Canadian Investor Protection Fund

CIPF Podcast Series – Investor Protection in Times of Crisis
No. 4 – Independence of Compensation Funds

Transcript[1]

Moderator: Pierre Matuszewski
Speakers: Stephen Harbeck and Rozanne Reszel

Announcer:

You're listening to the Canadian Investor Protection Fund Podcast Channel. Here we connect with industry leaders and experts in the financial sector.

Rozanne Reszel:

Hello and welcome to another episode in our CIPF Podcast Series. I'm Rozanne Reszel, President and CEO of the Canadian Investor Protection Fund. The Canadian Investor Protection Fund, or CIPF for short, and the Securities Investor Protection Corporation, or SIPC, are compensation funds in Canada and the US respectively that aim to protect investors in the event of a dealer insolvency. Our topic of conversation today is independence of compensation funds. Our discussion will explore the role, mandate, and structures of compensation funds in Canada the US, and internationally.

Rozanne Reszel:

My guest today is Stephen Harbeck, former President and CEO of the Securities Investor Protection Corporation. Steve, it's a pleasure to have you join us for this podcast. I'm really looking forward to this conversation.

Stephen Harbeck:

It's nice to be here, Rozanne.

Rozanne Reszel:

To start us off, can you provide a brief overview of the role and the mandate of SIPC, including your involvement with the organization?

Stephen Harbeck:

Sure. I was a member of the SIPC staff for about 44 years, the last 25 or so as either general counsel or the President and Chief Executive Officer. As you said, the roles of SIPC and CIPF are very similar. The mandate is very similar, and that is as follows. It's our job when a

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brokerage firm fails or is in serious danger of failing to take control of the firm and return control of the cash and securities in each person's account as rapidly as possible by instigating a specialized form of bankruptcy.

Stephen Harbeck:

SIPC can use its funds to replace missing or stolen securities with limits that are not quite as generous as those in Canada. We can replace up to $500,000 worth of securities, of which as much as $250,000 could be based upon a claim for cash. The best tool we have is the electronic transfer of accounts to a solvent brokerage firm using SIPC's funds as necessary. SIPC's funds are on top of the percentage share of each customer's share of the assets that are in fact present. So again, very similar to the Canadian program.

Rozanne Reszel:

I can perhaps say a few words about CIPF. It is, as you've observed, very similar. CIPF returns property that may not be able to be returned by a member firm that becomes insolvent. We have two methods of doing that. One is to engage a trustee and use a court procedure and fund the trustee such that they can do a transfer of accounts to another member firm. There are times when we don't have a trustee, and that would most often occur when a firm has already been wound up and we receive claims after the fact and deal with them directly.

Rozanne Reszel:

Our limited coverage was increased from $500,000 to $1,000,000, any combination of cash or securities. And the reason for that was the adoption of a section of the Bankruptcy Act, Part 12, which allows us to create a customer pool and prorate any loss against all customers if we use the bankruptcy and trustee approach. We find that that limit is obviously very generous, particularly when, as with SIPC's, it's added to any distribution from the estate that's made by the trustee.

Stephen Harbeck:

Rozanne, we also have an extra judicial process as well for smaller cases. SIPC can use what's called a direct payment procedure, which avoids the court system. It's very quick and, again, is used in situations where the firm has already wound down its business but may still owe something to customers.

Rozanne Reszel:

It's interesting how we find similar approaches and solutions to similar scenarios. Steve, could you please describe at a high level SIPC's framework for regulatory accountability?

Stephen Harbeck:

That's very easy, Rozanne, because we have no regulatory role whatsoever. When Congress took a look at protecting investors in 1970, it was faced with the fact that there are five levels of inquiry at each brokerage firm in terms of regulation: the internal auditor of the brokerage firm, the independent external auditor brokerage firm, an industry self-regulatory organization, a state regulator, and a federal regulator.

Stephen Harbeck:

It was thought then, and I believe it's been proven to be wise, not to add SIPC as a sixth regulator, but to keep it as an entity that cooperates with regulators once SIPC has a role in an insolvency.

Rozanne Reszel:

That's interesting by contrast, and we've often remarked in Canada that CIPF does not have a statute. The fund was created privately from within the industry, and it's recognized by our securities regulators through formal orders. And those orders require us to provide regular reporting to them, that's the Canadian Securities Administrators, a group of 13 provincial and territorial regulators, and also to obtain their approval for changes in key CIPF policies, and that would include our coverage policy and our investment policy.

Stephen Harbeck:

Well, one of the things that is structurally different between your organization and SIPC is the fact that SIPC does in fact report directly to a federal regulator, the Securities and Exchange Commission. The most interesting thing about the relationship is that 99% of the time, the relationship is absolutely symbiotic and cooperative. But in the event that SIPC and the SEC have differing views on a particular point of law or even differing views as to whether SIPC should initiate a proceeding to liquidate a brokerage firm, the SEC cannot just force SIPC to act. It must meet us in court and have a judge tell SIPC and the Securities and Exchange Commission who is correct.

Rozanne Reszel:

It's that element of the statute and the court that we do not have here in Canada. It gives us some benefits, on the one hand, in as much as our board can address things like coverage limits with the oversight of the regulators. But conversely, it leaves to our board occasionally the need to review claims and appeals of claims that haven't been met to the client's satisfaction at the trustee level or the staff level. So big change on that front.

Stephen Harbeck:

Yes. The remedy for customers who are dissatisfied with their distribution in a SIPC proceeding is to ask the court to review it. I believe SIPC's record in that regard is extraordinarily good in that SIPC has no economic motive to deny coverage on any claim. It tends to follow the law rigorously and consistently throughout the country. And that gives us a good deal of standing or give SIPC a good deal of standing when it does come to a court and say, "This is why we cannot pay as much as the client wants or indeed anything to the client."

Rozanne Reszel:

Well, it's interesting thinking about structures and accountability. Right now in Canada, there are a couple of regulatory initiatives of note. One is the CSA review of the SRO structure. At the same time in Ontario, a task force was struck to look at the modernization of capital markets, and it also addresses the self-regulatory structure because IIROC, our national self-regulator, has responsibility for overseeing both member regulation and market regulation. Interesting developments as yet not concluded.

Rozanne Reszel:

Certainly many suggestions, recommendations about in terms of how to achieve further efficiency and benefits for investors. During your tenure at SIPC, Steve, were there regulatory framework reviews or times when the structure was considered for change?

Stephen Harbeck:

One thing comes to mind in that regard very specifically, and that is after the financial collapse in the United States of 2008 where many brokerage firms were in peril, Lehman Brothers failed, there was a review of how to handle a mega case, the liquidation of a gigantic nationwide financial organization. The methodology which the Securities and Exchange Commission and Congress came up with was to deal with what they call the single point of entry. In other words, having a court adopt a trustee for the headquarters company or the holding company of any financial conglomerate.

Stephen Harbeck:

And then SIPC's role would be to just deal solely with the brokerage firm sub corporation. Speaking solely for myself, the one problem I have with the concept of initiating an entirely new procedure that has never been tried before is that it would be tried in what is literally by definition the largest insolvency in history. Lehman Brothers was the largest insolvency in history to date. We're talking about something larger than that and super imposing a brand new framework on that strikes me as having some operational risk.

I would personally prefer to follow the Lehman Brothers model because it worked rather well.

Rozanne Reszel:

Very interesting, and Lehman certainly is a case that everybody, if not intimately familiar with, certainly would have read about with interest. Were there any other elements of that insolvency that might be interesting to our listeners today?

Stephen Harbeck:

Well, certainly it was the largest insolvency of any kind, financial corporation or otherwise, in history. What I found is, however, that the litigation structures were common to all parties, because most of the parties were sophisticated financial institutions trying to maximize their return as one always does in a situation like that.

Stephen Harbeck:

But I think by stark contrast, four months after the failure of Lehman Brothers, we had the failure of Bernard Madoff Investment Securities LLC. That was extraordinarily chaotic.

Stephen Harbeck:

It dealt a great deal of harm to individual investors, which did not occur in the Lehman Brothers case. In Lehman Brothers, the clients got back in control of their own portfolios within a week. In Madoff, since the records were completely fictional, it was not possible to transfer the accounts, and also indeed it became necessary to do something that we had never done on a large scale before, and that is to use the Bankruptcy Code provisions for returning fraudulent transfers to the trustee to make a more equitable distribution.

Stephen Harbeck:

That means that people who were net winners, people who took more out of the Ponzi scheme than they put in, were required to pay something back. That was a very difficult process for some of the investors and indeed a difficult process for SIPC as well.

Rozanne Reszel:

I recall being surprised at the very significant percentage return that was made ultimately on that insolvency. At the get-go, it seemed like, oh my goodness, people would be out of their whole life savings, but in fact, that wasn't the case, was it?

Stephen Harbeck:

No. Here's rough and dirty, the rounded off numbers. People thought they had $63 billion worth of assets in the aggregate deposited with Madoff. On a net money in, money out basis, they had actually deposited $17 billion. When the trustee took over the case, there was less than $100 million available. So the trustee had to find out who was responsible for any of the losses. And indeed, people who did not do anything wrong still had to return the excess of what they had taken out over a period of years pursuant to the concept of fraudulent transfer. The fraud is not by the recipient.

Stephen Harbeck:

It was the fraud by Bernard Madoff himself. By the way, the current percentage of distribution in the Madoff case is 70% of what each customer deposited with Madoff. When you put the SIPC advances on top of that, anyone with a $2 million claim has been satisfied in whole and everyone else has gotten 70%.

Rozanne Reszel:

Well, that's quite remarkable.

Stephen Harbeck:

They're not done yet either. The most recent case, a Second Circuit Court of Appeals case, allows the trustee to reach out across international borders and recover assets that were otherwise subject to a general rule that the Bankruptcy Code stops at the American borders. But in this case, because most of the action and the transfers of assets took place in New York, it was deemed that the trustee could reach out to Europe and the Caribbean and whatever.

Rozanne Reszel:

It's interesting when we start thinking about going across oceans and borders. I'm wondering, are there any cases or examples either within the US or internationally that you think might interest our listeners that might highlight some of the advantages or disadvantages of different models of regulation and protection?

Stephen Harbeck:

One case that comes to mind is what Sherlock Holmes might call the dog that didn't bark, the case that SIPC did not take over, and that was the liquidation of Allen Stanford and his financial conglomerate that stretched all across Central and South America and into Europe, but was not eligible for liquidation under the Securities Investor Protection Act because the losses were all lost in value, not stolen assets. The customers had the ability to get back their worthless assets. But as a result of that, SIPC did not start a case.

Stephen Harbeck:

The only clawback available to the trustee for Allen Stanford was under Texas State Law. The return in the Stanford cases was literally pennies on the dollar. While it was used as an equitable way to resolve the case, two factors entered into the fact that the return was so low. One, there was no entity like SIPC to pick up the administrative expenses, which SIPC did in Madoff, and two, the Bankruptcy Code wasn't available to use the more robust tools of fraudulent transfer and preference.

Rozanne Reszel:

There's no question that the elements of the bankruptcy acts both in Canada and the US, and I'm happy to say I think we copied much of what we have from your experience, because you had not only the statute, but a lot of legal precedent that could be looked to in a number of cases. But it's that protection that in Canada we call Part 12 that I think really does ensure that clients get the best opportunity not only to get a recovery from the trustee, but then if they're eligible, to add CIPF protection on top of that.

Stephen Harbeck:

The one thing that did occur in the Madoff case that was rather unique is there was a cooperation between the SIPC trustee and the Department of Justice who went after the estate of an individual that was deemed to be complicit in the Madoff fraud. The tools available to the Department of Justice to recapture assets set up a separate pool that was distributed under separate rules that were not in accordance with our statute but did give some relief to the people who were not eligible for relief under SIPC.

Rozanne Reszel:

As we sort of sat back in Canada and tried to think about the different models of compensation funds being independent of regulators or compensation funds being incorporated into regulators, we were reflecting on the fact that we actually have both models in two provinces, both Ontario and Quebec. We have provincial regulators that have compensation funds that are integrated into the regulator.

Rozanne Reszel:

We also have with our deposit insurer, CDIC, a separate or independent arrangement whereby they are in contact with and certainly have communication with OSFI, the federal regulator for banks and deposit takers, but are held separate and have a separate board. CIPF would be the other example where we are certainly in communication with and have an arrangement to exchange information with IIROC, but are held separate and under a separate board.

Rozanne Reszel:

Is there anything about the governance of SIPC or the process by which you interact with other agencies that would be relevant to the dialogue about independence versus consolidation in addition, obviously, to what you've already referenced?

Stephen Harbeck:

Well, yes, there is one very, very important precedent at law that arose in the context of the Allen Stanford case. The Securities and Exchange Commission believed that SIPC should in fact start a liquidation proceeding and indeed protect the investors from the money that was not technically even at the brokerage firm. But their concept was that if you smashed it all together, SIPC ought to pay it. I have lectured on this in a number of other national capitals.

Stephen Harbeck:

And the way I described whether your investor protection entity is independent is as follows: when the federal government sues you in a federal court and loses, you know that the investor protection entity is independent. And that is what happened in the Allen Stanford case. The court told SIPC that it was correctly construing its statute, that the SEC was not construing it correctly. And as a result, SIPC did not enter the case. One important thing about our statute is that individuals do not have the authority to go to court and compel SIPC to take action.

Stephen Harbeck:

Only the SEC may do that. They have only done it once, and they were not successful because the facts were contraindicated.

Rozanne Reszel:

It is interesting as we stay in touch with our colleagues around the world that for the most part, compensation funds tend to be custodial in nature, returning assets, but there are some that do cover other exposures. Any thoughts at all on the pros and cons of custodial versus other kinds of coverage?

Stephen Harbeck:

I think the nature of the protections under the Canadian Investor Protection Fund and under SIPC are as far as one could go under what's generally known as moral hazard. In other words, you have a right to believe that the securities and cash that you deposited with that firm are there, are in fact available to you. But once you start getting into the question of whether someone has been defrauded, you get into fact questions that are razor thin in their nature. They are expensive to resolve.

Stephen Harbeck:

Eventually if you satisfy every claim based on misdirection, it doesn't matter then if you take a wild gamble on something and it turns out to have been a complete fraud. That much under the CIPF system and under the SIPC system is such that you're responsible for that. And if you've made a bad investment, you've made a bad investment. On the other hand, if you've made a good investment and the securities aren't there, you're going to get them back. That's the moral hazard line drawn by our respective systems.

Rozanne Reszel:

Our time is going to be drawing to a close. Did you have any other concluding remarks that you'd like to make for our listeners, Steve?

Stephen Harbeck:

Yes. I think both the CIPF and SIPC have a long historical record of no other word to use but excellence. These two entities have been well-run. Even before they were up and running, they were well conceived to assist investors in their most dire need. That started in 1969 for the CIPF I believe, 1970 for SIPC. After eight years of work under that statute in 1970, Congress reviewed and gave SIPC the ability to transfer accounts electronically, which was a great move to making sure that customers got their assets back as rapidly as possible.

Stephen Harbeck:

I think investors can invest with great confidence that the assets that they left with their brokerage firm are going to be there under almost any circumstances.

Rozanne Reszel:

That's been quite a fulsome conversation and certainly an interesting review of many of the things that we've had an opportunity to speak about and discuss over time, Steve. I'm taking three major takeaways from our conversation today.

Rozanne Reszel:

The first is having a plan for dealing with a mega insolvency. We've not had the opportunity or perhaps unfortunate aspect of having to deal with something as large as Lehman. Certainly you handled it very capably and it sounds like you have a roadmap should something that size ever occur again.

Rozanne Reszel:

The second is a need for an equitable resolution in the case of fraud. There's not always a playbook for that, but it's important that there be an approach to finding it, which it sounds like you were able to do in Madoff.

Rozanne Reszel:

And the third was the relevance and the importance of the independence of the compensation fund to stay true to its mandate, which I think you explained quite well in the Stanford case.

Rozanne Reszel:

So unfortunately, our time together is now up, and I'd like to thank our listeners for their attention. And I hope you found the discussion as interesting as I have. We always welcome your comments. The best way to reach us is through our website. Finally, we look forward to welcoming you back to listen to the next CIPF podcast. In the meantime, stay tuned and be well.

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