on an unprecedented scale. The firm was placed in a SIPA liquidation proceeding on December 15, 2008, after the principal of the firm, Bernard Madoff, confessed to having stolen customer property over a period of many years. Irving H. Picard was appointed as trustee, and the law firm of Baker & Hostetler LLP was appointed as his counsel.

Unlike the LBI case, where customer records were accurate, it became apparent very early in the Madoff case that the customer statements Mr. Madoff had been sending to investors bore little or no relation to reality. The records sent to customers were inaccurate when compared to the inventory of securities actually held by the brokerage firm. For that reason, it was not possible to transfer all or part of any customer's account to another, solvent brokerage firm. Instead, pursuant to SIPA, Mr. Picard sought and received authority from the Bankruptcy Court for the Southern District of New York to publish a notice to customers and creditors, and to mail claim forms to them, as required by law, no later than January 9, 2009. The notice of the initiation of the case was published on January 2, 2009, and claim forms mailed to more than 8,000 investors at their addresses as they appeared on the Madoff firm's records within the last twelve months.

The trustee has requested information from each customer as to the sums given to the Madoff brokerage firm, and sums withdrawn from the firm, to assist in the analysis of what each customer is owed. There are some situations, particularly where the investors have not made withdrawals, where it will be relatively easy to determine exactly how much a claimant put into the scheme. In other situations, the extended time period of the deception, coupled with numerous deposits with or withdrawals of assets from the brokerage over time, may make that reconstruction very difficult. SIPC and the trustee are committed to using all available resources to resolve these issues quickly.

Mr. Madoff apparently has stated that he stole $50 billion. Even though this sum may include the annual "profits" he reported to investors in his fraudulent scheme, this defalcation is on a different order of magnitude than seen in any SIPA liquidation that has preceded it. Until customer claims are received and processed and further accounting and related work accomplished, SIPC will not know the extent of the demand on its resources. We can predict that the demand will be in excess of any previous case. Of course, the maximum amount under SIPA that SIPC can advance to any one claimant is $500,000 (including the $100,000 cash limit), even if the valid amount of the claim is much higher. The extent of recovery by customers beyond the amounts advanced by SIPC will depend upon the amount of customer property that the trustee is able to recover. To date, the trustee has identified over $830 million in liquid assets of the defunct brokerage firm that may be subject to recovery. Of these amounts, the trustee already has collected $91.8 million. Finally, the trustee has in place a team of highly trained attorneys, forensic accountants, and computer specialists, to assist him in locating and recovering assets. The trustee and SIPC will be aggressive in their pursuit of such recoveries.

The Committee has expressed interest in a number of specific points concerning the Madoff case. In order to give the Committee a better understanding of those specifics, I would note the following:

SIPC's Jurisdiction Over The Madoff Firm.

SIPC's jurisdiction is limited to brokerage firms registered as such with the SEC. Although there have been name changes over time, the Madoff firm has been a member of SIPC since SIPC's inception in 1970. The SIPA statute contemplates, and the Supreme Court agrees, that SIPC intervention is a last resort. When a brokerage firm is financially incapable of returning securities and cash in customer accounts, then and only then is SIPC involved. In the

Madoff case, FINRA and the SEC presented SIPC with evidence that, at the very least, the Madoff brokerage firm owed customers $600,000,000 worth of stock that it did not have on hand. That was the factual predicate for the exercise of SIPC's jurisdiction.

At the time of its failure, the Madoff firm was registered as both a brokerage firm and as an investment advisor, but there was only one corporate entity. SIPC does not have jurisdiction over any entity that is registered as an investment advisor.

SIPC's Process and Timetable in the Madoff case.

As mentioned above, SIPC filed its application for a decree declaring the customers of the Madoff firm to be in need of the protections available under SIPA on December 15, 2008. A trustee was appointed that day. On January 2, 2009, the trustee mailed a notice of the initiation of the SIPA proceeding and a claim form to the last known address of all customers, and to any other possible claimants then known to the trustee. Several hundred claims have been received by the trustee.

The extended nature and scope of the theft over several decades makes this an unprecedented case. The SEC and SIPC have conferred at the staff level about the appropriate treatment of claims under these circumstances. SIPC's Board will review this issue on January 30. I expect a similarly rapid review of the issue by the SEC. The legal issues are as complex as they are unprecedented. In any event, I would hope that the trustee could begin satisfying simple, straightforward claims as early as February.

The Sufficiency of the SIPC Fund.

Until all claims are filed and evaluated, it is not possible to determine exactly how much SIPC may be called upon to advance to the customers of the Madoff firm. Because SIPA limits the maximum advance SIPC may make with respect to any one customer claim, the call upon SIPC's resources is limited. By way of example, a perfectly valid claim for $100,000,000 would be eligible only for a maximum of $500,000 from SIPC. (Customers will also share, pro rata, in the corpus of "customer property" the trustee collects.) Until all claims are filed, and forensic accounting completed, it cannot be determined if SIPC's resources will be adequate.

The Prospect of Statutory Amendment.

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. Other refinements to the statute may also be considered. As this case moves forward and we have a clearer picture of the facts and their implications, SIPC will maintain a dialogue with Congress about any issues that may give rise to the need for changes to SIPA.

I would be pleased to answer any questions from the Committee.

Respectfully submitted,

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