WHO WATCHES THE WATCHERS?
THE SECURITIES INVESTOR PROTECTION ACT, INVESTOR CONFIDENCE, AND THE SUBSIDIZATION OF FAILURE

THOMAS W. JOO*

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* Acting Professor, School of Law, University of California, Davis (King Hall).  J.D., Harvard Law School, 1993; B.A., Harvard College, 1989.  This article benefited from the helpful comments and advice of Dwight Aarons, Vikram Amar, Holly Doremus, Robert W. Hillman, Edward Imwinkelried, Stefanie Roth, Robert B. Thompson, William K.S. Wang, discussants at the 1997 Joint/Western/Southwestern/Southeastern Law Professors of Color Conference, and my colleagues in the King Hall Faculty Colloquium Series.  I also owe special thanks to Kenneth Caputo, Deputy General Counsel of SIPC, for providing useful information.  Thanks also to my research assistants, Joshua Leach and Paul Gross.  The University of California, Davis and the UC Davis School of Law (King Hall) provided generous financial and moral support for my research and writing.  Any errors herein are, of course, my own.
I. INTRODUCTION: IT’S 10 P.M. DO YOU KNOW WHERE YOUR SECURITIES ARE?

As Professor Loss put it, the “recurrent theme” of federal securities regulation is “disclosure, again disclosure, and still more disclosure.”1 These disclosure requirements primarily concern data about the securities themselves, or more specifically, data about the firm that issues the securities. The principle of disclosure, however, does not apply with equal force

1. 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29 (3d ed. 1989).
to the regulation of the broker-customer relationship. For example, “disclosure” does not require securities firms to inform investors of the value of a broadly diversified, low turnover strategy requiring relatively little firm-specific data. Nor does it require securities firms to divulge that their investment advice generally yields returns no better than random stock picking. Moreover, the disclosure principle does not require that a securities firm disclose to the investor information about the reliability of the firm itself.

This last piece of neglected information is especially important. Securities firms not only recommend and sell securities, they also control the securities that investors own. When an investor purchases securities, they are generally not held in the name of that investor (sometimes referred to as the “beneficial owner”), but rather in the name of an intermediary. The

2. Such a requirement, it has been argued, would be akin to requiring a casino to disclose to gamblers the fact that the odds favor the house. See Paul Mahoney, *Is There a Cure for “Excessive” Trading?*, 81 Va. L. Rev. 713, 744 (1995).

3. Under the depository system of securities transfer, securities certificates are held in a central depository in the name of the depository, rather than in the customer’s name. Thus, when securities are traded, it is no longer necessary to process each trade individually by obtaining certificates, inspecting them, and reissuing and physically delivering new certificates in the name of the new owner. The depository retains record ownership. See Ralph C. Ferrara & Konrad S. Alt, *Immobilization of the Security Certificate: The U.S. Experience*, 15 Sec. Reg. L.J. 228, 237-40 (1987). Securities held in the name of an intermediary are commonly said to be held in “street name.”

It is important to note that individual beneficial owners of securities have no direct contractual relationships with the depository—rather, individuals have contractual relationships with their brokers, which in turn have contractual relationships with the depository or, as is often the case, relationships with another intermediary (or intermediaries) which in turn is in privity with the depository.

Most securities trades are made through a depository system known as the Continuous Net Settlement (CNS) System, involving the combined operations of two registered clearing agencies, the Depository Trust Corporation (DTC) and the National Securities Clearing Corporation (NSCC). Securities certificates are kept on deposit with DTC, registered under the name of DTC’s nominee, Cede & Co. See Charles Mooney, *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 Cardozo L. Rev. 305, 317-20 (1990). The interest of DTC’s participant institutions in the securities is recorded on the books and records of DTC. In turn, beneficial ownership of each participant’s customers is recorded in the participant’s books and records.

DTC keeps track of all securities trades by participants. Participants become responsible to transfer or entitled to receive only net changes in the amount of each securities issue and cash. In order to centralize the transfer of payments and securities, there is a novation of trade contracts, with NSCC coming between the parties on each side of the transaction. “In sum, on each settlement date, each NSCC participant pays to or receives one sum of money from NSCC and each NSCC participant transfers to or receives from NSCC, by book entry on the books of DTC, a single quantity of each security issue involved.” *Id.* at 319.

The vast majority of shares of major securities issues are on deposit at DTC and thus are not held in the name of their beneficial owners. As of 1988, NSCC cleared and settled about 95% of all equities trades on the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), and National Association of Securities Dealers (NASD) markets. See *id.* at 317-18 nn.23-24. Stock held in street name can represent as much as 80% of a public company’s outstanding shares. See John C. Wilcox, *A Proxy Contest Check List*, in 22D Annual Institute on Securities Regulation 511, 521 (PLI Corp.
intermediary retains custody of the securities. An investor’s claim to securities in her account with an intermediary, though sometimes treated by the law as a conventional property right, is more like a contractual relationship with the intermediary. Thus, “[u]nlike property claimants such as lessors and secured creditors, the sui generis claims of customers of a securities intermediary are marked by a lack of control and knowledge and an almost exclusive reliance on the integrity and solvency of the intermediary.” Nonetheless, the principle of disclosure and the attentions of investors remain focused on characteristics of securities and their issuers and pay little attention to the intermediaries that hold them on the investors’ behalf.

This Article focuses on the Securities Investor Protection Act (SIPA), one aspect of the securities regulation structure with the potential to improve the safety and reliability of the custodial relationship between broker and customer. SIPA could accomplish this goal by deterring broker misconduct and making customers more aware of the risks posed by it. In response to a wave of failures of securities broker-dealer firms in the late 1960s, Congress enacted the Securities Investor Protection Act of 1970 (SIPA). SIPA created special rules for the liquidation of insolvent broker-dealers and established the private, nonprofit Securities Investor Protection Corporation (SIPC). SIPC administers a fund to protect the accounts of securities investors somewhat analogous to the protection the Federal Deposit Insurance Corporation (FDIC) provides for the accounts of bank depositors.

Like the FDIC, which was established during the bank panics of the 1930s, SIPC and the SIPA scheme were created in a time of crisis. Although over a quarter century has passed since the enactment of SIPA, its basic, underlying concepts remain the same. The SIPA scheme remains

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5. The term “broker-dealer” does not appear in the securities laws, but is commonly used to refer to a person who is a broker, a dealer, or both.
6. The analogy is a very rough one, as subsequent description of SIPC will show.
7. The limited academic literature addressing the SIPA scheme, like most of the literature concerning the broker-dealer industry and its regulation, is more descriptive than critical. 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 (1983); Michael E. Don & Jo-
primarily a passive safety net designed to protect investors from losses due to broker-dealer failure and to promote investor confidence in securities markets. Its approach to protection is principally to reimburse customers for certain types of losses.

This Article argues that SIPA improperly distributes costs and thereby fails to realize its potential to prevent failures. In fact, SIPA does the opposite and undermines the self-regulatory industry’s own incentives to monitor its members. Because individual SIPC member firms and the industry as a whole benefit from SIPC investor protection by gaining investor confidence, the industry should bear more of the costs of SIPC liquidations. Furthermore, allocating the risk of losses due to failure to the parties best able to avoid such loss is a more efficient means to the long-term protection of customers, as well as the long-term health of the industry. As will be discussed below, the self-regulatory nature of the industry leaves the power to prevent failures and monitor firms’ financial status largely in the hands of the industry itself. To justify allowing the industry to retain its self-regulation, the industry should take action to prevent failures and pay for the consequences of its regulatory shortcomings.

This Article does not mean to suggest that misconduct is currently creating an epidemic of failures, as the current failure rate of SIPC members is quite low. Rather, it argues that part of SIPA’s original mission has become irrelevant, if not harmful. SIPA was created for the avowed dual purposes of protecting investors and instilling public confidence in brokerage firms and, by extension, the securities markets. There is no indication that the latter goal is still worthy of concern, if indeed it ever was. In fact, given the prolonged bull market of the 1990s, quite the opposite may be true. As a result, SIPA’s focus on protecting the industry has transformed into overprotection, and worse, a costly system of perverse incentives and externalization of the costs of self-regulation.

Part II examines the securities industry crisis that led to SIPA. It argues that SIPA fails to directly address the problems that caused broker-dealer failures at that time or today. Part III contends that SIPA is effectively a subsidy of the broker-dealer industry. It does little to reduce the likelihood broker-dealers will fail. Furthermore, although at first blush SIPC’s investor protection fund appears to be fully financed by the securities brokerage industry itself, it is not. The upshot is that the cost of pro-

tecting investors from loss due to broker insolvency is not currently borne by those most able to avoid such insolvencies. Finally, Part IV suggests ways in which Congress should reform SIPA to create incentives in the structure of self-regulatory organizations (SROs) and in the ownership structure of individual firms to monitor financial distress and avoid failures.

II. THE BROKER-DEALER INDUSTRY AND THE ORIGINS OF SIPA

A. THE PRECIPITATING EVENT: THE “BACK OFFICE CRISIS”

The immediate impetus for the passage of SIPA was the protracted “back office crisis” that plagued the securities industry in the late 1960s and early 1970s. Between 1967 and 1969, “brokerage firms [found] themselves in the paradox of being forced out of business by having too much business” as the total volume of securities transactions grew explosively during the 1960s. Average daily trading volume on the NYSE increased from 3,042,000 shares in 1960 to 12,971,486 in 1968. By January of 1969, the Dow Jones Industrial Average reached an unprecedented high of 968 points while regional stock exchanges and the over-the-counter market also experienced rapid growth.

Unfortunately, the brokerage industry failed to make the infrastructural improvements required to handle increased demand. Brokerage firms were slow to automate their back office procedures and continued to rely on outdated methods. Instead, they concentrated on exploiting demand in the short run by expanding their sales forces. In contrast to sales personnel who were direct income producers, firms gave little recognition to operations personnel, who were considered non-productive. Thus, firms accepted more and more trade orders while failing to upgrade their “back

9. See SECURITIES INDUSTRY STUDY, H.R. REP. NO. 92-1519, at 1, 3 (1972). In 1965, when the volume had reached 6,176,000, an NYSE planning report predicted the volume would reach 10.6 million shares by 1975. This point was surpassed by 1967. See id. at 3.
12. See Don & Wang, supra note 7, at 511.
14. See id.
The continued increases in the number of transactions eventually overwhelmed the resources of securities firms. “Stock certificates and related documents were ‘piled halfway to the ceiling’ in some offices; clerical personnel were working overtime, six and seven days a week, with some firms using a second or even a third shift to process each day’s transactions.” The shortage of qualified personnel was so acute that brokerages resorted to “pirating” workers from other firms’ back office staffs. Belated attempts to replace manual bookkeeping systems with unfamiliar new computerized systems only added to the confusion.

Errors were rampant and chaos ensued as a result of the failure of record-keeping procedures. From 1967 to 1970, the NYSE was required to intervene directly in the operations of over half of its members dealing with the public, or nearly two hundred organizations. Brokerage firms often performed their basic tasks—posting securities transactions to customer accounts, crediting dividends, and delivering securities and checks—incorrectly, duplicatively, or not at all. Errors were only part of the problem as the back office chaos also facilitated outright fraud and theft by brokers. According to the Justice Department, over $400 million worth of securities stolen in 1969 and 1970 remained unrecovered in 1971.

The breakdown of trade-processing and record-keeping procedures was dramatically illustrated by the huge number of “fails to deliver,” that is, transactions that were not completed because of one party’s failure to deliver securities by the settlement date of the transaction. In April 1968, $2.67 billion worth of transactions failed; in December 1968, that number

15. See id.; Don & Wang, supra note 7, at 510-11.
16. SELIGMAN, supra note 8, at 451 n.31.
17. See H.R. REP. NO. 92-1519, at 4; Don & Wang, supra note 7, at 511.
19. See id. at 5.
22. See BARUCH, supra note 10, at 93; H.R. REP. No. 92-1519, at 5.
23. See BARUCH, supra note 10, at 94. Even this figure may be low, however. Brokers’ claims under theft policies exceeded the amount of premiums paid by as much as 100%, and brokers may have underreported thefts in order to avoid cancellation of their theft policies. See id. at 93.
24. See H.R. REP. NO. 92-1519, at 5; SELIGMAN, supra note 8, at 451. See also S. REP. 91-1218. The term “settlement” refers to the completion of an executory contract to trade securities—that is, the buyer’s payment and the seller’s delivery of the securities. Since 1995, SEC Rule 15c6-1 has set the settlement date at the third day after the date of the contract, unless the parties expressly contract otherwise. Previously, the settlement date was the fifth day after the contract. See 17 C.F.R. § 240.15c6-1 (1998).
rose to $4.13 billion.\textsuperscript{25} Although the dollar value of fails declined thereafter, nearly twelve percent of all transactions failed in July 1969.\textsuperscript{26}

The seriousness of the crisis became manifest when it claimed Pickard & Co. as its first casualty in 1968. Pickard, “a habitual violator of SEC and Exchange regulations,” confessed to numerous “egregious violations” of securities laws.\textsuperscript{27} Pickard admitted misrepresenting its financial condition to lenders, selling unregistered stock, and manipulating the price of a stock.\textsuperscript{28} Pickard had further violated securities laws by taking customer orders for securities transactions when its books and records were not current and inaccurately reflected customers’ accounts, and when it neither had the requisite capacity to promptly execute customer orders and deliver cash and securities nor complied with the financial requirements of the NYSE.\textsuperscript{29} As the crisis wore on over the next two years, the SEC routinely discovered similar misconduct at other firms.\textsuperscript{30}

In response to the crisis, the NYSE and other exchanges, after discussions with the SEC, implemented temporary reductions in trading hours and even instituted a four-day trading week during 1968.\textsuperscript{31} The NYSE also required members with operational difficulties to curtail the scope or volume of their businesses.\textsuperscript{32} The NASD also urged its member firms to cut back their businesses.\textsuperscript{33} However, these measures failed to prevent a wave of collapses in 1969 and 1970.\textsuperscript{34}

Hurd Baruch, special counsel to the SEC during this period, has argued that brokerage firms did not merely respond to increased demand, but had fanned the flames of excessive speculation.\textsuperscript{35} Baruch described the market growth of the 1960s as a “frenzied speculative bubble.”\textsuperscript{36} Such bubbles, of course, eventually burst. Ironically, as brokerage firms slowly

\textsuperscript{25} See H.R. REP. NO. 92-1519, at 5; SELIGMAN, supra note 8, at 451.
\textsuperscript{26} See H.R. REP. NO. 92-1519, at 5.
\textsuperscript{27} See SELIGMAN, supra note 8, at 451-52.
\textsuperscript{28} See id. at 451. See also BARUCH, supra note 10, at 115-18.
\textsuperscript{30} See SELIGMAN, supra note 8, at 452.
\textsuperscript{31} See H.R. REP. NO. 92-1519, at 6-7.
\textsuperscript{32} See id. at 7-8.
\textsuperscript{33} See id. at 8.
\textsuperscript{34} See SELIGMAN, supra note 8, at 463.
\textsuperscript{35} See BARUCH, supra note 10, at 119-22.
\textsuperscript{36} Id. at 120-21.
and painfully implemented the automation, personnel expansion and other expensive back office improvements demanded by increased trading volume, the stock market entered a prolonged slump in 1969-70.\textsuperscript{37} From May 1969 to May 1970, the Dow Jones Industrial Average dropped from 969 to 631, a loss of thirty-five percent.\textsuperscript{38} Trading volume fell from a daily average of thirteen million shares in 1968 to eleven million in 1969-70.\textsuperscript{39}

The slump years saw the second and more severe phase of the crisis, described as “the greatest rash of broker-dealer firm failures in Wall Street’s history.”\textsuperscript{40} Firms experienced a drop in the value of their proprietary securities positions and depressed demand for their services. Against this background, it came time for firms to resolve the accounting problems that had built up during the back office crisis. Many firms had accumulated substantial short differences in their securities positions.\textsuperscript{41} Poor record-keeping often left it unclear whether apparent shortfalls were actual or merely the result of bookkeeping errors.\textsuperscript{42} Firms thus reflected the shortfalls on their accounting statements by establishing a reserve against their contingent liability in case the shortfalls were eventually resolved against the firm.\textsuperscript{43} Where the reserves ultimately proved inadequate to cover the actual shortfall, the firms had no choice but to absorb the shortfalls as charges against their capital.\textsuperscript{44} Such capital charges could be disastrous. For example, at the end of 1969, Goodbody & Co., the country’s fifth largest brokerage firm, reported a reserve of only $1.5 million against short differences of $18 million.\textsuperscript{45} Firms also had to absorb past due customer debts, which tend to go uncollected, as well as unsecured or inadequately secured customer debts, which had mounted as poor record-keeping and control allowed customers to trade on inadequate margins.\textsuperscript{46} In addition, many firms incurred substantial expenditures on larger offices and belated attempts to improve their processing systems.\textsuperscript{47}

\begin{itemize}
  \item \textsuperscript{37} See S. REP. NO. 91-1218, at 3 (1970).
  \item \textsuperscript{38} See SELIGMAN, supra note 8, at 452.
  \item \textsuperscript{39} See id.
  \item \textsuperscript{40} Id.
  \item \textsuperscript{41} See BARUCH, supra note 10, at 138-41.
  \item \textsuperscript{42} See id.
  \item \textsuperscript{43} See id.
  \item \textsuperscript{44} See id. That is, the firms were forced to take charges against their capital to “buy in” the short differences.
  \item \textsuperscript{45} See id. at 141.
  \item \textsuperscript{46} See id. at 141-43.
  \item \textsuperscript{47} See H.R. REP. NO. 92-1519, at 9-10 (1972).
\end{itemize}
Over 160 NYSE member firms and probably even more nonmember firms went out of business.\textsuperscript{48} Many firms, including major members of the Wall Street establishment, only narrowly escaped collapse. Goodbody & Co. avoided failure only by merging with Merrill Lynch.\textsuperscript{49} F.I. Dupont, Glore Forgan, the NYSE’s second largest firm, was rescued from the brink of failure by a reported advance of $79 million from H. Ross Perot.\textsuperscript{50} Neither the SEC nor the self-regulatory organizations had current or accurate data on the condition of these firms. Consequently, the SEC and SROs\textsuperscript{51} did not intervene until these firms had already deteriorated significantly.\textsuperscript{52} SEC Chairman Hamer Budge told a Senate subcommittee in 1970 that an estimated forty-five million dollars worth of securities had “mysteriously disappeared” during the preceding year.\textsuperscript{53}

\textbf{B. CONGRESSIONAL RESPONSE: PROMOTION OF “INVESTOR CONFIDENCE”}

In April 1970, Senator Edmund Muskie introduced the first Senate version of the bill that eventually became SIPA.\textsuperscript{54} Congress passed SIPA just eight months later. The legislative history indicates that Congress’ purpose was to save the securities industry from crisis. Muskie stated that an insurance program would “restore investor confidence and help the securities market to flourish.”\textsuperscript{55} Later, he clearly stated that the legislation was intended to serve “a dual purpose” as “[i]t would protect investors and the national economy from serious hardship which can follow the failure of

\begin{itemize}
  \item \textsuperscript{48} See id. at 10.
  \item \textsuperscript{49} See SELIGMAN, supra note 8, at 454.
  \item \textsuperscript{50} See id.
  \item \textsuperscript{51} The SEC has primary responsibility for administering the federal scheme of securities regulation. Pursuant to the Securities Exchange Act of 1934, however, the SEC cedes much of this authority to self-regulatory organizations (SROs), which include the NYSE, AMEX, NASD, and certain regional exchanges. Each broker is subject to regulation by one or more SRO.
  \item \textsuperscript{52} See H.R. REP. NO. 92-1519, at 10.
  \item \textsuperscript{53} See \textit{Federal Broker-Dealer Insurance Corporation: Hearings on S. 2348, 3988, and 3989 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong. 10 (1970) [hereinafter \textit{FBDIC Hearings}] (bills to provide greater protection for customers of registered brokers and dealers and members of national securities exchanges, April 16 and 17, June 18, and July 16).}
  \item \textsuperscript{54} Muskie’s bill, S. 2348, was entitled “Federal Broker Dealer Insurance Corporation” (“FBDIC”). The original House bills for broker-dealer insurance were H.R. 13308 and H.R. 17585. H.R. 18081 was the SEC’s proposal; H.R. 18109 was the proposal of the Joint Securities Industry Task Force. After hearings in subcommittee, the subcommittee reported a new bill, H.R. 19333, to the full committee. Congress enacted that bill, with “numerous technical amendments and corrections,” as SIPA. See H.R. REP. NO. 91-1613 (1970), \textit{reprinted in} 1970 U.S.C.C.A.N. 5254, 5257.
  \item \textsuperscript{55} \textit{FBDIC Hearings}, supra note 53, at 4 (statement of Sen. Edmund S. Muskie).}
\end{itemize}
financial institutions, and it would increase the soundness of these institutions and public confidence in them."56

Under the heading, “Purpose of Legislation,” the report on House Bill 19333, which was ultimately adopted as SIPA, stated: “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."57 Later in the report, however, the committee made a significant elaboration on the bill’s purpose: “[SIPA] will establish immediately a substantial reserve fund which will provide protection to customers of broker-dealers similar to that formerly provided by the exchange trust funds. This will reinforce the confidence that investors have in U.S. securities markets."58 That is, while SIPA is intended to protect customers from loss, protecting customers is not an end in itself. It is, rather, a tactic to boost investor confidence in the securities market which will, presumably, facilitate capital formation.

The report on the Senate version of the bill makes this connection explicit:

The economic function of the securities markets is to channel individual institutional savings to private industry and thereby contribute to the growth of capital investment. Without strong capital markets it would be difficult for our national economy to sustain continued growth; indeed, the state of U.S. capital market development[,] more advanced than that of any other industrial country, is an important contributing factor in the rapid economic growth this country has experienced. Securities brokers support the proper functioning of these markets by maintaining a constant flow of debt and equity instruments. The continued financial well-being of the economy thus depends, in part, on public willingness to entrust assets to the securities industry.59

56. Id. at 142 (statement of Sen. Edmund S. Muskie introducing the Amendment to S. 2348).
57. H.R. REP. NO. 91-1613, reprinted in 1970 U.S.C.C.A.N. 5254, 5255. According to the Senate report, SIPC, like the Federal Savings and Loan Insurance Corporation (FSLIC) and FDIC, was intended to serve several purposes: to protect individual investors from financial hardship; to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss.
C. CAUSES OF FAILURE IN THE BROKER-DEALER INDUSTRY, THEN AND NOW

Ironically, although SIPA was designed to protect broker-dealers by promoting investor confidence, the loss of investor confidence was not the cause of the failures that inspired SIPA. Rather, the reverse was the case: Congress feared the failures attributed to the back office crisis were causing a loss of confidence. Congress rushed to restore investor confidence without stopping to consider whether a loss of confidence, if it were indeed occurring, might administer a healthy dose of market discipline to the industry. This section discusses the causes of the original back office crisis as well as contemporary conditions contributing to the risk of customer loss and broker-dealer failure today.

1. Mismanagement and Misconduct

Despite the centrality of investor confidence in the SIPA scheme, neither Congress nor later commentators attributed the failures of brokerage firms to a loss of investor confidence in broker-dealers’ financial stability. Rather, it is generally accepted that the principal cause of the back office crisis was “incompetent broker-dealer firm management during the 1964-68 securities volume surge.”

Securities firms failed to upgrade processing capacity despite dramatic, steady increases in trade volume. SIPA required the SEC to report to Congress by the end of 1971 on “unsafe and unsound practices” in the securities industry. The SEC’s report concluded that the industry had “paid insufficient attention to properly handling and processing the business brought in by its sales efforts.” Industry leaders admitted to this failing. In 1968, NYSE president Robert Haack stated that “[t]he industry’s problem is its failure to gear total capacity of doing business to its capacity to produce business.”

In 1971, Donald Regan, chairman of Merrill Lynch, Pierce, Fenner and Smith, conceded before a Senate Committee that broker-dealer management had been “slipshod and blindly optimistic.”

A manufacturing company president who had invested in Hayden, Stone, Inc., a respected Wall Street firm that

60. SELIGMAN, supra note 8, at 455.
62. SELIGMAN, supra note 8, at 455 (quoting “Study of Unsafe and Unsound Practices of Brokers and Dealers,” an SEC study on the incompetence of the broker-dealer firm management during the back office crisis).
63. Id.
64. Id.
collapsed during the crisis, remarked, “In my business, if we are missing inventory, we stop everything and start looking for it. In [sic] Wall Street, if they are missing $7 million, they just accept it as part of the game. I know of no other business where this could happen.” 65

The SEC’s “Unsafe and Unsound Practices” report identified the technical backwardness that contributed to the back office failure. In response, Congress, in the 1975 Securities Exchange Act Amendments, instructed the SEC to establish a national system of trade processing and gave the SEC new powers to regulate trade processing. 66 This paved the way for the establishment of depositories for securities certificates, reducing the paperwork involved in transfers and, consequently, the processing problems that arose during the back office crisis. 67

Although correcting the trade processing system was an important step in addressing the issue of brokerage failures, limited processing capacity did not by itself cause firms to fail. In this sense, the term “back office crisis” is a misnomer. Limited capacity translated into back office failure only for firms that had voluntarily overburdened their processing machinery by accepting orders they were unable to process. Firms that did not wish to expand processing capacity had the option of refusing to accept orders in excess of capacity; such restraint would have cost firms increased immediate profits, but would not have led to failure. In any industry, accepting orders that cannot be filled violates basic principles of contract. Moreover, in the view of the SEC, such conduct constituted securities fraud. As the SEC informed broker-dealers during the crisis:

[I]t is a violation of the anti-fraud provisions of the federal securities laws, and particularly Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, for a dealer, as principal for his own account, to sell a security to a customer, or for a broker to buy a security as agent for a customer, or to induce the purchase of a security by a customer, if the broker-dealer has reason to believe that he will not be able to deliver the security to the customer promptly. This is consistent with the Commission’s long standing position taken in Commission decisions and discussed in Securities Exchange Act Release No. 6778, dated April

65. Id. at 456 (quoting Jack Golsen, president of an Oklahoma manufacturing corporation). Hayden, Stone had a shortfall of $9 million in securities in August 1969, of which $7 million was still unresolved in spring of 1970. See id.


16, 1962, that a broker-dealer impliedly represents that he will deal fairly with the public and that this representation includes the implied representation that the transaction will be consummated promptly, which includes prompt delivery to the customer.

. . . .

The Commission also warns broker-dealers that it is a violation of applicable anti-fraud provisions for a broker-dealer to accept or execute any order for the purchase or sale of a security or to induce or attempt to induce such purchase or sale, if he does not have the personnel and facilities to enable him to promptly execute and consummate all of his securities transactions.68

Because acceptance of excessive orders occurred on so great a scale, it cannot be dismissed as the work of a few rogue brokers. Firms failed to control their employees, at least in part because the firms enjoyed the short-term benefits of commissions earned from increased orders. Furthermore, although accidentally accepting some degree of excess orders might be understandable, the continued, widespread, and large-scale nature of this conduct indicates that firms must have been aware they were violating the law. Put bluntly, the immediate cause of the swamping of back offices was not technological backwardness, but rampant securities fraud. The chaos caused by back office failure also created the opportunity for other forms of securities fraud, including misappropriation. The 1968 failure of Pickard & Co., the first victim of the crisis, is emblematic.69 As noted above, its back office failure was only one of a host of problems, including securities law violations, that led to its demise. Thus, although it is true that mismanagement caused the back office crisis, mismanagement was not confined to the failure to upgrade processing capacity. It also included the greedy acceptance of excess orders and the failure—or refusal—to control the misconduct of employees.

2. Failure of Self-Regulation

The failure of oversight was not limited to the firm level. Day-to-day oversight of firms was, and remains, in the hands of the self-regulatory organizations—the NYSE, AMEX, the regional stock exchanges and the NASD. Given the unusually important role of SROs in regulation of the securities industry, all the failures of supervision attributable to firm

69. See supra text accompanying notes 28-29.
70. As an SEC Special Study stated, “There are, no doubt, many other instances in which the policy of entrusting a degree of social control to ‘private’ groups has been adopted, but securities regu-
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management are in some measure also attributable to SROs. As noted above, Pickard & Co. had been a chronic violator of Exchange and SEC rules for years prior to its failure. The Exchange had placed some restrictions on Pickard because of its misconduct, but failed to enforce them. As noted above, Pickard & Co. had been a chronic violator of Exchange and SEC rules for years prior to its failure. The Exchange had placed some restrictions on Pickard because of its misconduct, but failed to enforce them. For years before their financial disasters, Goodbody and DuPont’s requisite financial reports to the Exchange had indicated their precarious financial positions, yet the Exchange imposed no restrictions on their activities. While firms were crippling themselves by accepting orders far in excess of capacity, the Exchange did no more than suggest modest, voluntary steps to curtail business volume. The Exchange’s most dramatic step, shortening trading hours, only increased time pressure on brokers and compounded errors while doing little to reduce trading volume. The Exchange never even recommended that its members take direct steps to reduce volume, such as halting the opening of new branches, hiring new salespeople, advertising, or trading for their own accounts.

Although SROs are regulatory bodies, at the same time they are business groups representing broker-dealer firms, as well as businesses themselves. As is to be expected, SROs jealously guard their power from government encroachment. It is thus not surprising that they were neither cooperative nor forthcoming during the Senate’s hearings on the proposed SIPA legislation, even though the bill was intended to save the industry from its own excesses. During the crisis, stock exchanges attempted un-


71. See BARUCH, supra note 10, at 117.
72. See id. at 118.
73. See id. at 131-36.
74. An SEC report summed up the conflicting roles of SROs:

The Exchange Act requires SROs to act as quasi-governmental bodies implementing the federal securities laws as well as their own rules. Yet SROs also are membership organizations and as such represent the economic interests of their members. In addition, SROs are marketplaces concerned with preserving and enhancing their competitive positions.


75. When SIPA was eventually enacted at the end of 1970, Senator Muskie grumbled about the attitude of SROs stating that “we were continually frustrated in our efforts to decide precisely what steps should be taken immediately. This frustration was caused primarily because of a devastating lack of precise information concerning the exact condition of the industry and the causes of the problems it is experiencing.” BARUCH, supra note 10, at 76 (quoting 116 CONG. REC. 21101 (daily ed. Dec. 22, 1970)).
successfully to protect their customers against losses due to broker-dealer failures. In response to a member firm’s failure in 1963, the NYSE had amended its constitution to provide for a “Special Trust Fund.” The NYSE, however, considered the use of the fund entirely discretionary, and maintained that customers had no legal right to its protection. In fact, the fund was apparently used in a favoritist manner. The Exchange refused to protect the customers of three small member firms that failed in August 1970. The following month, however, it compensated the customers of the larger Hayden, Stone firm, a major Wall Street underwriter that had been in business since the 1880s.

The Exchange also failed to carry out its duty to ensure that brokers maintain capital cushions sufficient to protect their customers in the event of insolvency. In 1963, an SEC study argued that “those entering the securities business as entrepreneurs should have such sense of commitment to their business as is likely to produce responsible, reliable operations.” The study concluded that broker-dealers operating with limited capital committed a “disproportionate number” of SEC rule violations and were “significantly” more likely to run afoul of the existing capital-indebtedness ratio rules. The SEC implemented the recommendations of the Special Study and established minimum net capital requirements for broker-dealers in 1965. The requirement for broker-dealers engaged in general securities business, however, was a “negligible” $5000. NYSE members, however,

76. See SELIGMAN, supra note 8, at 461.
77. See BARUCH, supra note 10, at 214.
78. See H.R. REP. NO. 91-1613 (1970), reprinted in 1970 U.S.C.C.A.N. 5268. See also BARUCH, supra note 10, at 214-29; SELIGMAN, supra note 8, at 454. In a telegram to the Senate committee, NYSE President Robert Haack proudly proclaimed in April 1970 that no customer had ever lost cash or securities due to the failure of an Exchange member. See BARUCH, supra note 10, at 72. Haack added that an insurance program was unnecessary because the Special Trust Fund was “not near depletion” and the financial condition of member firms had “vastly improved” since the filing of the bill in mid-1969. See id. In testimony before the committee, Haack contended that the Exchange’s “conscientious and vigorous” surveillance of its members would serve as an “early warning system” to identify firms approaching difficulty. See id. at 73-74. Hayden, Stone was well on the way to a costly failure when Haack sent his telegram and when he testified before the committee, but Haack did not mention it to the committee. By the fall of that same year, however, NYSE liquidations of five member firms had exhausted the $55 million fund. See id. at 213; SELIGMAN, supra note 8, at 454.
79. See BARUCH, supra note 10, at 214-29; SELIGMAN, supra note 8, at 454. Baruch suggests that by August 1970, the Exchange, which had originally opposed the proposed legislation, had decided that it needed SIPC insurance and allowed customers of the three small firms to go unprotected in order to force Congress to pass the legislation. See BARUCH, supra note 10, at 227-29.
80. Molinari & Kibler, supra note 61, at 8 (quoting H.R. DOC. NO. 88-95, at 48 (1963)).
81. See id. at 9 (citing H.R. DOC. NO. 88-95, at 84-85, 91).
82. See SELIGMAN, supra note 8, at 457. As Hurd Baruch notes, even fast-food franchisees of the time required prospective franchisees to raise equity capital of 10 to 25 thousand dollars. See BARUCH, supra note 10, at 20.
were exempted from even these minimal SEC capital requirements. The SEC originally granted the exemption because NYSE minimum capital rules were nominally stricter than those of the SEC. However, the Exchange retained its exemption even when it subsequently relaxed its capital rules.83

Furthermore, as the SEC concluded in 1970, the Exchange had failed to enforce its minimum capital requirements during the back office crisis.84 The SEC determined that 16 NYSE member firms had violated Rule 325, the Exchange’s capital rule, in 1968. Of these firms, however, the NYSE took disciplinary action against only six and had reported only one to the SEC.85

3. Continuing Significance of Misconduct

Today, technological advances and the advent of centralized trade-clearing facilities have all but eliminated back office failures. Misconduct, however, continues to play a central part in broker-dealer failure. In general, a firm is vicariously liable for its agents’ misconduct. Thus as long as a firm is solvent, the firm, and not the customer, generally pays for its agents’ misconduct. The role of misconduct in failures, however, suggests that industry stability requires the elimination of misconduct, not merely the allocation of its costs to the firm. The persistence of misconduct indicates that the existing vicarious liability regime is not providing firms sufficient incentive to deter misconduct. Moreover, there is evidence that the vicarious liability regime, as administered by the industry-dominated arbitration system, does not adequately protect customers.86

The nature of the broker-dealer business makes insider fraud and theft especially easy. Broker-dealers, like other financial intermediaries, conduct “transactions that are (1) numerous, (2) in highly liquid form, (3) easily forgeable, and (4) involve large amounts of money which (5) often cross jurisdictional boundaries.”87 A broker-dealer has better access to and

83. See BARUCH, supra note 10, at 176-77. The NYSE capital compliance rules were further deficient in that they permitted the withdrawal of capital on 90 days’ notice; many brokers withdrew capital during the financial pressures of the back office crisis and fell out of capital compliance. See SELIGMAN, supra note 8, at 458.
84. See Molinari & Kibler, supra note 61, at 15 n.94. The SEC eventually eliminated the NYSE’s exemption and adopted the modern uniform net capital rule in 1975. See SELIGMAN, supra note 8, at 466.
85. See Molinari & Kibler, supra note 61, at 15 n.94.
86. See infra note 99.
87. Peter P. Swire, Bank Insolvency Law Now That It Matters Again, 42 DUKE L.J. 469, 510 (1992). The quoted material refers to bank account transactions, but is equally applicable to securities
information about the cash and securities in its customers’ accounts than do the customers themselves. The danger of abuse is exacerbated by many customers’ lack of information and sophistication concerning their brokers, securities and the brokerage industry in general.

In fact, misconduct is the leading cause of the insolvencies administered by SIPC. SIPC officials have estimated that over half of the 228 broker-dealer failures it had administered as of 1991 were due to some type of fraudulent conduct.\(^88\) Moreover, such failures are disproportionately expensive. While they comprised slightly over half of all failures, they accounted for over eighty percent of the $236 million in liquidation expenses SIPC had incurred as of the end of 1991.\(^89\) The most common form of misconduct leading to firm failure is the outright misappropriation of customers’ cash and securities. The most expensive SIPA liquidation to date, that of the Ohio firm Bell & Beckwith, cost the SIPC fund $31,722,352.\(^90\) The failure is attributed to a firm officer who “borrowed” $32 million in cash and securities from customers’ margin accounts over a five-year period in return for pledges of nearly worthless stock.\(^91\)


\(^89\) See REGULATORY FRAMEWORK, supra note 88, at 29.

\(^90\) See id. at 29-30.

\(^91\) See id.
The significance of misconduct as a cause of failures is underscored by the fact that SIPC liquidations often involve introducing firms that handled customer property without legal authority to do so. Introducing firms have retail relationships with customers, but may not hold cash and securities for customer accounts. The introducing firm receives customers’ cash and securities, but the accounts are held by a separate “clearing” firm.\textsuperscript{92} Such firms are nonetheless required to be SIPC members.\textsuperscript{93} When an introducing firm fails, all of the customers’ property should reside safely with the clearing firm.\textsuperscript{94} Hence, in theory, a properly run introducing firm should never be the subject of a SIPA proceeding. An introducing firm failure requires SIPC liquidation only if customers of the firm have need of SIPC protection, which can occur only if the firm has illicitly held—or misappropriated—customers’ cash or securities. Nonetheless, twenty-six of the thirty-nine firms SIPC liquidated from 1986 to 1991, or sixty-seven percent, were introducing firms.\textsuperscript{95} The SEC and SROs have not been particularly successful in monitoring broker misconduct. A 1994 study by the General Accounting Office found “shortcomings in the detection and discipline of unscrupulous [broker-dealer firms].”\textsuperscript{96} First, records regarding disciplinary history were not

\textsuperscript{92} For a description of the relationship between an introducing firm and its clearing agent, see generally Henry Minnerop, \textit{The Role and Regulation of Clearing Brokers}, 48 Bus. Law. 841 (1993). Clearing firms are also required to be SIPC members. To date, only one clearing firm has been the subject of a SIPC liquidation. \textit{See In re} Adler Coleman Clearing Corp., 195 B.R. 266 (Bankr. S.D.N.Y. 1996). The author of this Article was associated with counsel for the SIPC Trustee in that liquidation proceeding.

\textsuperscript{93} Introducing firms are subject to significantly reduced minimum capital requirements. They are currently allowed to operate with net capital as low as $50,000 under Rule 15c3-1(a)(2)(iv), as compared to $250,000 for carrying firms pursuant to Rule 15c3-1(a)(2)(i). Firms authorized neither to hold nor receive customer cash or securities may operate with capital as low as $5000 under Rule 15c3-1(a)(2)(vi). \textit{See} 17 C.F.R. \textsuperscript{96} § 240.15c3-1(a) (1998). The customer protection rule does not apply to such firms, of course, since any customer funds they hold are held illegally. Thus, an unscrupulous firm may be tempted to register as an introducing broker to evade net capital and CPR requirements while illicitly using customer property to finance its own proprietary trading or for hypothecation purposes.

Because of the relaxed net capital and CPR requirements, when an introducing firm does enter SIPA liquidation, it will likely depend heavily on the SIPC fund to satisfy customers. The very fact that SIPA requires introducing firms and other non-carrying firms to be SIPC members is a sign of Congress’ concern with the potential for gross broker misconduct. And as noted in the text, the majority of SIPC liquidations involve introducing firms that illicitly handled customer property. Nonetheless, net capital requirements remain low and neither net capital requirements nor SIPC assessments are raised for firms known to have disciplinary problems.

\textsuperscript{94} Of course, a failed introducing firm may have been in custody of small amounts of cash or securities recently received from customers but not yet transferred to the clearing firm at the time of failure. A firm should be able to return such amounts without SIPC intervention.

\textsuperscript{95} \textit{See} REGULATORY FRAMEWORK, \textit{supra} note 88, at 29.

\textsuperscript{96} GAO, \textit{SECURITIES MARKETS: ACTIONS NEEDED TO BETTER PROTECT INVESTORS AGAINST
easily accessible. The NASD and state securities regulators maintain the Central Registration Depository (CRD), a computerized database used to monitor the activities of brokers. Although originally designed for broker registration purposes, the CRD is the only centralized source of information about broker-dealer disciplinary proceedings and terminations. The GAO found the CRD in need of improvement as a regulatory aid. It was designed to provide information about individual brokers and not as a tool to monitor regulatory compliance. Second, the CRD is incomplete in that it does not include information on informal disciplinary actions.97 In addition, the reliability and completeness of CRD data are questionable because until recently, the SEC, American Stock Exchange and regional stock exchanges did not report their disciplinary proceedings to the CRD. Rather, CRD personnel had to research and compile data from public records.98 Although firms are required to report the terminations of employees, regulators suspect that when terminations are due to misconduct, firms often fail to report that fact. Third, the GAO found that the SEC and SROs imposed overly lenient punishments for disciplinary violations.99 For example, individuals temporarily barred from the securities business were often given “retroactive bars,” and individuals “permanently” barred from the industry were nonetheless allowed to return to the industry.100

The public does not have direct access to the CRD. However, NASD Regulation, Inc., the NASD’s regulatory subsidiary, discloses some infor-

UNSCRUPULOUS BROKERS, GAO/GGD-94-208, at 3 (1994) [hereinafter UNSCRUPULOUS BROKERS].

97. The SEC objected to the GAO’s suggestion that data on informal sanctions be included in the CRD, claiming that such information would needlessly clutter the database. See id. at 17.

98. See id. at 13. Federal and state regulators, as well as SROs are now required to report disciplinary information to CRD. See GAO, NASD TELEPHONE HOTLINE ENHANCEMENTS COULD HELP INVESTORS BE BETTER INFORMED ABOUT BROKERS’ DISCIPLINARY RECORDS No. B-259990, at 3-4 (1996).


100. See UNSCRUPULOUS BROKERS, supra note 96, at 10.
While it may be tempting to suggest reallocation of substantial regulatory and disciplinary powers from the SEC and SROs to SIPC, such a drastic change is unrealisic on both the political and logistical levels. The SEC and SROs would not give up such power, nor does SIPC have the resources or experience to handle such a role. Rather than consolidation, a more realistic approach to the prevention of misconduct and failures is increased policy coordination among SIPC and the SEC, as well as SROs. As argued below, however, SIPA as currently formulated does not contribute to the prevention of misconduct. Quite to the contrary, it may indirectly discourage attempts at prevention.

4. New Problems in the Industry: Increased Riskiness and Complex Corporate Structures

Mismanagement and misconduct are perennial problems that reached crisis proportions in the late 1960s and remain problems today. In addition, two more recent developments affect the risk of brokerage firm failure: the increased riskiness of broker-dealer business practices and the shift toward increasingly complex and diversified corporate structures.

The increased riskiness of broker-dealer firms stems from the shift in the source of broker-dealer revenue. Prior to the mid-1970s, broker-dealers received a significant proportion of revenue in the form of commissions. Following the abolition of fixed commission rates in 1975, commission rates began to decline. As late as 1980, commissions still made up approximately thirty-four percent of broker-dealer revenues. By 1990, they accounted for only seventeen percent. Firms have come to rely on riskier sources of income, such as trading and investment for their own ac-

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101. The Public Disclosure Program (PDP) provides information on past and pending disciplinary actions and related matters. See NASD Regulation Web site <http://www.nasdr.com/2002.htm> (visited Apr. 9, 1999). NASD Regulation’s Web site and PDP brochure state that the PDP offers the public access to “disclosable” information from the CRD. However, neither the Web site nor the brochure indicates how NASD Regulation determines the “disclosability” of CRD information. The NASD disclaims any responsibility for the accuracy or reliability of the broker-dealer disciplinary information it provides. Indeed, visitors to the NASD Regulation Web site must click to accept NASD’s strongly-worded disclaimers, along with other “terms and conditions,” before being allowed to use the PDP service. See NASD Regulation Web site <http://pdpi.nasdr.com/pdpi/disclaimer_frame.htm> (visited Apr. 9, 1999).


103. See id. at 38.
counts, arbitrage, and extending bridge loans. Although they present the opportunity for large profits, such activities, unlike commissions, can expose the firm’s capital to market and credit risk. In analyzing the losses suffered by a set of NYSE member firms in the October 1987 stock market crash, the SEC identified proprietary trading in equity securities as the most important factor. Similarly, market turbulence in 1989-90 caused difficulties in the repayment of bridge loans, and even defaults. Broker-dealer riskiness has also been heightened by a tendency toward increased leverage.

Broker-dealer businesses were traditionally conducted as partnerships. Today, however, like banks, they are usually incorporated and owned through holding company structures of increasing complexity. Within these complex holding company structures, affiliated corporations often engage in various securities-related activities outside the scope of SEC broker-dealer regulation and the SIPA scheme, such as trading in commodities or government securities. While federal banking law limits the types of business activities in which bank affiliates may take part, no such limits apply to the affiliates of securities firms. Affiliates may engage in more diverse financial and non-financial activities such as corporate finance, merchant banking, insurance, and even real estate and energy. To the extent that their activities are less regulated or unregulated, affiliates may be more highly leveraged and exposed to greater credit and market risk than their broker-dealer siblings. The SEC has noted that this is particularly true of unregulated affiliates dealing in foreign currencies, mortgages, and interest rate swaps. Although a broker-dealer may enjoy

104. See id. “Bridge loans” are large short term loans used to finance corporate mergers and acquisitions.
105. See id. at 39.
106. See id.
107. See id. at 41. From 1980 to 1990, total liability to equity ratios of broker-dealer firms increased from 13:1 to 18:1. See id. The GAO studied 13 major firms, including the country’s 10 largest, and found an average ratio of 27:1.
109. See ADDITIONAL FINANCIAL ACTIVITIES, supra note 102, at 36.
110. The Bank Holding Company Act of 1956, the Federal Reserve Act, and the Banking Act of 1933 (Glass-Steagall Act) limit the activities of bank affiliates. See id. at 62.
111. See id. at 36. See also Peter Truell, It’s Showdown Time on Wall St.; For Brokerage Houses, a New Class of Suitor Rides In, N.Y. TIMES, March 7, 1997, at D1 (discussing the interest of banks, insurance companies and other financial “outsiders” in acquiring securities firms).
112. See Jamroz, supra note 108, at 893. See also ADDITIONAL FINANCIAL ACTIVITIES, supra note 102, at 4.
113. See ADDITIONAL FINANCIAL ACTIVITIES, supra note 102, at 57.
corporate separateness from such affiliates, affiliates’ financial problems can affect the stability of the broker-dealer. The SEC has expressed concern that such affiliates and holding companies, which often have financial resources inferior to those of the broker-dealer, may rely on the broker-dealer’s excess net capital in times of financial need.114

Experience teaches that the financial weakness of affiliates has the potential to drag down SIPC member firms. For example, the collapse of Bevill, Bressler & Schulman, Inc. (BBS), one of the costliest liquidations in SIPA history, has been blamed on BBS’s attempts to bail out a financially ailing affiliate, an unregulated secondary dealer in government securities.115 Similarly, Drexel Burnham Lambert, Inc. (DBL) narrowly avoided SIPC liquidation when it failed due to the collapse of its holding company. The holding company had withdrawn approximately $400 million of the capital cushions of DBL and an affiliate (a government securities dealer) before the SEC and NYSE ordered a stop to the withdrawals.116 The potential impact of affiliated corporations on a broker-dealer’s health is further underscored by the fact that a quartet of major firms—First Boston Corporation, Shearson Lehman Hutton Inc., Prudential-Bache Securities Inc., and Kidder, Peabody & Company Inc.—received large capital infusions from their corporate parents in 1990 which may have averted their failures.117 While these cases show how strong corporate parents can protect firms in financial distress, they also show broker-dealers’ dependence on the parents’ financial strength. Moreover, corporate parents have no legal obligation to assist ailing subsidiaries.118

D. SIPA’S APPROACH TO THE PROBLEM OF BROKER-DEALER FAILURE

1. SIPA Investor Protection in a Broker-Dealer Liquidation

With certain limited exceptions, SIPA requires every securities broker-dealer in the United States to be a SIPC member.119 When a member

114. See id.
117. See REGULATORY FRAMEWORK, supra note 88, at 37.
118. See ADDITIONAL FINANCIAL ACTIVITIES, supra note 102, at 43.
firm becomes insolvent and cannot meet its obligations to its customers, SIPC oversees its liquidation under SIPA, and not the Bankruptcy Code. Unlike the FDIC, SIPC may not give financial assistance or take any other action to help restore an insolvent member to financial health. The SIPC fund is used as necessary to compensate certain claims of the debtor firm’s customers (but not other creditors) that the firm’s estate is unable to pay.

Like the FDIC, SIPC maintains its protection fund by assessing fees on its members. Member assessments have historically been a nominal flat fee or a uniform percentage of each member’s gross revenues. From the fund’s inception in 1971 until 1977, SIPC assessed each member firm one-half of one percent of that firm’s annual gross revenues from the securities business. Since then, the assessed rate has varied but has remained significantly lower than the original level. SIPC has made remarkably low flat assessments of $25 to $150 in some years and revenue-based assessments no higher than 0.25% in other years. SIPC set annual assessments of 0.065 to 0.095% for the years 1991 to 1995. Assessments in 1996 and 1997 were a flat $150, the statutory minimum.

When the SEC or an SRO informs SIPC that a broker-dealer “is in or is approaching financial difficulty,” SIPC may apply to a federal district court for an order declaring that the firm’s customers require SIPC protection. SIPC appoints a trustee to oversee the liquidation which is transferred to the jurisdiction of the bankruptcy court. SIPC makes advances to the trustee from the SIPC fund to cover shortfalls in a debtor firm’s estate primarily outside the U.S., and persons whose business as a broker or dealer consists exclusively of (I) the distribution of shares of registered open end investment companies or unit investment trusts, (II) the sale of variable annuities, (III) the business of insurance, or (IV) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts.


120. The Bankruptcy Code also includes provisions for stockbroker liquidation, but such a liquidation does not give customers the protections of the SIPC fund. When a firm does not need the assistance of the fund to protect customers against loss, it may self-liquidate under the auspices of its SRO.


123. See id.

124. See id.


126. In smaller liquidations (those with fewer than 500 customers and less than $750,000 in liabilities to unsecured general creditors and subordinated lenders), SIPC may appoint one of its own employees to serve as trustee. See 15 U.S.C. § 78eee(b)(3) (1994). To conserve administrative expenses in liquidations with aggregate customer claims of less than $250,000, SIPC may forego a liquidation proceeding and simply conduct a “direct payment procedure.” See 15 U.S.C. § 78fff-4 (1994).

127. With respect to the roles of the federal courts in a SIPA liquidation, see generally Harbeck, supra note 7.
tate with respect to certain claims of the member’s “customers,” as narrowly defined by the statute.\textsuperscript{128}

Liquidation under SIPA is based on the division of the debtor firm’s estate into three categories: customer name securities, the fund of customer property, and a general estate.\textsuperscript{129} “Customer name securities” are those registered in the name of the investor.\textsuperscript{130} Such property is returned to the investor outright. In modern practice, however, securities held by a brokerage firm for an investor are not generally registered in the investor’s name.\textsuperscript{131} Rather, in order to enhance their transferability, they are generally registered in the name of an intermediary.\textsuperscript{132} Thus, very few of the securities a firm holds for investors fall into the “customer name” category.\textsuperscript{133} The bulk of a SIPA debtor’s estate falls under the category of “customer property”—the cash and securities (other than customer name

\textsuperscript{128} See infra text accompanying note 135.

\textsuperscript{129} This tripartite division, along with much of the SIPA liquidation scheme (exclusive of its “insurance” provisions, of course) is derived from former Bankruptcy Code section 60(e), which provided for the bankruptcies of stockbrokers. See Don & Wang, supra note 7, at 525-29; Harbeck, supra note 7, at 278.

\textsuperscript{130} Because SIPA contains a technical definition of the term “customer,” this discussion will use the term “investor” to refer to the persons who, in the lay sense, were the customers of the debtor—the persons who had accounts with the debtor through which they conducted their securities transactions. See infra note 135.

\textsuperscript{131} The differing treatment of “customer name” securities and other securities might suggest that it is preferable to hold all securities in customer name rather than in the name of the broker or an intermediary (commonly referred to as “street name” holding). However, this would only simplify recovery of those securities in the debtor’s possession at the time of insolvency. Recovery of missing securities would still require the assistance of the SIPC fund.

Moreover, street name holding has greatly simplified the transfer of securities. Today’s higher trading volumes make old-fashioned processing all the more difficult. While daily trading volume of 13 million shares taxed processing capabilities in 1968, daily volume surpassed one billion shares on October 28, 1997. Furthermore, the CNS system requires street name registration. Thus, even if uncertificated book entry registration were to eliminate the paperwork and physical transfer involved in customer-name ownership, DTC’s nominee would still have to be the registered owner of most securities in order for the CNS system to operate. See Mooney, supra note 3, at 320.

However, while street name holding improves liquidity and therefore facilitates trading, there are those who argue that trading should not be encouraged for its own sake, because excessive trading contributes to market volatility. See generally Paul G. Mahoney, Is There a Cure for “Excessive” Trading?, 81 VA. L. REV. 713 (1995).

\textsuperscript{132} See Jeanne L. Schroeder & David Gray Carlson, Security Interests Under Article 8 of the Uniform Commercial Code, 12 CARDOZO L. REV. 557, 560-61 nn.9-10 (1990). Most major securities are on deposit at DTC and registered in the name of DTC’s nominee. See supra text accompanying note 3.

\textsuperscript{133} See Schroeder & Carlson, supra note 132, at 656. It is more likely that “the customer claims a pro rata share of a fungible bulk, which in turn is a pro rata share of a fungible bulk in another financial intermediary, and so on. In such a case, the broker may have too many subscribers for the securities it holds.” Id.
securities) held by the debtor for the accounts of investors.\footnote{134} The debtor’s remaining assets constitute the general estate.

Although it is often said that the SIPC fund will satisfy “customer claims,” this does not mean that the fund guarantees reimbursement of all losses suffered by an investor who had an account with the failed firm. Rather, the fund applies only to satisfy a certain type of investor claim—namely, claims for the net contents of accounts with the debtor. These claims, properly referred to as “customer claims for net equity,” include claims for securities held in accounts and for cash deposited for the purpose of securities trading.\footnote{135} Investors with customer claims for net equity receive a pro rata recovery from the fund of customer property. To the extent that the fund of customer property may be insufficient to satisfy all customer claims for net equity, the SIPC fund will cover the shortfall.\footnote{136}

\footnote{134}{See 15 U.S.C. § 78lll(4) (1994).}

\footnote{135}{The literature and jurisprudence often use the less accurate term “customer claim” in this context. For the technically-minded reader, some statutory arcana may be useful at this point. The statute allocates the fund of customer property to the debtors’ “customers,” who receive a ratable share of the fund “on the basis and to the extent of their respective net equities.” SIPA defines a “customer” as a person who has a claim on account of securities received, acquired, or held by the debtor 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. The term “customer” includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities . . . . 15 U.S.C. § 78lll(2) (1994). “Customer” is further defined to exclude persons who are brokers or dealers, persons whose claims arise out of transactions with a foreign subsidiary, and persons whose claims are for cash or securities that are part of the capital of the debtor or subordinated to the claims of the debtor. See id. SIPC funds may not be used to satisfy the claims of customers who are the debtor’s general partners, officers, or directors, or who have a five percent or larger ownership interest in the debtor firm.

A customer’s “net equity” is the difference between what would have been owed to the customer by the debtor if the customer had liquidated its account on the day of insolvency filing and what would have been owed by the customer to the debtor as of that date. See 15 U.S.C. § 78lll(11) (1994).

Although SIPA defines the noun “customer,” the term is more useful as an adjective, as in “customer claim for net equity.” This is because a person may be a customer with respect to certain claims and not to others. Take for example a person who files a claim in the SIPA liquidation of ABC Brokerage accurately stating that her account contained 100 shares of XYZ Corp. stock and that she had an unsatisfied $15,000 arbitration award against ABC. She is a customer with respect to her claim for 100 shares of XYZ Corp., but not with respect to her arbitration claim. Rather than saying that she is and is not a customer, depending on the claim at issue, it is more useful to say that her claim for the 100 shares is a “customer claim for net equity” and her claim for the $15,000 is not a “customer claim for net equity.” See id.

The expression “customer claim,” often found in SIPA jurisprudence, should be properly understood as an abbreviation of the term “customer claim for net equity.” See id.

\footnote{136}{In the event that all customer claims for net equity can be satisfied out of the fund of customer property, of course, recourse to the SIPC fund is unnecessary. In such a case, any remaining customer property becomes part of the general estate. See 15 U.S.C. § 78fff-2(c)(1) (1994).}
This is the so-called “SIPC insurance” aspect of SIPA. When necessary, SIPC will pay, out of the SIPC fund, up to $500,000 to each holder of a valid customer claim for net equity.\textsuperscript{137} Of that $500,000 total, a maximum of $100,000 will be paid for that portion of the claim which is for cash.\textsuperscript{138}

Investors who were, in the lay sense, customers of the failed firm often suffer losses that will not be paid out of the SIPC fund. Most obvious among such investors are those whose customer claims for net equity exceed the $500,000 total or $100,000 cash limitations. Investors who had accounts with the debtor may have claims that do not qualify as customer net equity claims. To the extent that the general estate may be inadequate to satisfy these claims, the SIPC fund provides no “insurance.” Examples of such claims are those based on declines in the market value of securities, fraud or breach of contract by the debtor. Investors with such claims must seek recovery from the debtor’s general estate along with the debtor’s other general creditors.\textsuperscript{139} Because a broker-dealer generally has a limited general estate, determining whether a given creditor’s claim is a “customer net equity” claim is usually crucial to whether that creditor makes any recovery.

SIPC has no “watchdog” powers over its members.\textsuperscript{140} SIPC does not impose any financial requirements or proscribe any practices. Nor may it conduct examinations of its members. The SEC retains authority and discretion to investigate violations of the federal securities laws and to pass regulations regulating the actions of broker-dealers. The SEC delegates much of that power and responsibility over broker-dealers to the self-regulatory organizations.

SIPC is empowered only to react to failures or impending failures, and only when notified by the SEC or an SRO. SIPA directs the SEC and the SROs to inform SIPC if and when they are “aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or is approaching financial difficulty.”\textsuperscript{141} The wording of this section clearly indicates that the SEC and SROs are under no affirmative duty to watch for signs of financial difficulty, but merely to report any signs of which they become aware. Indeed, SIPA specifically grants the SROs immunity from any liability for failing “in good faith” to report the financial difficulty of a

\begin{itemize}
\item \textsuperscript{138} See 15 U.S.C. § 78fff-3(a) (1994).
\item \textsuperscript{139} See 15 U.S.C. § 78fff-2(c)(1)(B) (1994). General creditor claims will be discussed below.
\item \textsuperscript{140} See Don & Wang, supra note 7, at 514 n.26.
\end{itemize}
member. The SEC and SROs do not actively monitor brokers’ financial health; rather, the financial conditions of broker-dealers are largely self-reported. Furthermore, even if the SEC becomes aware of broker-dealer financial distress, it is unclear who within the SEC has primary responsibility for reporting it to SIPC. SEC regulations assign the statutory duty to a number of different officials at various levels. Nonetheless, only the SEC can order SIPC to initiate a SIPA liquidation proceeding; individuals have no standing to sue SIPC to compel it to do so.

2. **SIPA and Financial Responsibility Rules**

With respect to the means of promoting investor confidence, the legislative history indicates that Congress initially considered the SIPC fund less important than industry reform. According to the House Report on the bill, “It is clear that the protections to investors provided by the proposed SIPC fund are really only an interim step. The long-range solution to these problems confronting the industry today is going to be found in the ultimate raising of the financial responsibility of the brokerage community.”

In reality, however, the statute itself did little to pursue the “long-range solution.” Rather, the SIPC “insurance” plan was the centerpiece of the legislation. In SIPA, Congress addressed financial responsibility only by “passing the buck” to the SEC and, to a lesser extent, to SROs and SIPC. Congress merely directed the SEC to promulgate rules regarding financial responsibility and SIPC and SROs to collect information; it did not give any substantive guidance as to these tasks. Congress delegated the task of addressing financial responsibility in two ways. First, it amended section 15(c)(3) of the Exchange Act with respect to SEC rulemaking authority. Second, it assigned financial information-gathering tasks to SROs.

Despite Congressional rhetoric and the real need for reform, neither the 1970 SIPA nor any of its many amendments has ever included a single...
substantive regulation of broker-dealer financial responsibility, other than prohibiting the violation of such rules as the SEC sees fit to promulgate. This approach is consistent with Congress’ historic tendency in securities regulation to shy away from challenging the financial industries and instead cede that responsibility to the SEC.148 Professor Seligman’s characterization of the original Exchange Act as a “marvel of irresolution” is equally applicable to the SIPA approach to financial responsibility:

Rather than providing the [SEC] with a clear mandate, the legislators had granted the agency authority to study the controversy or issue its own rules. In effect, Congress had broadly defined the Commission’s areas of expertise and invited it to forge its own mandate. The political processes that produced the jerry-built statute were allowed to continue.149

Broker-dealer financial responsibility rules are justified primarily on the “liquidity principle”—that each broker-dealer should maintain adequate liquid assets to self-liquidate, if necessary, and thereby satisfy all current liabilities, particularly customer claims.150 Although the financial responsibility requirements can help create a “capital cushion” to insulate a firm from market and credit risks,151 their primary intent is to facilitate orderly liquidation in the event of failure. They do not directly prevent firms from becoming insolvent, nor are they intended to do so.152

148. Cf. MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 143 (1970). Describing the creation of the SEC, Parrish writes: “Congress, unwilling to offend powerful, entrenched economic interests and reluctant to impose statutory solutions, had given the new commission extensive rule-making authority.” Id.

149. SELIGMAN, supra note 8, at 99. Abdication of broker-dealer financial responsibility standards to the SEC is particularly problematic because such standards involve complex accounting issues. As Professor Seligman has observed, the SEC has historically neglected such issues, and SEC commissioners have consistently lacked expertise and interest in accounting matters. See id. at 416-17. Although Professor Seligman wrote specifically with reference to corporate accounting standards, his observations apply equally to broker-dealer accounting.

150. See Molinari & Kibler, supra note 61, at 2; Jamroz, supra note 108, at 863-64. A secondary purpose of the Exchange Act’s regulation of broker-dealer financial responsibility was to limit the amount of credit available for speculation in the stock market, on the belief that rampant speculation on credit had contributed to the severity of the 1929 stock market crash. See Molinari & Kibler, supra note 61, at 4 n.20. Additional rules aimed directly at limiting the availability of credit for securities purchases are Regulation T (governing extensions of credit by brokers for securities purchases); Regulation U (governing extensions of credit by banks); and Regulation G (governing extensions of credit by other lenders). See 12 C.F.R. § 220.4 (1998). Professor Galbraith, however, has rejected as “obviously nonsense” the theory that speculation on credit caused the 1929 crash. See JOHN KENNETH GALBRAITH, THE GREAT CRASH OF 1929 7 (1954).

151. See Molinari & Kibler, supra note 61, at 26.

152. “While requiring additional amounts of capital will not prevent firms from failing, the additional capital serves as a fund from which the expenses associated with a liquidation can be paid. Moreover, the greater sum will act as a more reliable cushion against the use of SIPC money.” Net Capital Rule, Exchange Act Release No. 34-31511, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,064, at 83,565 (Nov. 24, 1992). See also ADDITIONAL FINANCIAL ACTIVITIES, supra note 102, at
While the tradition of regulation in this area is long, Congress and the SEC have not implemented very demanding capital rules, and have left much of the responsibility for enforcing the rules to the industry itself. Section 15(c)(3) of the Exchange Act, adopted in 1938, gave the SEC authority to promulgate regulations governing the financial responsibility of over-the-counter broker-dealers. The SEC’s current Rule 15c3-1 (the “Net Capital Rule”) allows firms to choose one of two methods of calculating their net capital. The rule requires firms “to maintain specified levels of net liquid assets as a ratio or percentage of aggregate indebtedness (if on the basic method) or customer related receivables (if on the alternative).” A firm that falls below the net capital requirements must cease trading until it is in capital compliance. Whether a firm’s operation in violation of net capital requirements is discovered, however, depends primarily on its own honesty and, failing that, on the vigilance of the SRO charged with overseeing it.

SIPA amended section 15(c)(3) to authorize the SEC to promulgate rules “with respect to the financial responsibility and related practices of brokers and dealers.” Although the amendment clarified that the SEC had the power to pass rules directly affecting broker-dealers’ use of customer property, it did not give the SEC any direction in making such rules. This vague provision was enacted as a compromise between legislators who wanted the complete segregation of customer property from a firm’s proprietary accounts and industry advocates who argued that broker-dealers required free access to customer property for use as working capital.

51. The SEC promulgated Rule X-15c3-1, the first version of the net capital rule, in 1942. For a detailed history of the rule, see Molinari & Kibler, supra note 61, at 14-18. Section 8(b) of the 1934 Securities Exchange Act made it an offense for a broker-dealer doing business on a national exchange to allow its aggregate indebtedness to exceed 2000% of its net capital, or a lesser percentage as prescribed by the SEC. Rule X-15c3-1 adopted the 2000% standard. As noted above, the rule was soon amended to exempt members of securities exchanges such as the NYSE that imposed stricter minimum capital requirements. See id. at 8.

154. Id. at 26.

155. 15 U.S.C. § 78o(c)(3) (1994). The amended section prohibits the violation of SEC rules promulgated as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers’ securities, and the carrying and use of customers’ deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers’ deposits or credit balances . . . .


156. See Molinari & Kibler, supra note 61, at 13-14. Senator Brooke of Massachusetts unsuc-
The SEC adopted Rule 15c3-3, the Customer Protection Rule ("CPR"), pursuant to § 15(c)(3) as amended by SIPA. The CPR regulates the broker-dealers’ use and handling of customer cash and securities. Under the CPR, a broker-dealer must have physical possession or control of fully paid and excess margin\(^{157}\) securities carried for customer accounts. The broker must also make a weekly deposit of cash in the net amount owed to all customers.\(^{158}\)

Like the statutory provision it is promulgated under, the CPR is a compromise between customer protection and broker-dealer flexibility. The intended effect of the CPR is to limit a broker-dealer’s ability to put customer cash and securities at risk by using them to finance its own activities, such as proprietary trading. However, the rule allows brokers to use customer’s margin securities (as long as they are not excess margin securities) as collateral to borrow funds.\(^{159}\) Furthermore, the rule does not require a broker to earmark specific securities for specific customers. A broker may maintain control of a certain type of security in bulk for all customers with a claim to that type of security. In addition, a broker need not actually possess the securities. The broker may satisfy the rule’s requirement of “physical possession” or “control” by leaving the securities in the possession of an intermediary such as a clearing corporation, bank, or another broker, as long as the securities are not subject to lien.\(^{160}\)

The SEC has voiced suspicion that brokers do not comply with the CPR. In 1982, the SEC acknowledged that 15c3-3 “by itself, is not an

\(^{157}\) The term “margin” refers to securities bought on credit. “Excess margin” securities are those whose market value plus cash in the customer’s account exceeds 140% of the amount the customer owes the broker. See Harold S. Bloomenthal & Donald Salcito, Customer Protection from Brokerage Failures: The Securities Investor Protection Corporation and the SEC, 54 U. COLO. L. REV. 161, 168 (1983).

\(^{158}\) More specifically, the broker-dealer must make a computation at the end of each week of its net position in relation to customers. If customer monies and monies earned therefrom exceed the amount customers owe to the broker-dealer, the broker-dealer must deposit the excess at the beginning of the following week. If there is no excess, however, the broker-dealer need make no deposit. See Molinari & Kibler, supra note 61, at 15.

\(^{159}\) See Bloomenthal & Salcito, supra note 157, at 168.

\(^{160}\) See id. at 169 (citing Rule 15c3-3(c)).
adequate financial responsibility test."\textsuperscript{161} It found “substantial and continuing violations of Rule 15c3-3 and a lack of understanding of the rule . . . .”\textsuperscript{162} The SEC recognized that the CPR and the net capital rule, though seemingly redundant, were both necessary to achieve customer protection.\textsuperscript{163} While some violations may be due to a failure to understand the complexity of Rule 15c3-3, it is likely that some brokers deliberately flout this rule in order to realize higher gains on customer assets. Some brokers that are poorly capitalized apparently defy the rule when they encounter financial difficulties. It is precisely at such junctures, of course, that compliance with the rule is necessary for the protection of customers.\textsuperscript{164}

Although the net capital rule and the CPR are based on the “liquidity principle,” they are not always sufficient in practice to protect customers when a broker-dealer becomes insolvent. Problems of compliance and enforcement aside, capital may be insufficient to satisfy customers even if an insolvent broker had been in compliance with the rules.\textsuperscript{165} Because of the volatile nature of the securities industry, apparently adequate capital cushions can be wiped out rapidly by market downturns.\textsuperscript{166} Another problem with monitoring firm financial responsibility is that innovations in the securities industry often run ahead of the law. The industry rapidly finds new financial devices to meet capital requirements, and the law must struggle to keep up and determine how to treat these new devices for net capital purposes.\textsuperscript{167}

As noted above, SIPA also contains provisions regarding financial reporting. However, it does not authorize SIPC to inspect or examine any of its members. Nor does it authorize SIPC to require self-reporting by its members. Rather, it instructs the SROs to file reports with SIPC as re-


\textsuperscript{162} Id.

\textsuperscript{163} Nonetheless, it relaxed the net capital rule’s alternative method of net capital computation. Specifically, it reduced the percentage of aggregate debt items under the alternative method from four to two percent. See id.

\textsuperscript{164} See id. at 36.

\textsuperscript{165} See Bloomenthal & Salcito, supra note 157, at 166, 178.

\textsuperscript{166} See Molinari & Kibler, supra note 61, at 25-26.

\textsuperscript{167} See id. at 26-33. Chief among these devices are repurchase, or “repo,” agreements. See id. Unregulated financial innovations contributed to disaster during the era of the back office crisis. At that time, NYSE members were exempt from SEC net capital requirements because the NYSE’s own requirements were, on their face, more stringent. The exemption, however, did not take into account NYSE members’ practice, condoned by the Exchange, of meeting net capital requirements with subordinated debt that could be, and often was, withdrawn on short notice. See SELIGMAN, supra note 8, at 458.
required by SIPC rules. SIPC rules do little with this authority. They require only that SROs file a report with regard to changes in the membership status of SRO’s members.

III. CRITIQUE OF THE SIPA APPROACH

A. INVESTOR PROTECTION OR INDUSTRY PROTECTION? “BAILOUT” AS STATUTORY PURPOSE

In SEC v. Packer, Wilbur & Co., the Second Circuit stated that “the objective of SIPA was to protect members of the investing public, not brokers. There was no intention to ‘bail out’ the securities industry.” But the court’s own explanation of the statute’s purpose is inconsistent with this characterization. The court acknowledged that SIPA’s investor protection benefits the securities industry by encouraging investors to remain in the market. In fact, as the court stated, “Congress’ intent in providing for the reimbursement of investors was to restore confidence in and strengthen the operation of the securities market.” Indeed, the concept behind SIPA is to strengthen the market by supporting broker-dealers, its main intermediaries. Like the Second Circuit, SIPC officials Michael Don and Josephine Wang have argued that SIPA is not intended to “bail out” broker-dealers. Another SIPC official, Stephen Harbeck, has written that SIPC “does not ‘insure’ broker-dealers in the true sense of the term.”

As suggested above, the history of SIPA’s passage supports the view that Congress enacted SIPA in order to assist the brokerage industry. In this respect, the Second Circuit in Packer, Wilbur missed the point of the legislation in stating that “there was no intention to ‘bail out’ the securities industry.” In fact, that was precisely the purpose of the statute. SIPA was drafted and passed rapidly as an immediate response to a perceived

168. See 15 U.S.C. § 78iii(d) (1994). SIPC has the authority to propose administrative rules and regulations, but they are effective only if enacted by the SEC.
171. See id.
172. Id. at 985.
173. See Don & Wang, supra note 7, at 512.
174. Harbeck, supra note 7, at 279.
175. See supra Part II.B.
176. Packer, Wilbur, 498 F.2d at 984.
threat to the securities industry. While Don and Wang are correct in the limited sense that SIPA does not rescue individual failing firms, this section will argue in detail that the statutory scheme subsidizes the securities industry.

1. 

Distinguishing SIPA from Bankruptcy Law

It is often said that a SIPA liquidation is “essentially . . . a bankruptcy proceeding.” 177 Thus, it is argued, SIPA is a “neutral” statute that does not protect the securities industry. While a SIPA liquidation sometimes superficially resembles a bankruptcy in that the statute incorporates Chapter 7 as a gap-filling provision, the policy concerns behind a SIPA liquidation differ fundamentally from those that motivate bankruptcy law. Indeed, the Bankruptcy Code still contains its own provisions for the liquidation of stockbrokers, and SIPA is invoked only when it is determined that the need for customer protection renders the Code approach inappropriate.

There is vigorous debate as to the goals that bankruptcy law should serve. One commentator has divided the debaters into two camps: 178 the “complicators,” who argue that bankruptcy law does, and is intended to, serve multiple and often contradictory policy goals, 179 and the “clarifiers” who argue that it should (but does not always, if ever 180) target narrow goals—typically the goal of economic efficiency. 181 Few would contend that bankruptcy is intended to protect customers or to prevent enterprise failure. Efficiency-minded commentators argue that bankruptcy law is

178. See John D. Ayer, Through Chapter 11 with Gun or Camera, But Probably Not Both: A Field Guide to Chapter 11, 72 WASH. U. L.Q. 883, 904 (1994) (“Chapter 11 serves a variety of purposes, overlapping and superficially similar, yet often in tension . . . [But] there is good reason to believe that the drafters intended just this sort of thing.”).
179. Professor Ayer falls squarely in the “complicator” category. He counts among his coreligionists “allies as unlikely as Elizabeth Warren and David Gray Carlson” as well as Donald Korobkin. Id. at 883. See also Elizabeth Warren, Bankruptcy Policy, 54 U. CHI. L. REV. 775, 776 (1987); ELIZABETH WARREN, BUSINESS BANKRUPTCY 21 (Fed. Jud. Cir. 1993) (bankruptcy law may implicate “value-enhancement and distributional questions” as well as “political, economic, and social questions”).
primarily “a collectivized debt-collection device.” 182 Under this view, the main purpose of bankruptcy law “is to permit the owners of assets to use those assets in a way that is most productive to them as a group in the face of incentives by individual owners to maximize their own positions.” 183 Even the “complicators” generally agree that overcoming collective action problems and maximizing the recovery of creditors are key goals of bankruptcy law. 184

SIPA’s goals are very different. It is concerned primarily with the health of the securities industry. SIPA does not attempt to maximize the debtor’s estate, as indicated by the fact that it does not contain reorganization procedures, but only liquidation procedures. Under SIPA, a question central to bankruptcy—whether liquidation or reorganization would yield the greatest value for creditors 185—is not even a topic of discussion.

2. SIPA as Bailout

Professor Cheryl Block defines a “bailout” as “a form of government assistance or intervention specifically designed or intended to assist enterprises facing financial distress and to prevent enterprise failure.” 186 SIPA clearly fits this definition in that Congress acted in 1970 to assist brokerage firms that faced financial distress due to the back office crisis and to prevent their failures. Federal “insurance” programs like SIPC or FDIC deposit insurance 187 may have customers as their direct beneficiaries, but the member enterprise receives assistance in that it is relieved of its obligation to the investor or depositor. 188 However, the liquidation of any given securities firm with the aid of the SIPC fund is not a bailout of that firm. Unlike the FDIC, SIPC cannot rehabilitate an insolvent member firm, but

183. Id. at 5. Professor Jackerson uses the metaphor of a lake stocked with fish. If only one person fished in the lake, he would see that it was in his interests to limit his catches in order to keep the lake stocked. But if several persons fish in the lake, a collective action problem ensues. Because no one angler knows whether others will observe the principle of limiting one’s catch, it is in each one’s interests to catch as many fish as possible, thereby depleting the lake. See id. at 11.
184. See, e.g., Warren, supra note 179, at 20.
185. See Ayer, supra note 178, at 889 (stating that when a business is worth more as a going concern than in liquidation, “the debtor’s strongest card is the threat of suicide”); Warren, supra note 179, at 31 (noting that in reorganization negotiations, debtors often threaten to go into liquidation while creditors threaten to force liquidation; Prof. Warren compares this situation to that of the debtor threatening to jump off a building while creditors threaten to push him).
187. Other roughly analogous insurance programs include the National Credit Union Share Insurance Fund and the Pension Benefit Guarantee Corporation.
188. See Block, supra note 186, at 1004.
Once the SEC or an SRO has informed SIPC of a member’s insolvency, SIPC’s only discretion lies in initiating a SIPA liquidation or doing nothing.189

a. **Investor confidence and “prospective bailout”**: Even without rescuing firms in distress, however, federal “insurance” programs serve a more subtle form of industry assistance that Professor Block refers to as a “prospective bailout.” That is, their reassuring presence helps each firm in the insured industries by increasing customer confidence and thereby increasing business volume. Consumer confidence is a key principle behind both the FDIC and SIPC.190 As Block states, “the presence of federal insurance instills consumer confidence and provides direct and immediate benefits to the industries whose customers are willing to leave higher deposits or invest more funds than they would if uninsured.”191 This is the explicit Congressional reasoning behind the SIPA scheme. The failure of any firm, and the mere potential for losses due to firm failure can erode public confidence in broker-dealer firms generally. The SIPA scheme was enacted to promote investor confidence in each broker-dealer firm and in the broker-dealer industry as a whole on the theory that this would help to prevent individual and firm-wide failure.192 Thus, in Professor Block’s analysis, it was a prospective bailout of each member firm and of the industry generally.193

189. See 15 U.S.C. § 78eee(a)(3) (1994). See also Sheila Cheston, Investor Protection Under SIPA: A Reassessment and Recommendations for Future Change, 19 Colum. J.L. & Soc. Probs. 69 (1985). This article argues that SIPC should be allowed to operate the debtor’s business. Although theoretically appealing, operating an insolvent broker-dealership is likely unworkable in practice. A failed firm has lost the confidence of customers, fellow institutions, and creditors. Furthermore, the failed broker would have to be restored to capital compliance, presumably from the SIPC fund. This would significantly increase the fund’s exposure, probably requiring a dramatic increase in assessment levels. Moreover, it would be expensive and difficult to staff a failed broker. Failures are often due to misconduct and SIPC has no immediate way of determining which employees can be trusted. Thus, a prerequisite to operating a failed broker would be an extensive, lengthy investigation of the role of employees in the broker’s failure, or the hiring and training of an entirely new staff.


191. Block, supra note 186, at 973.

192. The irony, as noted above, is that Congress adopted this “preventive” approach to failures while failures were occurring for reasons unrelated to investor confidence.

193. Cf. Block, supra note 186, at 960 (The “‘bailout’ in the savings and loan story arguably is not the money now being used to satisfy the government’s insurance obligation, but the federal deposit insurance system itself, established just after the Great Depression [began] in order to restore consumer confidence, prevent bank runs, and keep the banks operating.”).
The bailout effect extends to SROs as well. The stock exchanges and NASDAQ compete for investor dollars not only with each other, but also with other forms of investment. The existence of SIPC protection for investor accounts gives SROs an advantage in attracting investor dollars. Investor confidence in the members of an exchange translates into investor confidence in the exchange. Moreover, to the extent that firm insolvencies can be attributed to self-regulatory failure, a customer protection fund that absorbs customer losses due to failures also insulates SROs from negative repercussions, such as political pressure for external regulation. Despite the massive failure of self-regulation by the securities industry demonstrated by the back office crisis, Congress did not even consider reforming the existing self-regulatory structure. Instead, SIPA was designed to fit within it—indeed, to protect it by promoting public confidence in it. SIPC was constituted as a nongovernmental private corporation “to maintain consistency with the self-regulatory character of the securities industry under the overall supervision and oversight of the SEC.”  

In the wake of the back office crisis, Congress and the securities industry (whose representatives testified extensively before Congress) scrambled to institute an investor insurance scheme. But there was no significant discussion of possible reform of the self-regulatory system itself. In keeping with the concept of self-regulation, SIPA requires the President of the United States to appoint three representatives of the securities industry to SIPC’s seven-member board of directors.

Congress’ goal of investor confidence may be in the short-term interests of the securities industry, but is hardly the wisest approach to investor protection. Orthodox economic theory holds that the stock markets play an

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194. In fact, the “overwhelming” majority of trading in the regional stock exchanges consists of NYSE and AMEX securities. See MARKET 2000, supra note 74, at 8. In the first half of 1993, the regional exchanges “captured” 20% of orders in NYSE stocks and 16% of orders in AMEX stocks. See id. The exchanges and NASDAQ also compete with one another for listings of securities. “It has been estimated that over 1,000 of the companies quoted on NASDAQ meet the financial listing standards for the NYSE; over 2,000 meet the equivalent AMEX standards. These companies are aggressively recruited by the NYSE and AMEX.” Id. at 10.


196. In fact, despite the failures of self-regulation and the inadequacy of trust funds set up by the exchanges during the back office crisis, industry representatives argued that an industry-run insurance program would be superior to an independent fund.

197. During the original Congressional hearings on SIPA, Donald T. Regan, president of Merrill Lynch, Pierce, Fenner & Smith, testified in favor of continued self-regulation. He pointed out the industry’s past success in self regulation without even mentioning the ongoing debacle that had prompted the hearings.

important role in efficient economic resource allocation. The conventional view is that trading has indirect effects on resource allocation in that the prices set by trading indicate a firm’s expected future earnings and thereby serve as a signal to direct investment capital to its most potentially productive uses. Therefore, the theory goes, securities regulation should minimize transaction costs so as not to interfere with trading. The brokerage industry, as the intermediary between investors and the markets, is thus worth preserving through government and quasi-government intervention, despite the industry’s own inability to control itself.

It has been suggested, however, that the current regulatory structure goes too far and rather than merely removing impediments to trading, ac-


This Article argues that the SIPA regime suffers from inefficiencies and unfairly distributes the costs of failures. Unorthodox observers suggest a more fundamental criticism of a securities industry bailout. They dispute the basic assertion that the stock markets contribute to capital formation. See, e.g., William K.S. Wang & Marc Steinberg, Insider Trading 28 (1996) ("Resource allocation is not directly affected by trades of existing securities."); Stout, The Unimportance of Being Efficient, supra, at 640-77. See also Lynn Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation, 81 VA. L. REV. 611, 615 n.10 [hereinafter Stout, Stock Markets] (citing other sources); William K.S. Wang, Some Arguments that the Stock Market is Not Efficient, 19 U.C. DAVIS L. REV. 341 (1986). Stout also challenges the "managerial signaling," "wealth effect," and "market-for-control" theories of the stock market’s effects on resource allocation. See Stout, The Unimportance of Being Efficient, supra, at 677-92. These commentators argue that the capital firms receive from the sale of equity does not depend on the level of trading in secondary markets, but only on new issues. Equity sales translate into capital only when stock is issued. Cf. id. at 645. Thus the vast majority of equity securities transactions do not contribute to capital formation, but merely redistribute wealth. See, e.g., Adolf Berle, The American Economic Republic 130 (1963) ("Stock exchanges do not allocate capital. They shift wealth from one hand to another."); John Maynard Keynes, The General Theory of Employment, Interest, and Money 159-60 (1964) (comparing stock markets to casinos). The lack of systemic economic shock following the 1987 stock market crash may indicate the irrelevance of the stock market to economic resource allocation.

If the critique of the secondary securities markets is accurate, encouraging investor confidence in the securities markets generally is a dramatically overinclusive method of serving the public policy goal of increased investment in productive capital. Rather, for the purposes of stimulating capital formation, encouraging investor confidence would be appropriate only with respect to the primary bond market and the market for new equity issues. The securities regulation scheme, rather than devoting attention to investor confidence, could more freely pursue investor protection as an end in itself on grounds of consumer welfare and distributive fairness, since market intervention would not have significant consequences for resource allocation.

200. Because computer technology has facilitated the development of on-line stock trading by individuals without the need for the mediation of a broker, it is at least theoretically possible that the brokerage industry may someday become unnecessary to the existence of capital markets. See Christina K. McGlosson, Comment, Who Needs Wall Street? The Dilemma of Regulating Securities Trading in Cyberspace, 5 COMMLAW CONSPECTUS 305, 305 (1997). Hurd Baruch suggested this possibility as early as 1971.
tively encourages trading as if it were an end in itself. SIPA’s “investor confidence” approach goes further still. It goes so far as to deliberately obscure market signals that might correctly alert the investor not to trade, or at least not to trade with a given broker. Such a policy is akin to resuscitating the canary rather than leaving the coal mine. Consumer mistrust of brokers is a barrier to trading, but in some cases it may be a warranted and valuable one. Loss of public confidence, translated into lost business, can be good for industry health in the long run by spurring the securities industry to improve its reliability. Rather than attempting to make brokers stable and thus worthy of investors’ trust, SIPA encourages investors to ignore the issue of broker instability. SIPA may act as a type of subsidy to firms that systematically engage in or allow their individual brokers to engage in risky or unethical behavior, since SIPC insurance can encourage investor confidence in firms that do not merit it. An investor may be led to invest with a firm with which she would not have invested absent SIPC protection—a firm that eventually becomes insolvent. Firms that would otherwise have to pay for their riskiness or instability by discounting their fees, or simply by attracting fewer customers, are relieved of that burden by the availability of SIPC insurance.

When a firm in which a customer has been “overconfident” goes into liquidation, the customer may suffer significant uncompensated losses, even if his account is within the dollar limits of SIPC protection. Such losses may include those due to broker fraud and inability to access the contents of a frozen account.

201. See, e.g., Paul Mahoney, Is There a Cure for “Excessive” Trading?, 81 VA. L. REV. 713, 737 (1995). Customers deal primarily with brokerage employees whose primary function is as salesperson. Because their compensation is linked to the amount of services they provide, these salespersons have incentive to encourage customers to trade, perhaps excessively. Mahoney further suggests that the mandatory disclosure provisions of the regulatory regime exacerbate this problem by focusing on the disclosure of firm-specific data rather than on the disclosure of intermediaries’ incentive structures. This focus, Mahoney argues, may lead investors to believe that the key to investment success is keeping up with new developments in industry by maintaining a constantly shifting portfolio. See id. at 740-41. Stout argues that active stock trading causes resource misallocation in the form of billions of dollars wasted in trading-related expenses. See generally Stout, Stock Markets, supra note 199. Because he regarded stock trading as primarily speculative and destabilizing, Keynes suggested a tax to discourage stock transfers. See JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 159-60 (1964). Senator Carter Glass, father of the 1933 Banking Act, unsuccessfully advocated just such a tax in 1927. See SELIGMAN, supra note 8, at 7. Glass proposed a five percent tax on sales of stock held less than sixty days. See id.

202. My colleague Holly Doremus suggested this metaphor.

203. “Because termination of deposit insurance is considered the equivalent of a death penalty for banks, that penalty is rarely used. The FDIC insurance fund has thus become a sort of ‘assigned risk’ pool, with the government required as sole insurer to take on all the bad risks.” Swire, supra note 87, at 498. In the SIPA context, it is the SIPC fund, and not the government, that bears primary risk, but it is important to keep in mind that the fund is supplanted by a $1 billion line of credit from the Treasury.

204. See Jamroz, supra note 108, at 865. SIPC does not protect customers against securities
Thus, while SIPA qualifies as a bailout because of its intent to use investor confidence to protect broker-dealers from failure, the reasoning behind this intent is questionable. First, as noted above, lost investor confidence is not, and has not been, a significant cause of broker-dealer failure. Second, engendering investor “overconfidence” prevents market discipline from encouraging firms and SROs to attack the real causes of failures. Thus it likely does little to prevent failures and may even indirectly contribute to failures.

b. Protection from the “domino effects”: In addition to its prospective bailout effect, SIPA attempts to protect surviving firms by insulating them from the potential “domino effect” of one firm’s failure. In Congressional hearings on the original Senate bill, Senator Muskie specifically invoked the domino effect of a brokerage firm’s collapse as one reason for intervention in the wake of individual firms’ failures. “Stock brokers owe money to one another. The failure of one aggravates the problem and reduces the financial soundness of all other firms to which it is indebted.”

A Wall Street Journal article of the time elaborated on the domino effect:

Brokers worry, too, that failure of one big house could trigger a series of collapses in a sort of domino effect. One obvious reason: Collapse of house A could freeze stock and cash it owed house B—and that could tie up just enough capital to prevent house B from bailing out of its own difficulties.

A still worse nightmare: Brokers fear that the collapse of several houses, or even only one big one, could set off waves of panic selling by customers of other houses—even the strong ones.

The second type of “nightmare” described above is merely a dramatic manifestation of the loss of investor confidence. Such hypothetical panics would be similar to the contagious “bank runs” witnessed during the Great

fraud, but a defrauded customer retains a right of action against the broker. See SIPC v. Vigman, 803 F.2d 1513, 1517 n.1 (9th Cir. 1986). Judgments on such claims are often uncollectable, however, since they are general creditor claims if made against the debtor, or subject to judgment-proof problems if made against an individual representative of the debtor. With respect to judgments against the debtor, SIPA itself adds to the likelihood that the judgment will be uncollectable because it directs that administrative expenses of the liquidation be paid out of the general estate.

205. The domino effect remains a concern today. Professor Rogers has argued that containment of the domino effect is the chief advantage of revised Article 8 of the Uniform Commercial Code. See James Steven Rogers, Policy Perspectives on Revised Article 8, 43 UCLA L. Rev. 1431, 1539-40 (1996).

206. Statement by Senator Edmund S. Muskie on introducing the Amendment to S. 2348, FBDIC Hearings, supra note 53, at 142.

Depression. It has been argued, however, that the likelihood of bank runs causing macroeconomic ripple effects is very low. The same may be true of “broker runs,” even assuming that their occurrence is a real danger. Moreover, while both “domino effects” seem theoretically possible, there is no indication that either has played a significant role in failures during the “back office crisis” or at any other time in Wall Street’s history.

Although SIPA’s main concern is with investor confidence, it also protects broker-dealers from the other type of domino effect—losses due to incomplete transactions. SIPC rules promulgated under SIPA require the trustee to complete executory securities contracts, though only where a customer of the other party (not the debtor) has an interest. As a result, the SIPA scheme further insulates each member of the industry from the collapse of a fellow firm.

Certain aspects of the SIPA scheme further illustrate Congress’ intent to use investor protection primarily as a means for industry protection. Because “customer” is a term of art in the statute, it is little more than a

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208. See George Kaufman, Bank Runs: Causes, Benefits, and Costs, 7 CATO J. 559, 566 (1988), cited in Swire, supra note 87, at 496. Professor Kaufman argues that such repercussions have occurred only during the Depression and the bank panic of 1893.

209. The primary effect of “broker runs” would be a decline in stock prices. The lack of macroeconomic shocks from the 1987 stock market crash suggest that “broker runs” might have little economic effect.

210. A firm failure may create a less dramatic type of domino effect in the form of information losses analogous to the temporary loss of credit information caused by a bank failure. Customers (both individuals and other firms) of a failed firm must find a new firm with which to do business. The solvent firms are unable to quickly obtain reliable credit information on these new customers and thus cannot distinguish the creditworthy from the insolvent potential customers. This information problem can raise the cost of contracting high enough to cause a market breakdown. The potential harm of the temporary information loss is particularly significant when conditions are especially time-sensitive, as in the OTC derivatives market during periods of market volatility. See Larry D. Wall, Ellis W. Tallman, & Peter A. Arken, The Impact of a Dealer’s Failure on OTC Derivatives Market Liquidity During Volatile Periods 2-4, (Fed. Res. Bank of Atlanta Working Paper No. 96-6, 1996). Like the other domino effects, however, there is no evidence that this effect has ever caused a firm to fail.

211. Oddly enough, the statute is phrased to prohibit the trustee from closing out executory contracts except as permitted by SIPC rule. See 15 U.S.C. §78fff-2(e)(1) (1994). The statute originally mandated completion of executory contracts; the reasons for the change are unclear. As originally enacted, SIPA required trustees to complete all the debtor’s “open contractual commitments relating to transactions in securities” in which a customer either of the debtor or of the counter-party firm had an interest. Securities Investor Protection Act of 1970, Pub. L. No. 91-598 §6(d), reprinted in 1970 U.S.C.C.A.N. 1922-23. For purposes of this section only, “customer” was defined to include “any person other than a broker or dealer.”

212. See 17 C.F.R. §300.301 (1998). By not requiring contract completion where the customer of the debtor had an interest, the rule leaves the trustee free to repudiate executory contracts not in the interest of the debtor’s customers.
tautology to state that “SIPC protects customers.”

213 SIPC officials Michael Don and Josephine Wang have stated that because SIPA is a “statutory scheme with very definite goals, [the concept of] ‘customer’ is defined in furtherance of those goals.”

One of those goals, Don and Wang argue, is “to protect persons who had entrusted cash or securities to their brokers for the purposes of trading and investing, that is, ‘for some purpose connected with participation in the securities market.’”

The statute is intended to encourage active investment in securities and not merely to reimburse individuals for their losses. This is demonstrated by the ways in which customer protection provisions favor securities investments over cash. Of the $500,000 maximum in SIPC coverage, no more than $100,000 may be a claim for cash on deposit with the broker.

In addition, that coverage extends only to cash deposited for the purpose of purchasing securities. There is no SIPC protection at all for a customer’s cash left idle in a brokerage account. A customer must take the attendant higher risks of investing to enjoy SIPC protection for either cash or securities.

The 1978 SIPA amendments went even further in favoring securities over cash. SIPA attempts to satisfy customer net equity claims with securities as much as possible, even to the extent of using the proceeds of customer property or SIPC advances to purchase them for the customer, regardless of their value.

That is, if, on the filing date of the SIPA

213. SIPC officials Michael Don and Josephine Wang note dryly that the term “customer” as used in the statute “is not one that is given its ordinary meaning.” Don & Wang, supra note 7, at 534.

214. Id. at 534-35.

215. Id. at 535. In contrast to Don and Wang’s clear statement, courts often make mystifying statements of legal positivism that give the misimpression that the boundaries of coverage are set arbitrarily. See SIPC v. Pepperdine Univ. (In re Brentwood Sec., Inc.), 925 F.2d 325, 330 (9th Cir. 1991) (stating that SIPA “does not comprehensively protect investors from the risk that some deals will go bad or that some securities issuers will behave dishonorably.”); SEC v. Packer, Wilbur & Co., 498 F.2d 978, 983 (2d Cir. 1974). Accord In re Bevill, Bresler & Schulman, Inc., 83 B.R. 886, 886 n.3 (Bankr. D.N.J. 1988).

If equity were the criterion [for SIPC coverage], most customers and creditors of [the debtor] would be entitled to reimbursement for their losses. Experience, on the other hand, counsels that they will have to settle for much less. SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customer.

Id.

216. The limitation on cash reimbursement is not coincidentally the same as FDIC limit. One reason given is that commercial banks objected to more protection for investment accounts for fear that customers would have incentive to keep their savings with a broker. This objection is groundless, since SIPA does not protect cash left idle in a brokerage account.


liquidation proceeding, a customer’s account contained 100 shares of X Corp. stock, the SIPC trustee would be instructed to return 100 shares of X Corp. to her. If the fund of customer property did not contain sufficient X Corp. stock, the SIPC trustee must attempt to use customer property or SIPC advances to purchase it on the open market for her account, regardless of whether it had appreciated or depreciated.

The Senate report on the 1978 amendments stated that this policy “not only would satisfy the customers’ legitimate expectations, but also would restore the customer to his position prior to the broker-dealer’s financial difficulties.” Although returning securities to customers in general satisfies the reasonable expectations of customers, requiring the trustee to purchase securities for an account is beneficial to the customer only where the securities retain their value or appreciate. While any investor bears the risk of volatility, the risk to which a SIPA customer claimant is exposed is far greater than the normal market risk. During the pendency of customer claims processing, customer accounts are effectively frozen, often for months (and, for contested claims, even years) and despite the possibility of a decline in the price of his securities (normal investor risk), the customer has no power to sell. Furthermore, where the debtor was a primary market maker in an issue, the collapse of the debtor can decimate securities value overnight. In such cases, SIPA’s policy of restoring securities rather than cash to customers serves only to keep investment capital in the securities markets and is inconsistent with the customers’ “legitimate expectations.” Furthermore, because purchasing the securities on the market is not without transaction costs, which are borne by the general estate and then the SIPC fund, the policy of maximizing the return of securities can result in a net loss for the customer, general creditors, and the fund.


220. The trustee is relieved from the duty to purchase securities, however, where they cannot be purchased in a “fair and orderly market.” See 15 U.S.C. § 78fff-2(d) (1994). This is intended to suspend the duty when the market is controlled by artificial influences, such as outright stock manipulation, but would not apparently extend to the situation described in the text. See H.R. REP. NO. 95-746, at 22 (1977).

221. The utility of this goal has been questioned. See supra text accompanying note 201.

222. See infra Part III.B.
B. SIPA SUBSIDIZES THE BROKER-DEALER INDUSTRY BY SHIFTING THE COSTS OF FAILURES

The SIPC fund provides the most dependable firms and the least stable firms alike with uniform protection, at the same negligible cost. Thus, the safer members of the industry subsidize the premiums of the industry’s less stable firms. They do so by paying the same flat premiums as the risky firms. They pay an additional, subtler subsidy when, despite SIPC protection, the collapse of one firm has some adverse effect on investor confidence in the entire industry. This system appears to be self-financed by the industry, in that risks created by the industry are shifted among members of the industry.

Thus it may be argued that even if SIPA assists the securities industry, it is not a publicly funded “bailout” because it only involves risk-spreading within the industry. This section contends, however, that the costs of failures are not borne entirely by the SIPC fund or ultimately by the securities industry. The direct costs of SIPC protection—the assessments that make up the fund, are spread out among broker-dealers and, by extension, their customers. Similarly, the putative benefits of SIPC protection—customer protection leading to improved investor confidence and increased investment—are shared by broker-dealers and their customers. However, within the class of customers and within the class of broker-dealers, the costs of liquidation are not distributed in a fair or efficient way. Furthermore, certain costs of SIPC protection, most notably administrative expenses, are placed on parties who do not gain from SIPC protection, a situation which is neither fair nor efficient with respect to reducing the likelihood of failure. The SIPA scheme shifts many costs outside the industry and thus the system is partly financed by taxes on other parties.

1. Burdens on the Economy Generally

Although the SIPC “insurance fund” is nominally financed by its members rather than by taxpayers, it receives some indirect subsidies from taxpayer money. First, SIPC has a $1 billion line of credit from the Treasury.223 Such an arrangement may be characterized as a “put option” on the

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223. SIPA has never had to use this credit, and by securing alternate lines of credit with commercial lenders, SIPC has reduced the likelihood that it will need to do so in the future. It is certainly possible, however, as shown by the savings and loan debacle. In the worst-case scenario of a major failure or chain of failures large enough to exhaust this line of credit, it is not clear whether the government would allow the SIPC fund to default. Given the strength of Congressional faith in the central role of the securities markets in the economy, Congress might authorize a multibillion dollar cash bailout.
Treasury. Second, SIPC and the billion-dollar SIPC fund are not subject to taxation. Third, the broker-dealer industry and its customers may be purchasing SIPC insurance at a bargain rate. There has been no serious attempt to estimate the market value of SIPC “insurance.” SIPC’s practice has apparently been to set assessment rates based on its desired fund level rather than on the possible effect those rates can have on the fund’s exposure. In 1991, the SIPC Board set a target fund level of $1 billion to be reached by 1997. When it became apparent that it was approaching target level ahead of schedule, SIPC promptly lowered its assessments for 1996 and 1997 to a flat $150 annual rate, the current statutory minimum. Even as it sets its target fund levels, however, SIPC itself concurs with the GAO’s conclusion “that there is no methodology that SIPC could follow which would provide a completely reliable estimate of the amount of money SIPC might need in the future.” The GAO’s 1994 report on SIPC expressed concern that SIPC is unprepared to handle the logistics of the failure of an extremely large firm or a large wave of failures. However, it did not address the question of whether the billion dollar fund would be sufficient to handle such failures. In 1994, each of the five largest broker-dealers had over one million customer accounts, while the largest SIPC liquidations thus far have involved approximately sixty thousand accounts.

It is unclear whether the private insurance market could provide satisfactory investor insurance, particularly at a low cost comparable to that of SIPC assessments. It is true that certain private insurers offer broker-dealers so-called “excess SIPC” policies that supposedly insure customer accounts against losses that exceed SIPC’s dollar limits. Such policies,

224. Professor Swire uses this term to describe the fact that the Treasury must cover, without limit, shortfalls in the FDIC insurance fund. See Swire, supra note 87, at 497-98 n.126. Taxpayers, of course, eventually paid directly for the shortfall in the savings and loan fund. See id. While SIPA does not provide for such a bailout, a $1 billion guarantee has the same effect, albeit to a much lesser degree. Furthermore, voluntary government bailouts from general revenues do occur, as in the case of Chrysler Corporation. If the government ever extends the $1 billion credit, the possibility exists that it may see itself as “in for a penny, in for a pound.”


226. In a similar context, it has been argued that “deposit insurance may have been underpriced for most or all of its history from an actuarial standpoint.” Swire, supra note 87, at 498 n. 126. Thus, taxpayers, by effectively guaranteeing this shortfall, may have been subsidizing the FDIC and RTC programs for their entire history.

227. See REGULATORY FRAMEWORK, supra note 88, at 18. Professor Swire suggests that augmentation of the FDIC’s insurance fund may be attributable largely to bureaucratic self-preservation.

228. See 1996 SIPC ANN. REP. 3

229. REGULATORY FRAMEWORK, supra note 88, at 87.

230. See id. at 52.
however, are not comparable to SIPC. They are individually negotiated and do not offer blanket coverage for the entire industry, and as the name implies, they are predicated on the fact that SIPC protects the first $500,000 of each customer’s claim.\textsuperscript{231} Furthermore, since they are not subject to SEC regulation,\textsuperscript{232} the nature of the coverage they provide is unclear and not necessarily consistent. Finally, excess SIPC coverage is not always available when necessary. When Drexel Burnham Lambert, Inc. and Thomson Securities closed in 1990 and 1989, respectively, their customers only narrowly avoided SIPC liquidations. Prior to their closings, private insurers had declined to renew the firms’ “excess SIPC” policies.\textsuperscript{233} In fact, it is not clear that any insurer has ever paid a claim on such a policy.\textsuperscript{234}

The lack of any objective pricing mechanism for SIPC protection suggests the possibility of an allocative inefficiency problem. A great deal of scholarship has been devoted to questions regarding the efficiency of capital market pricing and the resultant effect on allocative efficiency. However, the scholarship tends to consider only the relationship between underlying value (however calculated) and market price. It tends to downplay, if not ignore, the relationship between the value and the full cost to the investor—which includes the transaction costs involved in participating in the market.\textsuperscript{235} These costs, largely imposed by the broker-dealer industry, include not only commissions, fees and margin interest, but also the risk of exposure to broker-dealer failure. If SIPC insurance is indeed underpriced, the cost of investing in securities is also underpriced. Thus,

\begin{itemize}
\item \textsuperscript{231} If insurers wait for the disposition of an “over-the-limits” SIPC claim before paying a customer’s “excess SIPC” claim, which seems likely, a customer could wait months or even years, since the over-the-limits claim is likely to be disputed.
\item \textsuperscript{232} See generally Aetna Casualty & Surety Co., SEC No-Action Letter (June 25, 1979), available at 1979 SEC No-Acct. LEXIS 3055.
\item \textsuperscript{233} See REGULATORY FRAMEWORK, supra note 88, at 51-52.
\item \textsuperscript{234} According to one newspaper report, Aetna and London Insurers, two major providers of “excess SIPC” policies to Wall Street firms, had never paid a single claim as of 1991. See Susan Antilla, \textit{Bad Times Push Brokers to Cut Outside Deals}, USA TODAY, Mar. 11, 1991, at 6B.
\item Furthermore, few potential “excess SIPC” claims have arisen thus far. According to SIPC, only 303 claims had been made as of the end of 1996 for cash or securities in excess of the dollar limits of SIPC protection. See 1996 SIPC ANN. REP. 7. The dearth of large claims may be explained in part by the fact that although the original failures of the back office crisis involved large firms, most SIPC liquidations have involved smaller firms, whose customers tend to be smaller investors.
\item \textsuperscript{235} See RONALD COASE, \textit{THE FIRM, THE MARKET, AND THE LAW} 174 (1988) (“The world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave.”); Daniel Farber, \textit{Parody Lost/Pragmatism Regained: The Ironic History of the Coase Theorem}, 83 VA. L. REV. 397 (arguing that critics of the Coase Theorem’s assumption of zero transaction costs are in fact more faithful to Coase’s purpose than are those who defend his famous theorem).
\end{itemize}
SIPA may act as a subsidy to the securities industry as well as to securities issuers by causing investors to overinvest in the securities market.

2. Burdens on General Creditors

SIPA further subsidizes the costs of broker failure in the way it allocates the often immense costs of administering a liquidation. The administrative costs of a liquidation are paid out of the debtor’s general estate. The SIPC fund finances administrative costs only if and when the general estate has been exhausted. From 1970 to 1996, the general estates of SIPA debtors paid for over $171 million in administrative expenses. During the same period, the primary protection SIPA afforded to customers—total distributions from the SIPC fund for customer claims—amounted to only $174 million.

SIPC operates with a lean staff of approximately thirty persons, but SIPC’s officers and staff administer only the smaller liquidations. Larger liquidations require the retention of a professional trustee, attorneys, consultants, and accountants, as well as an administrative staff. Because the professionals must be experienced in complex issues of the securities business and securities law, they are often very high profile and prestigious, and therefore very expensive. Liquidations often involve extensive litigation which can continue for years.

As in a Chapter 7 liquidation under the Bankruptcy Code, claims for administrative expenses in a SIPA proceeding have highest priority on the general estate. As a result, general creditors ultimately shoulder the administrative costs of a proceeding. General creditor claims have the lowest priority, and due to the nature of the securities business, a securities firm’s

236. “[Liquidation] procedures are not only rigid and sometimes slow, they are expensive. There have been some cases where the trustee’s administration expenses have exceeded the amounts advanced to satisfy customer claims.” Securities Investor Protection Act of 1977: Hearings on H.R. 8331 Before the Subcomm. on Consumer Protection and Finance of the Comm. on Interstate and Foreign Commerce, 95th Cong. 83 (1977) [hereinafter Hearings on H.R. 8331] (statement of SIPC Chair Owens).


238. SIPC may advance funds to the trustee to cover administrative costs. If so, such funds are recouped as priority administrative claims on the general estate. See id.

239. See 1970-1996 SIPC ANN. REPS., App. II.

240. See id. at 17.

241. Given the complicated and esoteric nature of some of the work, it may be necessary to hire such expensive personnel. It is worth noting, however, that SIPA does not require SIPC or the trustee to consider cost or take bids in choosing personnel. The trustee must, however seek approval of expenses from the bankruptcy court, in accordance with bankruptcy practice.

general estate is usually quite small, both in absolute terms and in relation to its fund of customer property. Furthermore, it is the depletion of net capital—the primary component of the general estate—that often necessitates a SIPA liquidation in the first place. As a result, not only is the cost of administration of general creditor claims a relatively small portion of the total administrative expenses of a SIPA liquidation, but general creditors are also unlikely to recover much, if at all, on their claims. A SIPC Special Task Force report noted in 1977 that administrative expenses “frequently” exhaust the general estates of debtors and preclude recovery by general creditors.243 This exhaustion appears to continue today.244

Allocation of a bankruptcy’s administrative expenses is based on a simple equitable principle: “[L]et those pay who derive the primary benefit.”245 In a SIPA liquidation, however, this principle is largely ignored. Under the equitable principle of cost allocation, general creditors would bear little, if any, of the administrative costs. Prior to 1978, allocation of administrative expenses in SIPA cases followed the equitable principle. The trustee divided the burden of expenses between the general estate and customer property246 according to which creditors benefited from the administrative tasks.247 The 1978 amendments, however, abrogated the equitable rule in favor of placing all administrative costs on the general es-

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243. See Hearings on H.R. 8331, supra note 236, at 124. The Task Force was a SIPC-appointed group, consisting of SIPC, SEC, and industry representatives, charged with evaluating the effectiveness of SIPA.

244. SIPC made net advances for administrative expenses, in 46 of the 53 proceedings completed in the years 1991 through 1996, inclusive. See generally 1992-1996 SIPC ANN. REPS. SIPC’s claims for recoupment of such advances enjoy first priority on the general estate. Thus, the fact that SIPC made net advances in these 46 cases seems to indicate that administrative expenses exhausted the general estate prior to any recovery by other general creditors in these cases. Even when a general estate does exist, it may be years before general creditors may recover from it.

In 1977, the Special Task Force recommended that administrative expenses be charged solely to the general estate, but also recommended that SIPC relinquish the priority status of administrative expense claims. See Special Task Force Report 21, in Hearings on H.R. 8331, supra note 236, at 99, 124. The former recommendation was adopted, the latter was not. The exhaustion problem is likely even more common today than in 1977, since at that time, administrative expenses were borne in part by the single and separate fund, while today they are borne solely by the general estate.


246. Actually, the term “fund of customer property” did not exist at this time. Prior to 1978, the analogous concept was the “single and separate fund.”

247. The court found that [t]he basis for fees to counsel, etc. is principally their time spent. Those who received the benefit of the time spent should pay the expense of that time. The trustee made the allocation of expenses depend on the allocation of time as between the problems of the fund and those of the general estate. This seems fair and reasonable. In re Weis Sec., 416 F. Supp. at 864.
The House committee report on these amendments acknowledged that the allocation of costs was “a significant departure from current law” without explaining the grounds for the departure.249

SIPA concentrates almost exclusively on the satisfaction of members of the customer class, in the belief that their satisfaction (and not that of general creditors) is crucial to the continued health of the industry. Thus, most of the business of a liquidation has great importance to the industry and its customers, and very little to do with the interests of general creditors. Although general creditors shoulder the administrative costs in bankruptcy, the comparison to SIPA is inapposite. In effect, a SIPA liquidation is the liquidation of two separate estates—the fund of customer property and the general estate. Nonetheless, the cost of administering the fund of customer property is charged to the general estate, not to the fund of customer property or its guarantor, the industry-financed SIPC fund. Administrative costs receiving administrative priority include the costs of processing—and litigating—customers’ claims for net equity, closing out open contractual commitments, transferring securities and cash to customers, and investigating the debtor’s failure.250

As noted above, SIPC rules mandate the completion of open contractual commitments—that is, the trustee must complete the debtor’s executory obligations to pay another broker for securities purchased or deliver securities for cash received.251 Completion of transactions is intended primarily to guard against the possibility of the debtor’s failure setting off a “domino effect” among firms with which it did business. This safeguard is for the benefit of industry stability and for the investor who is the counterparty to the transaction. Nonetheless, payments made to complete open contracts are charged to the general estate as administrative expenses.252 Furthermore, the trustee is required to purchase securities to satisfy customer claims, even where such purchases may result in a loss to both the estate and the customer.253 The trustee’s administrative costs of making such purchases are, of course, administrative expenses charged to the general estate.

248. See H.R. REP. NO 95-746 (1977) (discussing the 1978 Amendments for section 6(e)).
249. Id. at 28.
250. These administrative costs include the costs and expense of SIPC personnel used by the trustee in the liquidation. See 15 U.S.C. § 78fff(e) (1994).
In effect, SIPA obliges general creditors to pay the costs of administering the fund of customer property and the SIPC fund, despite the fact that general creditors recover nothing from either fund. General creditors also pay the administrative costs of such trustee tasks as the purchase of securities for customer accounts, the completion of executory securities contracts, and the investigation of the debtor’s failure. This is an inequitable and inefficient result in that the costs of failure should be placed on the parties most able to avoid those failures. It is true that SIPA avowedly pursues the goal of protecting customers. But in the SIPA context, unlike in a liquidation under the Bankruptcy Code, privileging one class of creditor (customers) does not have to be done at the expense of another class of creditor (general creditors). Rather, the burden can be placed on the intended beneficiaries of the SIPA scheme—the members of the broker-dealer industry—by allocating the costs to the SIPC fund.

It may be argued that the current structure assumes that general creditors are best able to judge the creditworthiness of a securities firm, and that they can impose market discipline on broker risk taking. Although that assumption may be accurate in other contexts, it is less plausible in the broker-dealer industry. Broker-dealer financial reporting requirements are notoriously complex, and there is no private cause of action under those requirements. Furthermore, it is currently very difficult to evaluate other risk factors, such as a firm’s disciplinary history. As a result, it is hard to believe that general creditors, who may include landlords, equipment vendors, and nonprofessional employees, are the market actors best able to evaluate and avoid the risks of broker failure. Furthermore, broker-dealer customers often fail to understand the SIPA regime. The same may be true for general creditors, who may not realize at the time of contracting that their likelihood of recovery under the SIPA scheme is significantly less than that under bankruptcy law.

254. Equity owners are one group of general creditors that properly bear the burden of failure because they presumably have the power to control firm behavior. Because of the limited size of general estates, however, preserving the general estate will not likely relieve the burden on equity owners, whose claims on the estate are the most subordinated.


256. Voluntary creditors face the possibility of nonpayment due to limited liability, as well as the possibility that “after the terms of the transaction are set[,] the debtor will take increased risk, to the detriment of the lender. As long as these risks are known, the firm pays for the freedom to engage in risky activities.” Easterbrook & Fischel, supra note 255, at 50-51 (emphasis added). But if the risks are unknown, the firm takes the risks for free.
It is also important to keep in mind that the distinction between “general creditors” and “customers” is in many cases an arbitrary one. A great number of a failed firm’s general creditors are individuals whose claims arise directly out of their customer relationships with the firm. They are relegated to general creditor status because they have net equity claims in excess of SIPC’s dollar limitations or claims based on fraud or breach of contract by the broker-dealer. Thus, such persons—the firm’s customers in the common meaning of the term and therefore victims of the failure—may bear a significant portion of the cost of a liquidation. This may seem equitable when the SIPA scheme is viewed as a debt-collection device; however, it seems much less fair and much less efficient when SIPA is viewed as a bailout of the broker-dealer industry. Increased assessments on members, and not the firm’s general creditors, should pay for liquidation administration expenses.

3. Burdens on Customers

The SIPA scheme places costs on customers as well as on general creditors and the economy generally. Customers pay directly for SIPA protection, of course, in the sense that firms can pass on the cost of SIPC assessments to their customers. This practice is fair and efficient, in that it is evenly distributed among the beneficiaries of SIPC protection. In any case, it is minimal, given the nominal size of SIPC assessments. However, SIPA may cause customers to pay more significant and economically unjustified costs in addition to the direct costs passed on by the firms.

As noted in the discussion of the “bailout” effect of SIPA, SIPC protection may engender investor “overconfidence” in a firm. In the event of firm failure, those investors may bear more of the costs of failure than they had anticipated. While the hypothetical “rational investor” should be aware of the limits of SIPC protection, in reality it is unreasonable to expect the typical individual investor to appreciate the complexities of the statutory scheme.257 For example, there is a complicated jurisprudence re-

257. Institutional investors may be quite sophisticated and thus not susceptible to the information failure problems described here. Furthermore, institutional investors generally trade through a custodian bank rather than a broker. See Mooney, supra note 3, at 319-20. This article, like SIPA itself, is primarily concerned with the individual investor. Despite the growing significance of institutional investors, they have hardly replaced the traditional individual investor, at least not yet. Although household investors’ share of the market has declined since SIPA was enacted, they retain a huge portion of the market. Household investors held 68% of corporate stock in NYSE flow of fund accounts in 1970; this share has fallen, but remained a healthy 47.7% as of 1994. See WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 11 (7th ed. Supp. 1997).
garding the definition of a "customer claim." Moreover, customers often fail to understand the differing levels of protection for cash and securities claims. Due to the complicated nature of securities investments and the narrow, technical definition of a SIPC-protected "customer" claim, less sophisticated investors may not understand that despite SIPC protection, they are exposed to potential losses due to market downturns, broker fraud, and inability to access accounts “frozen” during the processing of claims. Customers are also unprotected with respect to products held by a member but not covered by SIPC.

The primary manner in which SIPC informs customers about SIPC protection is a slim brochure entitled “How SIPC Protects You.” The brochure, while somewhat dense reading for the layperson, provides a good summary of customer protection in a question-and-answer format. However, there is currently no legal requirement for its distribution. SIPC must rely on broker-dealers to distribute the brochures to their customers. In addition, the regulatory enforcement branch of the NASD has observed a tendency for brokers, whether intentionally or not, to misinform customers as to the nature and extent of SIPC coverage.

258. Courts recognize the centrality and complexity of the “customer” definition. Thus, for purposes of appellate review, a determination of “customer” status is a matter of law, not a finding of fact. See SIPC v. Wise (In re Stalvey & Assoc’s), 750 F.2d 464 (1985); SEC v. White & Co., 406 F. Supp. 806, 807 (E.D. Mo. 1975), aff’d, 546 F.2d 789 (8th Cir. 1976); SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 571 (3d Cir. 1977).

259. SIPC Chair Hugh Owens told Congress in hearings on the 1978 SIPA amendments, “many customers have never been able to understand that their protection from [sic] SIPC is different if their claim is for cash as opposed to securities.” Hearings on H.R. 8331, supra note 236, at 70.

260. Customers routinely sue trustees and SIPC unsuccessfully seeking recovery on just these sorts of claims, although the statute, decisional law, and SIPC informational literature very clearly state that SIPC does not cover such claims. See, e.g., In re Adler Coleman Clearing Corp., 195 B.R. 266 (Bankr. S.D.N.Y. 1996) (denying customers’ claims for loss of market value of securities).

261. See REGULATORY FRAMEWORK, supra note 88, at 65. Such products include unregistered investment contracts, gold, silver, and commodities.

262. SIPC, How SIPC Protects You (7th ed. 1994).

263. For example, under the heading “Who is a ‘customer’ protected under the Act?” the brochure states, “‘Customers’ are persons with claims for securities received, acquired, or held by the firm from or for the securities accounts of such persons for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting a transfer.” Id. at 5. This definition, primarily a verbatim quote from the statute (15 U.S.C. §78ll(2) (1994)), is not only dense, but is also unhelpful in that, as noted above, a person’s status as a customer is not as relevant to SIPC protection as whether a person’s claim is a “customer net equity claim.” See supra text accompanying note 135.

264. See NASDR Sees Increase in Misleading SIPC Ads, FIN. NETNEWS, April 21, 1997, at 6. A new development exacerbating this problem is brokers’ dissemination of advertising material via the Internet without review or approval by NASDR. See id. See also In re Donald T. Sheldon, 51 S.E.C. 59 (1992), aff’d, 45 F.3d 1515 (11th Cir. 1995) (SIPC member’s sales representatives sent SIPC brochures to customers of a nonmember affiliate firm and the affiliate displayed SIPC emblem, leading
Moreover, even an investor who understands that protection is limited may not realize that SIPC did not conduct an analysis of the firm’s riskiness. SIPC gives investor confidence the same quantum of encouragement with respect to each member firm. SIPC insures customers of all brokers in the same way and charges each broker the same annual assessment. SIPC lacks the power to channel investor confidence toward the soundest houses and away from riskier ones because it gives investors no information at all in this regard. It also lacks the power to give firms any incentive to become less risky. The statute requires SIPC to “insure” the customers of all registered broker-dealers. The financial criteria for registrability, which are minimal, are set by the SEC and not by SIPC. SIPC must therefore protect and encourage investors in all American brokerage firms as long as the SEC believes they are qualified to do business, regardless of whether SIPC believes them to be a good “insurance risk.”

Thus, the SIPC insignia in a broker’s window may inadvertently lull investors into a false sense of security due to their misunderstanding of what it means. The fact that a person or institution is insured often indicates that the insurer has examined the insured party and deemed it an acceptable risk. SIPC insurance entails no such endorsement, though investors may believe that. Even where investors understand fully the limits of SIPC coverage, SIPC membership gives the investor no information about the relative soundness of the firm, as nearly every firm in the country is a member.

The following exchange from the 1970 Senate hearings indicates that Congress and the SEC recognized the potential for investor confusion with respect to both the limits of protection and the government’s role in protection:

Senator Williams. If we allowed many of the marginal broker-dealers to display an FDIC [sic] emblem all over their place of activity similar to that displayed by Merrill Lynch or Bache, would we not be lulling the customers of the affiliate to believe they were protected by SIPC?; In re Consolidated Inv. Serv., Inc., Exchange Act Release No. 36,687 (Jan 5. 1994), available in 1996 SEC LEXIS 83 (perpetrator of a Ponzi scheme involving nonexistent securities fraudulently used “How SIPC Protects You” brochure to assure victims their “investments” were protected by SIPC); Regulation of Broker-Dealers, Exchange Act Release No. 34-18262 (Nov. 17, 1981), available in 1981 SEC LEXIS 313 (suggesting that some brokers may be offering interest-bearing accounts to entice customers to maintain large cash balances without disclosing that SIPC does not protect customer cash balances maintained to earn interest rather than for investment). Misinformation is also occasionally disseminated by well-meaning and generally trusted sources in the popular press. See Ken Sheets, Sizing Up All-in-One Investment Accounts, KIPLINGER’S PERS. FIN. MAG., Mar. 1996, at 103 (stating (incorrectly) that SIPC protects customers against fraud and that it provides “$25 million coverage on assets in stocks, bonds or mutual funds”).
public into a false sense of security—a feeling that their investment would be guaranteed by the Federal Government?

. . . .

Senator Muskie. I think the question raised is whether or not the public would feel that the guarantee is broader than it is. In other words, that it would guarantee against investment losses as opposed to the kinds of losses it would actually cover.

. . . .

Mr. Budge. [drawing an analogy between federal investor protection and the presence of the SEC label on registration statements and prospectuses] That is a problem that the Commission encounters almost daily. We have no authority to pass on the merits of a public offering of securities. The Congress very wisely determined that the Commission should simply see that the investor is sufficiently informed so that he can make an intelligent decision and did not give the Commission power to judge the merits of the investment at all.

It is amazing how many members of the public, who see anything with SEC on it, think it is guaranteed by the Government.265

Another cost of administering a liquidation is the resolution of disputed claims. For example, a central issue with respect to any SIPA creditor’s claim is whether it qualifies as a SIPC-protected claim for customer net equity. This issue has been the subject of a great deal of SIPA litigation. The unlikelihood of recovery on a general creditor claim makes it all the more imperative for each creditor to seek a judicial determination that its claim qualifies as a “customer claim.”266 Even once this threshold has been crossed, controversy may arise. A customer may argue, for example, that the debtor’s records are inaccurate and the trustee’s determination of the customer’s claim, based on those records, is therefore incorrect. Such claims can be difficult to resolve because debtors’ record-keeping is often poor. SIPC and the trustee it appoints may have wrested control of the debtor firm away from an unwilling management on the suspicion that the management was corrupt or incompetent. Ironically, if a customer dis-

265. FBDIC Hearings, supra note 53, at 25-26. Senator Muskie’s comment notwithstanding, Senator Williams seemed to be concerned about the effect of an insurance scheme appearing to give equal endorsement to “marginal” and stable broker-dealers.

266. The depletion of a debtor’s general estate by administrative expenses aggravates the collective action problem caused by the meagerness of the general estate. Not only does this encourage litigation to establish customer status, but it also sets a vicious circle in motion. Creditors who know the general estate is limited engage in protracted litigation with the SIPA trustee over the issue of customer status. Because the trustee’s legal fees are paid out of the general estate, such litigation only further depletes the general estate.
letes the disposition of his claim, SIPC and the trustee may then find themselves in an adversary proceeding in which they “defend” the customer property portion of the debtor’s estate against the customer’s claim. Customers incur costs including attorneys’ fees and costs due to lack of access to accounts during the pendency of such disputes. The general estate bears the costs of the trustee’s attorneys’ fees.

Like placing administrative costs on general creditors, the distribution of these costs is neither fair nor efficient. Customers, perhaps even more than noncustomer general creditors, often lack the necessary information to avoid costs by avoiding brokers likely to become insolvent. While the SIPA scheme is intended for the benefit of customers, taxing them through the costs of resolving disputed claims assigns the burden of liquidation costs in the form of a random tax on those who happen to have disputed claims. No customer can know in advance whether her account will become the subject of a dispute in a SIPA liquidation. It is particularly inequitable to place the cost of dispute resolution on the customer and general creditors when fraud by the debtor caused the failure or when—as is frequently the case—the dispute is a result of the debtor’s poor record-keeping. Yet customers whose claims become the subject of dispute bear this cost disproportionately.

According to the Third Circuit, customers may not recover attorneys’ fees for any types of legal action that assists the trustee or SIPC in the conduct of a liquidation. While the court may have been correct as a matter

267. When the trustee and the customer cannot agree, the dispute must be resolved in an adversary proceeding in bankruptcy court.

268. These latter costs include not only the time value of the frozen assets, but also increased exposure to short-term risk due to inability to trade.

269. Cf. Peter Swire, supra note 87, at 501, 502 n.132 (describing the “random tax” problem created by government “superpowers” in bank insolvency proceedings). As Swire notes, the market can ameliorate the random tax problem over time. However, such an adjustment places transaction costs on the relevant market actors and at least temporary efficiency costs on the market generally.

270. In that case, customers filed a successful motion against objections of the trustee for the joint administration of the debtor’s SIPA liquidation and the Chapter 11 cases of its principals and related entities. Because the joint administration conserved resources of the estate, the bankruptcy court granted their petition for attorneys’ fees for “making a substantial contribution” to the liquidation under section 503(b)(3)(D) of the Bankruptcy Code. However, the district court held, and the Third Circuit agreed, that because that Code section applies only to cases under Chapters 9 and 11, and a SIPA liquidation pursuant to section 78fff(b) is to be conducted like a Chapter 7 liquidation, the customers were ineligible to recover attorneys’ fees. See In re Lloyd Sec., Inc., 75 F.3d 853 (3d Cir. 1996), aff’d 183 B.R. 386 (Bankr. E.D. Pa. 1995). In a footnote, the court noted that subchapter III of chapter 7 (which is not incorporated into SIPA by 78fff(b)), which governs stockbroker liquidations conducted without SIPC involvement, does not allow customers to recover attorney fees. Thus, the court argued, “it would be strange” if Congress were to allow such recovery in a SIPA proceeding. See id. at 858 n.4. This argument is really only a minor variation on the theme that “a SIPA proceeding is a bankruptcy.” If a
of positive law, the denial of fees is not justifiable on policy grounds. Customers should be encouraged to pursue action against malfeasant brokers. Such misconduct may be an early sign of a firm’s financial distress. Customer actions can supplement the monitoring capacities of the SEC and SROs, which are insufficient by themselves to detect all such signs. Where the action assists SIPC in performing a liquidation, the customers should be entitled to attorney fees from the SIPC fund.

C. SIPA DOES NOT FOCUS ON FAILURE PREVENTION

SIPA was apparently intended in part as a failure prevention device since it seeks to promote investor confidence and requires the completion of open contractual commitments. But neither lost confidence nor incomplete transactions has been shown to be a significant cause of broker-dealer failure. Furthermore, both these “preventive” concepts are purely reactive. They only attempt to contain the “domino effects” after a failure has occurred, rather than preemptively attacking the root causes of failure. No part of SIPA is designed to prevent misconduct or the other types of firm behavior that are the cause of broker-dealer failure. SIPA’s role as safety net evidences a passive resignation to the fact of destructive broker-dealer misconduct rather than a proactive attempt at combating it.

Because SIPA was rapidly enacted during a period of crisis, its lack of long-term orientation might be attributed in part to the exigent circumstances of its creation. But haste cannot fully explain the passivity of the SIPA scheme. Since its introduction in 1970, SIPA has been amended many times, including a major revision in 1978. Moreover, even in 1970, Congress explicitly acknowledged the importance of reform to long-term industry health. Nonetheless, the SIPA scheme neither polices misconduct nor encourages firm owners or SROs to do so. SIPA includes no significant prevention-oriented provisions. Nor does it create economic incentives to reduce risk by placing the costs of failure on an offending stockbroker were to be liquidated under subchapter III, it would presumably be because SIPC had made a determination that its assistance was not needed—that is, a determination that the firm’s customers needed no protection, and SIPC funds are not necessary to protect public confidence (for example, where the firm is insolvent, but has sufficient capital to satisfy all customer claims). But where SIPC involvement is needed, the case is one that implicates investor protection and by extension, the protection of the industry. Productive customer legal action in such circumstances deserves encouragement.

271. For an example of the role of customer vigilance, see In re MV Sec., Inc., 48 B.R. 156 (Bankr. S.D.N.Y. 1985), where a customer’s pursuit of a grievance against a firm inspired an SEC investigation and ultimately a SIPC liquidation. Nonetheless, even though the customer helped initiate the SIPA liquidation, she did not recover on her claim based on an arbitration award for broker misconduct because her claim was not a “customer net equity claim.”

272. See supra Part II.D.2.
Who Watches the Watchers?

To the extent that the SIPA scheme reallocates some of the costs of misconduct that would otherwise be borne by firms and SROs, it not only misallocates the costs, but also indirectly subsidizes misconduct.

Congress recognized the link between misconduct and broker-dealer failure long before SIPA. Section 60(e) of the Bankruptcy Act of 1938 designated the “single and separate fund” as the portion of a bankrupt stock broker’s estate reserved to satisfy the claims of customers. Section 60(e)’s “single and separate fund” included “property unlawfully converted”—that is, property misappropriated by the broker. SIPA also recognized that broker misconduct commonly caused customer losses in broker failure. As the Second Circuit has noted of SIPA, “Legislative attention was focused on the small investor who suffered significant losses when a brokerage house collapsed, often because the house had in its last days misappropriated the investor’s funds to its own use.”

SIPA’s strongest protection of investors against misconduct is the inclusion of “property wrongfully converted” in the definition of customer property. While section 60(e) of the Bankruptcy Act included this type of property in the “single and separate fund,” SIPA goes farther by paying such claims from the SIPC fund when necessary.

SIPCA protection extends only to claims based on misappropriation and unauthorized trading. It does not cover losses due to fraud or breach of contract, or other types of misconduct. See MV Sec., Inc., 48 B.R. at 160-61; S.E.C. v. Howard Lawrence & Co., Inc., 1 B.C.D. 577, 579 (Bankr. S.D.N.Y. 1975). “Failure to execute” customer orders is a type of misconduct similar to unauthorized trading, but it rather arbitrarily falls outside of SIPA protection. An egregious form of this misconduct takes place when a failing firm, attempting to prop up the value of “house stocks” (typically, volatile small-cap stocks in which the firm specializes) deliberately ignores customers’ attempts to sell them. Although securities held by an agent against the principal’s instructions to sell qualifies as “property


274. SEC v. Packer, Wilbur & Co., 498 F.2d 978, 984 (2d Cir. 1974). But see Schultz v. Omni Mut. Inc., 1993 U.S. Dist. LEXIS 18464 at *3 (S.D.N.Y. 1993). The District Court in Schultz maintained that between 1970 and the 1990s, the cause of failures had changed from back office failure to misappropriation, and that SIPA had adapted to this change by amendment and judicial interpretation: “As technology has evolved, such back office failures have become extinct . . . SIPA and the courts . . . have not maintained blinders to the [new] root cause of many broker-dealer failures—the misappropriation of the broker-dealership’s funds.” Id. at *10.

275. Courts have interpreted the inclusion of property unlawfully converted in the fund of customer property to mean that a customer net equity claim may include claims for securities misappropriated from a customer’s account. Courts have also interpreted it to mean that a claim for losses due to unauthorized trading—that is, purchase or sale of securities for a customer account without the customer’s permission—qualifies as a customer net equity claim. See Schultz, 1993 U.S. Dist. LEXIS at *3.

276. Although the SIPC fund thus reimburses customers for losses due to some types of misconduct, SIPA
does nothing to deter brokers from misconduct. The statute also directed the SEC (not SIPC) to present to Congress by the end of 1971 a report identifying unsafe or unsound practices by SIPC members and describing measures being taken under current law to combat them, as well as recommendations for further legislation.277

SIPA was further tailored to the misappropriation problem by the 1978 amendments. Under the pre-1978 system, “cash customers”—those who owed no cash or securities to the debtor—could recover outright “specifically identifiable property”—cash or securities that could be traced to the customer’s account. Such property included securities identifiable by certificate number, as well as property that had been physically set aside for the customer or allocated to the customer on the debtor’s books.278 Property held for customers that was not specifically identifiable made up the “single and separate fund.”279 This fund satisfied remaining customer claims on a pro rata basis.

The 1978 amendments narrowed the category securities reclaimable outright to include only “customer name securities”—securities registered in the customer’s name. Correspondingly, the amendments created the broader “fund of customer property” to replace the “single and separate fund.” By reducing the amount of property recoverable outright and increasing the role of pro rata sharing,280 Congress sought to more widely distribute among all customers the risk that the debtor misappropriated a particular type of security.281 After 1978, “[a]ll customers who left negotiable securities in their broker’s possession share the risks of misappropriation and share ratably in remaining customer property.”282 While this


278. See Don & Wang, supra note 7, at 526, 528.
279. Id. at 531.
280. Under state property law, customers claiming a given type of security have a proportionate interest in the “fungible bulk” of securities of that type held by the debtor, while under SIPA, customers have a proportionate interest in the entire fund of customer property. See Mooney, supra note 3, at 334-35, 352 (citing U.C.C. § 8-313(1)(d)(ii)-(iii); this property right is the same under both the 1978 “new” Article 8 and the pre-1978 version). Thus, the SIPA scheme (in its original form and, even more, in its post-1978 incarnation) is a significant deviation from state property law. See Mooney, supra note 3, at 360.
measure attempted to distribute risks equitably among customers,\(^2\) it did not shift any of the risks away from customers as a group or away from the SIPC fund.

Although Congress was aware of the intimate link between broker-dealer misconduct and firm failures, SIPA made no significant attempts to improve the prevention of such misconduct. Although SIPA, in its original form and as amended, included measures explicitly designed as responses to misappropriation, SIPA has never been designed to prevent misconduct.

1. \textit{Prevention and Moral Hazard}

Moral hazard has been defined as

the detrimental effect that insurance has on an individual’s incentives to avoid losses . . . Anyone who is insured against a risk will not capture the full benefits of efforts to reduce the risk. The incentives to avoid or to mitigate losses are therefore compromised by insurance, unless an individual can somehow commit to undertaking optimal precautions at the time that an insurance contract is struck.\(^4\)

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283. Professor Mooney has suggested that the choice among customer property allocation regimes has only distributional consequences and does not affect the total amount of property recovered by customers. \textit{See Mooney, supra} note 3, at 358. While this is true with respect to claims made against the fund of customer property, not all claims of customers are made against that fund. Customer net equity claims that exceed SIPC dollar limits, as well as claims for fraud or breach of contract, are made against the general estate. \textit{See supra} Part II.D.1. Because administrative expenses of a SIPA liquidation are paid out of the general estate, the cost of administering the chosen allocation procedure can affect overall customer welfare. \textit{See supra} Part III.B.2. Identifying the components of customer property, identifying all claimants entitled to a share, and calculating each claimant’s pro rata share can be an enormous task, particularly where the debtor has not kept precise records, as is the case in many SIPA liquidations.

284. Ralph A. Winter, \textit{Moral Hazard and Insurance Contracts}, in \textit{Contributions to Insurance Economics} 61-62 (Georges Dionne ed., 1992). \textit{But see} Tom Baker, \textit{On the Genealogy of Moral Hazard}, 75 Tex. L. Rev. 237, 240 (1996) (“[C]onventional economic accounts of moral hazard exaggerate the incentive effects of real-world insurance and, at the same time, underestimate the social benefits of insurance.”). The term “moral hazard” was coined by nineteenth century insurers to refer to persons who presented a greater risk for insurers because of poor “character”: those likely to be careless or fraudulent. \textit{See id.} at 250. Moral hazards and physical hazards (for example, persons with medical problems who seek life insurance, or wooden buildings whose owners seek fire insurance) have the same effect on the probability of loss, but the early insurance industry treated them very differently. Nineteenth century insurers were willing to insure most physical hazards, albeit at higher premiums, but refused, at least as a matter of official policy, to insure moral hazards. \textit{See id.} at 252-53. The prominent role of deliberate misconduct in broker failures indicates that many SIPC members are “moral hazards” in the nineteenth-century sense of the term. Insurers now seek to insure “moral hazards” of this type because there is profit to be made from demanding high premiums for the service. If SIPC “insurance” is to include brokers whose disciplinary history shows them to be moral hazards, it should insist on high “premiums” as well.
“Insurance” is provided when the risk of loss due to one party’s actions is transferred to another party. Moral hazard arises in insurance relationships when two conditions are met. First, the insured party can take measures that will affect the likelihood of occurrence of the insured risk after the parties enter the insurance contract. Second, the insurer cannot, without cost, specify which measures the insured must take, or cannot costlessly enforce such specifications. For example, an insured driver can, by careful driving, reduce the likelihood of a car accident. The insurer can require careful driving, but cannot enforce this requirement without cost. Thus, a driver’s incentive to be careful is reduced because he will not bear the full cost of an accident.

One way market actors deal with moral hazard is by gathering information about the level of care taken by the insured. For example, an insurer may check whether an insured building has a burglar alarm or fire sprinkler system. SIPA does little in this regard. It makes its membership assessments without regard to risk level and does not collect data about the riskiness of its members. Furthermore, SIPC does not gather financial information on its own, but merely collects self-reported data.

As demonstrated above, SIPC protection and the entire SIPA scheme shift the risk of loss due to failure in several ways. They thus constitute insurance. In theory, the unusual structure of investor protection under SIPA “insures” multiple parties and creates the potential for multiple moral hazard problems: with respect to brokerage firms; with respect to the individual agents of brokerage firms; with respect to customers of brokerage firms; and with respect to the brokerage industry and SROs that regulate it. Even though customer accounts are “insured,” the broker and the brokerage industry also receive “insurance.” The customer does not suffer the full loss of cash and securities that may result from his decision to invest with the debtor. The debtor and its owners are not held liable for all the

285. See id. at 272 & n.170.
286. See Winter, supra note 284, at 62.
287. The insurer may attempt to enforce the requirement, thereby partially reducing moral hazard by, for example, increasing a driver’s premiums if he does not drive carefully, as indicated by traffic tickets or accident claims.
288. As noted above, SIPA required the SEC to report to Congress in 1971 regarding “unsafe and unsound practices” in the securities industry. But the Act did not impose continuing duties on the SEC, SROs, or SIPC to compile reports on unsafe practices and how they affect the stability of broker-dealers. Thus, SIPC is not required to keep abreast of innovations in technology, financial products, and broker-dealer practices that may affect risks. A 1992 study by the General Accounting Office expressed concern that broker-dealers are engaging in more and more risky practices that are technically sophisticated and poorly understood. See REGULATORY FRAMEWORK, supra note 88, at 37-38.
289. See infra text accompanying note 317.
customer losses engendered by the failure, which may have been caused by their own misconduct or mismanagement. 290 Finally, SROs and the securities industry generally do not bear the costs of customer losses, including lost investor confidence, which may be the result of their own regulatory failure. As business entities, SROs may succumb to the temptation to emphasize short-term profit over long-term investment in structural improvement—just the sort of thinking that allowed the back office crisis to occur in the late 1960s.

2. Moral Hazards of Customer, Firm and Industry

Insuring customers against loss due to broker failure may reduce customers’ incentive to investigate the reliability of a broker before investing. Customers know SIPA will protect them even if they invest with a risky broker. It might therefore be argued that SIPC insurance is counterproductive in that reduced customer diligence weakens the role of market discipline on the broker-dealer industry and ultimately undercuts SIPA’s goal of strengthening the industry. 291

As noted earlier, however, an insured party presents a moral hazard risk only when reducing the risk is within the insured party’s control. That is, “[f]or insurance to reduce care, the people who stand to benefit from the insurance must be capable of modifying the behavior that matters.” 292 While customers are insured under SIPA, they have only limited power to affect the likelihood of risk after the insurance contract is made. 293 The primary measure a customer can take to reduce the likelihood of occurrence of the insured risk (loss due to broker failure) is to choose a reliable brokerage firm with little risk of failure. However, it is difficult for the layperson customer to evaluate the riskiness of a brokerage firm. As a re-

290. This is, of course true of insolvency law generally. As noted above, however, the SIPA scheme differs from bankruptcy law in many fundamental ways, particularly with respect to its subsidy effect.

291. SIPA protection could arguably be scaled back or even eliminated in order to subject brokers and the industry to unalloyed market discipline. Such drastic reform, however, would be politically unrealistic. In 1991, the Treasury Department recommended that Congress increase the role of market discipline over banks by reducing the scope of deposit insurance coverage to leave more depositors uninsured. The recommendation was based on the theory that the lack of insurance would give depositors incentive to “discipline” bank management by demanding higher returns to compensate for the risk of bank insolvency. See Lissa Lamkin Broome, Redirecting Bank Insolvency Risks: Bank Holding Company Structure, 26 U.C. DAVIS L. REV. 935, 959 (1993). Such a scheme, however, was “politically impossible” and Congress rejected it. See id. at 959 & n.92. Reducing SIPC coverage, to say nothing of eliminating it, is also likely to be politically impossible.


293. It can be said that the each investor’s SIPA “insurance contract” is made even before that person decides to invest because SIPA protection extends to customers of all SIPC members.
sult, it is questionable whether the typical customer, even given the proper incentive to do so, can play a significant role in imposing market discipline. Consumers’ lack of relevant information and expertise decreases their ability to reduce their risk and therefore limits the applicability of moral hazard analysis. Evaluating the riskiness of a financial institution requires expert assessment of a great deal of technical information—a—information not readily available to the average investor. Because SIPC membership is offered to practically all broker-dealers, SIPC itself conducts no assessment of the riskiness of broker-dealers.

Moreover, even if this information were available, it is unlikely that it would be of much use to the typical American investor who has only limited understanding of financial matters. Individuals make decisions subject to incomplete information as well as cognitive limitations. It is simply unrealistic to formulate policy without acknowledging these

294. See Broome, supra note 291, at 956 & n.83 (referring to banks). “It may well be unfair or inefficient to expect the client [of a brokerage] to monitor for the risk of conversion.” Swire, supra note 87, at 512 n.162. Furthermore, the “usual market signals” may be deceptive to a potential investor seeking to evaluate the reliability of a broker. See id. at 512. This is because a brokerage may sell securities with high rates of appreciation, which may appear to indicate that the broker is skilled in recommending stocks. However, the appreciation may in fact be an unsustainable illusion caused by manipulation by the broker. Cf. id. at 512 (making analogous observations about bank interest rates and citing CHARLES A.E. GOODHART, THE EVOLUTION OF CENTRAL BANKS 59-61 (1988)). In fact, many risky or illegal strategies may yield early high returns only to later cause massive failure. See id. at 512 & n.164. This pattern was common in the savings and loan crisis of the 1980s. See id. at 512 n.164.

295. For a discussion of financial reporting, see infra text accompanying note 317.


facts. Many customers probably learn the value of carefully choosing a broker only after the broker has failed and the customer has suffered losses not compensable by the SIPC fund. The insurance aspect of SIPA, then, creates no significant customer moral hazard problem because customers can do little through their own diligence to choose safer brokerages.

SIPA’s moral hazard effect is more significant with respect to the “insurance” it provides for broker-dealer firms. The SIPC fund boosts investor confidence in all firms. Hence, much of the cost of creating consumer confidence in a firm is spread out among all firms paying into the fund. By transferring the cost of riskiness, SIPA decreases the incentive for any one firm to reduce its riskiness. Moral hazard results in this situation because the firm is in the best position to control its own riskiness. As argued above, the risk exposure of a firm is largely within the firm’s own control. Most firm failures are not caused by the vicissitudes of the market, but by firm behavior, which may include deliberate misconduct.

The firm’s owners are further “insured” by the corporate law regime of limited liability. While enhanced corporate liability may be considered a form of “insurance” for the consumer with attendant consumer moral hazard problems, so too may limited liability be seen as a form of insurance for owners of an incorporated firm. Limited shareholder liability and the availability of FDIC and FSLIC bailout funds may have contributed to the savings and loan crisis by creating moral hazards that reduced shareholder diligence in regulating the risks undertaken by bank managers. A similar analysis applies to the shareholders of a broker-dealer

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299. In the IPT Survey, only fifty-five percent of 1001 investors surveyed knew that SIPC does not protect investors against a decline in the stock market. Ten percent believed that it does, and thirty-five percent did not know. See IPT Survey, supra note 296, at 19-21.

Unregulated markets will supply optimal contracts of information if perfect. “Perfect information” includes at least three assumptions: “First, consumers know what their contracts say . . . . Second, consumers will shop for contracts they like, and therefore will know what options markets offer . . . . Third, consumers perceive risks correctly and can appreciate the effect on risk of product alterations . . . . These three assumptions seldom seem satisfied in consumer markets.” Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 372 (1988).

300. However, customers could be given the power to identify safer brokerages before investing if SIPC were to conduct risk-assessments of its members and pass that information on to the customer. See infra Part IV.A.
301. Cf. Baker, supra note 284, at 273-74. Baker, speaking in the tort context, uses “limited liability” to refer to tort regimes other than strict manufacturer liability for product-related consumer injuries. But the limited liability of shareholders under corporation law has an analogous effect.
302. See Broome, supra note 291, at 937.
firm. As the firm nears insolvency and shareholders become aware that their investment is lost, their limited liability limits their incentive to police the risks the firm takes. Rather, once it becomes clear that the firm is insolvent, the shareholders face no additional risk from further losses the firm may incur in a failed attempt to regain solvency. Successful gambles will accrue to the shareholders’ benefit, while losses will fall on customers and the SIPC fund. This problem is intensified by the current tendency toward complex corporate structures. Such structures give shareholders an additional level or levels of protection from liability for firm failure, further reducing their incentive to monitor management. Furthermore, diversification of the holding company’s interests, like diversification generally, dilutes the owner’s incentive to take efforts to monitor any particular interest.

Failure to recognize the risk-shifting role of limited liability stems from taking for granted the corporate entitlement of limited liability. SIPC insurance redistributes risks, but so does the “initial” distribution of entitlements—the limited liability regime. Since firm owners and the industry have greater power than investors to control the riskiness of firms, it follows that the firm and industry moral hazards are greater than the customer moral hazard created by SIPC investor protection.

The SIPA scheme also creates moral hazards for SROs which are “capable of modifying the behavior that matters”—the behavior of their members. Self-regulatory organizations not only have this capability, but also have primary legal responsibility for monitoring and disciplining their members. SIPA, however, “insures” SROs against negative repercussions—both potential liability and lost business—that can result from their own failure to control misconduct, thereby reducing their incentive to improve their attempts at controlling the problem. SROs receive this protection at no cost. A party’s own morality, of course, may limit its susceptibility to the perverse incentives offered by insurance. However, empirical evidence indicates that such internal constraints are often insufficient with respect to brokers, since fraud is blamed in fully half of SIPA liquidations. Even if SROs accept the moral responsibility to prevent mis-

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303. Cf. id. (making similar observations about bank shareholders and the FDIC). In general, neither the shareholders nor any other general creditor can expect to recover from the general estate.
304. See Baker, supra note 284, at 275.
305. Cf. id. at 280 (making similar point about manufacturers and consumers in the product liability context).
conduct by their members, their efforts in this regard have been insufficient.

The moral hazards are compounded by investors’ lack of information. In the product-safety context, “people’s judgments about generic classes of activities and products are likely to be sounder than their judgments about the differing performance of firms within such classes.”307 As a result, no individual manufacturer has a market-based incentive to make its product safer than the average product in its class.308 Where the consumer is unable to fully gauge how safe the product is, the manufacturer need invest in safety only “to the maximum level observable by the consumer.”309 This sort of opportunistic behavior may be curtailed if the manufacturer is made liable for the consumer losses it causes.310 This same analysis is applicable if “broker-dealer” or “SRO” is substituted for “manufacturer” and “investor” is substituted for “consumer.”

IV. SUGGESTED IMPROVEMENTS TO THE SIPA SCHEME

Firms and SROs bear too few of the costs of losses due to firm failure. First, the costs of the administration of liquidations are improperly placed on general creditors and, in some cases, customers.311 Second, firms and SROs are artificially isolated from negative repercussions of customer uncertainty about the stability of broker-dealers. This situation is not only inequitable, but also inefficient in that broker-dealers and SROs do not have proper incentives to reduce misconduct and other types of risk.

Both types of costs should be placed on the parties most able to prevent failures, namely, the firms and the SROs. Proper allocation of administrative costs would require amending SIPA to place administrative costs, except those benefitting general creditors, on the SIPC fund rather than the general estate. The following sections suggest further ways in which SIPA can be reformed to make firms and SROs more responsible for the losses due to firm failures and thus give them incentive to reduce the risk of loss.

309. Geistfeld, supra note 296, at 243.
310. See id.
311. See supra text accompanying notes 266-71.
A. Risk-Related Distribution of SIPA’s Costs

1. Distribution of Costs Among Firms

   Part of the moral hazard posed by SIPA lies in the fact that SIPC provides each member the same protection at the same cost regardless of that member’s risk of failure. SIPA authorizes SIPC to base membership assessments on risk, but SIPC has never exercised this authority. In its report to Congress on the bills that eventually led to SIPA, the Board of Governors of the Federal Reserve System endorsed the use of risk-based assessments. The Federal Reserve acknowledged that the FDIC deposit insurance fund made flat assessments on its members, but pointed out (ironically, in retrospect) that banks are less risky than brokerage firms. In fact, in the wake of the savings and loan debacle, Congress has amended the federal deposit insurance scheme to incorporate a risk-based assessment system.

   Despite its theoretical appeal, a risk-based assessment system is not the perfect solution it appears to be. Instituting a risk-based system

313. SIPC assessments have always been flat fees or a percentage of revenue. See supra Part II.D.1. Although a firm’s gross revenues may arguably have a correlation with risk exposure, there is no data to support this. Indeed, most failed firms are smaller firms. Furthermore, SIPC has never justified its revenue-based assessments on risk-based grounds.
314. According to the Federal Reserve, “uniform assessment rates would not recognize the fact that the risk of exposure to SIPC funds varies among broker-dealers according to both the relative degree to which they hold customer securities or credit balances and the general manner in which they conduct their business.” Hearings on H.R. 18081 and H.R. 18109 Before the Subcomm. on Commerce and Finance of the Comm. on Interstate and Foreign Commerce, 88th Cong. 146 (1970) (report of Board of Governors of the Federal Reserve System).
316. The FDIC began experimenting with risk-based assessments in 1993. Risk based assessments originally varied within a narrow range of 0.23 to 0.31% of insured deposits. See Noel V. Lateef & Raymond S. Szudlo, Federal Deposit Insurance Funds: The Impending Rate Disparity Between Banks and Thrifts, 112 BANKING L.J. 353, 364-65 (1995). This was implemented in 1993 as a “transitional” system. The FDIC met with some criticism for its failure to implement higher assessments. See Sara Jane Hughes, Banking and Deposit Insurance: An Unfinished Agenda for the 1990s, 68 IND. L.J. 835, 849 (1993). The most recent rates, implemented in 1996, are no higher, but have a broader range of 0 to 0.27%. See 12 C.F.R. § 327.9 (1998). Institutions are assessed based on two evaluations: a three-tier evaluation of capitalization level, and a three-tier evaluation of financial soundness based on a supervisory evaluation performed by the bank’s primary federal regulator. See 12 C.F.R. § 327.4(a)(2) (1998).
would involve two tasks: first, gathering information with respect to the
risk-related characteristics of each firm, and second, determining the price
of insuring firms with given risk profiles. The first task is no mean feat,
but is within the expertise of SIPC and the SEC. The second task, how-
ever, is beyond the ability of either agency and probably beyond the market
as well.

Current securities law already requires firms to report financial and
other information to the SEC and SROs. Firms are required to file detailed
monthly, quarterly and annual financial reports known as “FOCUS Re-
ports.” In addition, the Market Reform Act of 1990 and Rule 17h-17
and 2T passed under the Act explicitly require record-keeping and re-
porting information relating to “Risk Assessment” to the SEC. Currently,
it is unclear precisely how the SEC intends to use this “Risk Assessment”
data. The actuarial mechanics of risk evaluation are beyond the scope of
this article. But this data, in combination with firm financial information,
can form the basis for creating risk profiles.

To enhance its ability to create useful risk profiles, SIPC should de-
vote more of its efforts to studying the causes of broker-dealer failure.
SIPC may already have at its disposal a good deal of information on this
issue. As mandated by SIPA, the SEC investigated and reported to Con-
gress concerning the causes of the back office crisis in 1971. Neither the
SEC nor SIPC has continued to study the causes of failures. However,
SIPA requires SIPA trustees, as part of their liquidation duties, to investi-
gate the causes of the debtor’s failure and report the results of this investi-
gation to SIPC and the bankruptcy court. The investigation and report-
ning requirement was apparently intended to enhance the marshaling of the
debtor’s assets, but effective analysis of each debtor’s failure can also be

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“FOCUS Report” is an acronym for “Financial and Operational Combined Uniform Single Report.”
319. See 17 C.F.R. § 240.17h-1T to 2T (1998). Rule 17h-2T requires broker-dealers to file Form
17-H with the SEC.
320. The law and rules were inspired by the risks to broker-dealers posed by affiliated institutions.
In 1989, the SEC and NYSE intervened to prevent the failing Drexel Burnham Lambert Group holding
company from withdrawing the capital cushions of its subsidiary brokers. Thus, Congress sought spe-
cifically to obtain information about holding company structures and affiliated firms, but the law and
rules designate no systematic use for the information. It would seem that the information is to be avail-
able to be used on an ad hoc basis. See H.R. REP. No. 101-524, at 21 (1990), reprinted in 1990
321. The trustee is required to “investigate the acts, conduct, property, liabilities, and financial
condition of the debtor, the operation of its business, and any other matter, to the extent relevant to the
useful in predicting and preventing further failures. A SIPA trustee is in a unique position to determine the cause of the debtor’s failure and to gather information about the causes of broker-dealer failure generally. In practice, trustees’ final reports often fail to state clearly the causes of the failure. SIPC should demand that its trustees pay greater attention to the statutory investigation requirement. Furthermore, SIPC or the SEC should analyze the information trustees gather. As noted earlier, SIPC attributes over half of failures to “fraud.” SIPC has not, however, conducted an in-depth analysis of precisely what types of fraud are most likely to contribute to failure. A related question is whether the fraud involved in failures tends to involve the firm’s “official policy” or constitutes the work of rogue individuals within the firm. Where rogue individuals are responsible, a further question is whether the firm is guilty of lax supervision, or whether the misconduct is unpreventable or undetectable.

Although these and other questions remain concerning misconduct, it is clear as a general matter that misconduct plays a key role in failures. Thus, a firm’s disciplinary history and that of its employees should play a significant role in the evaluation of a firm’s riskiness. Information on past misconduct is important because persons who commit securities fraud are often recidivists. This is particularly true of those guilty of fraud in the penny stock industry. Moreover, regardless of the recidivist tendency...

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323. See supra note 88 (citing SIPC Trustees Closing Reports). This is very likely due to the fact that resources are consumed by the more immediate tasks of marshaling assets and satisfying creditors. SIPC and the SEC should make investigation a higher priority and make resources available from the SIPC fund to make extensive investigations possible. Because the benefits of such investigations go to the securities industry and its customers, they should be paid for out of the SIPC fund and not out of the debtor’s general estate or out of tax revenues.

324. See supra Part II.C.1.

325. The GAO has argued that most SIPC members requiring liquidation “did not engage in particularly risky activities.” REGULATORY FRAMEWORK, supra note 88, at 41. The GAO report implies that a firm’s risk of failure is practically unpredictable, and that risk-based assessments are thus pointless. Its report stated that most SIPC liquidations involve introducing brokers, which “engage[] in very low risk lines of business.” Id. It is true that introducing brokers are prohibited by law from the risky business of handling customer funds and securities. But clearly, if introducing brokers are most prone to failure, they are by definition not in a “low risk line of business.” The risk is created not by the nature of introducing brokers’ legitimate activities, but by misconduct which seems to plague introducing brokers as a class (this phenomenon may be related to the fact that introducing brokers are small operations with low capital requirements). Given the important role of misconduct in causing failures, it is likely that failure can be at least partly predicted by disciplinary histories and at least partly deterred by risk-based assessments based on disciplinary histories.


327. See William H. Lash, III, Loose Change: The Campaign for Penny Stock Reform, 60 UMKC L. REV. 1, 21 (1991). Penny stocks are stocks that typically sell for less than one dollar per share. Many, though not all, brokers specializing in such stocks engage in manipulation and unscrupulous
cies of individuals, misconduct by a firm’s employees may indicate the firm’s failure to supervise its employees properly. Rules 17h-1T and 2T do not call for the reporting of any disciplinary information. To verify firms’ self-reporting in this regard, the CRD should be modified to create comprehensive disciplinary history profiles on the firm as well as on the individual level. Risk-reporting based on disciplinary history can compensate for the laxity of SRO discipline by giving firms incentive not to employ brokers with a track record of misconduct.

Once relevant information regarding a firm’s risk factors has been gathered, however, setting assessment levels based on that information would be largely arbitrary because there are no standards by which to set the cost of given risk factors.328 Furthermore, in order to deter risk, risk-based assessments would have to exact significant financial costs on risky institutions.329 Since the billion-dollar fund has been built from very low assessments, raising individual assessments to financially significant levels might result in the overpricing of SIPC membership.330

Regulators can assemble information relevant to firm riskiness, but neither regulators nor the market can readily translate that information into a dollar figure. Because of the futility of attempting to put a price tag on firms’ risk factors, SIPC should pursue an alternative market-based method of disciplining firms based on their risk factors. Risk-related information should be used to inform the investing public of the relative risks of firms. As suggested earlier, the lack of firm discipline stems partly from information failure: Investors have no reliable way of gauging the riskiness of a broker. Therefore, the most useful application of risk information is simply to address that failure directly.

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328. In the deposit insurance context, commentators have argued for a private reinsurance or co-insurance market to address this problem. See Jonathan R. Macey & Geoffrey P. Miller, America’s Banking System: The Origins and Future of the Current Crisis, 69 Wash. U. L.Q. 769, 801-02 (1991). The market solution is an unconvincing panacea, however. An efficient market cannot spring up overnight. Furthermore, as noted above, it is questionable whether the market can provide investor insurance. In addition, a market insurance price will not properly take into account the external losses that may result from a failure. Given the assumption that the securities industry is central to capital formation, such externalities could be far-reaching. Thus, it may be desirable to accept the risk that SIPA “over-deters” such events as the failure of a major firm or a large chain of failures.

329. Although the range has been broadened from 0.04% to 0.27% in the FDIC context, the question remains whether 0.27% is high enough to be a risk deterrent.

330. Given this Article’s suggestion of placing greater burdens on the SIPC fund, higher assessment levels may become necessary. Even if current total assessments are doubled, however, they will average only $300 per member.
Thus, the SEC and SIPC should use information on risk factors to assemble a kind of risk “report card” for each firm. This report card should evaluate firms based on a series of risk factors such as capitalization level and disciplinary history. As noted above, the SEC already collects much of this data, but has no clear use for it. The additional costs of adapting the data to implement a risk-reporting system can be paid for out of increased SIPC assessments, not out of tax revenues. This information would inform investors on multiple levels. Not only do investors currently lack information about specific brokers, they also know little about what factors contribute to riskiness and little about the issue of broker failure generally. Just as brokers are currently required to disclose whether they are or are not SIPC members, they should also be required to disclose their SIPC risk rating.

Admittedly, such evaluations will depend on the subjective judgments of regulators. The FDIC’s system of calculating risk-based assessments has been criticized for its reliance on subjective supervisory judgments by bank regulators.331 This criticism, however, relies on the unlikely assumption that it is possible, and desirable, to reduce the complex concept of risk to a number of purely objectively measurable criteria. Furthermore, the SEC and SIPC together are in the best position to identify the types of problems and misconduct that cause firm failures. Given proper information, investors could impose market discipline on firms by refusing to patronize the riskier firms. Indeed, such publicity about risk could be a more potent incentive for self-policing than the threat of higher assessments.

2. **SRO Discipline**

SIPA should implement measures to combat moral hazard and encourage failure prevention with respect to SROs as well as to individual firms. Indeed, if monitoring and discipline of misconduct are to remain with SROs, policy must give them proper incentive to exercise their powers. For efficiency and fairness reasons, the cost of risk should be allocated to the party in the best position to avoid the risk. In addition, the cost of protection should be placed on the party that reaps its benefits. SIPC protection gives exchanges and the NASD a competitive advantage over other investment markets, an advantage for which they presently pay nothing. Under the current scheme, SROs contribute nothing to the SIPC fund, even though they have responsibility over the type of conduct that causes failures. Their only legal relationship to the fund is their duty to

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provide as collection agents for SIPC.\textsuperscript{332} As collection agents, they are obligated to remit assessments to SIPC only to the extent that they receive the assessments from firms.\textsuperscript{333}

It is incoherent to cede regulatory duties to SROs without holding them accountable for failure to discharge those duties. This is especially true in the SIPC liquidation context where such failure results in external costs. Thus, SIPC should have the right to seek indemnification from the SRO for SIPC’s costs when a firm’s collapse is due to a failure of oversight by the responsible SRO. Where a collapse is due to egregious misconduct or regulatory violations by the firm or its members, there should be a presumption of SRO responsibility. SIPC trustees are charged by statute with investigating the causes of member failures. Furthermore, SIPC has statutory authority to collect reports from SROs.\textsuperscript{334} SIPA further empowers the SEC to require an SRO to furnish SIPC with financial information about the SRO’s members. In conjunction, these provisions are sufficient authority for SIPC and the SEC to establish a system of gathering information with respect to an SRO’s role in the failure of a SIPC member.\textsuperscript{335}

In addition, because SROs are businesses that compete with one another for customers, releasing and publicizing data with respect to the relative disciplinary and other risks of the various exchanges and NASD could help impose market-based discipline on them.\textsuperscript{336} This would create incentives for SROs to discipline, impose high fees or penalties on, or if necessary, eject member firms that are unstable or that undertake unwise risks.\textsuperscript{337}


\textsuperscript{333} See id.

\textsuperscript{334} See id. at § 78iii(d).

\textsuperscript{335} Furthermore, as long as SROs retain primary disciplinary responsibility, the SEC should have authority to levy fines against SROs for the egregious misconduct, risky financial activities, or collapse of an SRO’s member firm.

\textsuperscript{336} Recent scholarship has created a healthy debate over the extent to which securities regulation should be left to the market. For example, Paul Mahoney argues that market competition among the exchanges will yield self-regulatory schemes that maximize investor welfare. See Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453 (1997). Roberta Romano argues for such competition at the state level, along the lines of interstate competition for corporate charters. See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359 (1998).

Marcel Kahan has challenged Professor Mahoney, in part on the ground that the interests of an exchange are sometimes at odds with investor welfare. See Marcel Kahan, Some Problems with Stock Exchange-Based Securities Regulation, 83 VA. L. REV. 1509, 1511-18 (1997). Furthermore, Professor Kahan observes that our cumbersome system of shared regulation seems to be working. Despite the superior theoretical appeal of exchange-based regulation he argues, one ought not to fix that which isn’t broken. See id. at 1518-19.
B. HOLDING AND AFFILIATED COMPANIES SHOULD PAY FOR LIQUIDATIONS

Increasingly complex corporate structures are exposing broker-dealer firms to new risks. The legislative history of the Market Reform Act of 1990 demonstrates that Congress recognized the potential risks that affiliated firms pose to broker-dealer stability. However, the Act and the rules implementing it require only record-keeping and self-reporting with respect to affiliates and do nothing to regulate the affiliates’ activities. Whereas the Federal Reserve Board has authority to regulate bank holding companies, there is no analogous regulation of the holding companies of broker-dealer firms. Although the health of broker-dealers is becoming

Finally, proponents of regulatory competition, like most commentators on securities regulation, are not primarily concerned with issues of broker-dealer regulation. Professor Mahoney concentrates primarily on questioning the common wisdom that unregulated exchanges produce anticompetitive rules. And at least with respect to egregious fraudulent conduct, he acknowledges that government involvement is appropriate because of its greater powers of sanction. See id. at 1498-99. Professor Romano concentrates primarily on disclosure by issuers, and specifically exempts broker-dealer regulation from her proposal. See Romano, supra, at 2361.

337. It might be argued that risk assessment might direct customers toward brokerages that deal in established issues and thus prevent the growth of new and smaller issues (which tend to be riskier). It would do so, however, only in the sense that it would alert investors to risk levels before they choose a broker. Moreover, the increase in cost due to higher risk-based assessments would be based on the riskiness of the broker, not on the riskiness of any security in which it deals. Investors interested in speculative investment would simply be encouraged to find the safest firm through which to make such investments. The cost of risk-based assessments would, however, encourage firms not to rely excessively on speculative securities to meet capital requirements. A firm meeting capital requirements in cash and stable securities would not necessarily be subject to higher risk based assessments, even if it dealt largely in speculative issues.


341. The GAO has argued that the regulation of bank holding companies is justified because bank depositors do not consent to take investment risks. By contrast, regulation of brokerage holding companies is unjustified because investors willingly assume greater risks by their decision to invest rather than save. See ADDITIONAL FINANCIAL ACTIVITIES, supra note 102, at 71. This comparison is misleading, however. Neither the FDIC nor the SIPA scheme purports to protect the customer from loss in the value of his or her assets, whether they be money or securities. That is, SIPC does not protect investors against decline in the market value of securities, and the FDIC does not protect depositors against inflation or currency fluctuation. Rather, they both protect the customer from loss due to failure of the institution holding the assets. The GAO’s argument fails to explain why customers of brokerage institutions should be less protected from institutional failure than those of depository institutions. By choosing to invest in securities rather than place their money in savings, brokerage customers are choosing a riskier class of asset. The risk of the class of institution is in part determined by the nature of institutional regulation, thus it would be somewhat circular to cite that risk as a justification for the differing standards of regulation. Rather, the justifications for protection against institutional failure are the same for banks as for broker-dealer firms: protection of customers and the resultant promotion of an industry credited with an important role in the economy.
increasingly dependent on the unregulated activities of their affiliates, the SEC regulates broker-dealers only *qua* broker-dealers, even where the distinction between a broker-dealer firm and its parent and affiliates may be a purely formal one. Neither the SEC nor any other agency regulates the diverse, interdependent activities and financial conditions of parents and affiliates. Foreign regulators, officials of the NYSE and Federal Reserve Bank of New York, and officials from the two major rating agencies have expressed concern about the lack of holding company regulation.

An obvious approach to this problem would be to assign the “super-regulation” of broker-dealer holding company structures to a government agency. It is probably inadvisable to make the SEC the “super-regulator,” since it does not possess the requisite expertise to supervise non-securities-related affiliates or the overarching conglomerate structures. “Super-regulation” might be assigned to the Federal Reserve, since it conducts such regulation in the banking context. However, this would add significantly to the Federal Reserve’s regulatory responsibilities. Proper “super-regulation” of holding companies might even require the cumbersome, costly, and politically distasteful establishment of an entirely new agency.

“Super-regulation,” however, is not the only method of controlling holding company risk. Since the 1980s, bank holding companies have been accountable for the financial crises of their bank subsidiaries. The Federal Reserve’s “source of strength” doctrine requires bank holding companies to provide financial assistance to bank subsidiaries facing failure. During the height of the savings and loan crisis, Congress enacted new legislation further redistributing insolvency risks from the FDIC and the taxpayer (and, to a lesser extent, from uninsured depositors and creditors) to bank shareholders. The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), passed in 1989, included a “cross guarantee” provision allowing the FDIC to recover its losses due to a bank or thrift failure from “commonly controlled” banks or thrifts. Claims of shareholders and of non-bank affiliates are subordinated to this FDIC

342. The two major rating agencies are Moody’s Investors Service Inc. and Standard & Poor’s Rating Group.
343. See Additional Financial Activities, supra note 102, at 80-81.
345. See 12 U.S.C. § 1815(e) (1994); Swire, supra note 87, at 531; Broome, supra note 291, at 960. In this context, “commonly controlled” institutions are those controlled by the same holding company. See id. at 960-61 (citing 12 U.S.C. § 1815(e)(9) (1994)).
Such provisions create incentives for holding companies and other shareholders to be more diligent in controlling the risks taken by banks. The scope of the cross-guarantee provision is limited, however, in that it does not permit recovery from the bank’s holding company or its non-bank affiliates.

Similarly, SIPC should have the authority to impose the costs of a member’s failure on the member’s corporate parent and affiliates. In contrast to the narrow limits of the cross-guarantee in banking law, SIPC should be able to reach the holding company and non-broker affiliates in addition to commonly controlled broker-dealers. Banking law’s current limitations on the cross-guarantee provision are artificial and possibly counterproductive. There is no principled reason why the guarantee requirement should not be expanded horizontally to non-broker-dealer affiliates and vertically to the holding company. Indeed, such limitations can undermine the purpose of a cross-guarantee requirement by allowing the holding company to move capital out of broker-dealer affiliates and into a “safe” corporation. If cross-guarantees are available only as to affiliated broker-dealers, vigorous enforcement could lead to their failures as well, while leaving the holding company untouched.

347. Although there has been no study of the efficacy of the cross-guarantee provisions, there is preliminary evidence that enhanced holding company liability can help prevent failures. Professor Jackson has noted that where thrift regulators have required financial guarantees from holding companies, thrift institutions controlled by holding companies have performed better and failed less often than other thrifts. When failure did occur, the failures of thrifts controlled by holding companies were less costly than those of other thrifts. See Jackson, supra note 108, at 576-82. Professor Jackson acknowledges, however, that his study only shows a correlation and does not establish the causal role of enhanced obligation rules. See id. at 579.
348. This approach would not require a “super-regulator” of holding company activities, but it would require definitions of the concepts of “broker-dealer holding company” and “affiliate.” A “bank holding company” is one that “controls” a bank. The element of “control” can be satisfied in several ways. For example, ownership of 25% or more of voting stock is proof of “control.” See Bank Holding Company Act, 12 U.S.C. § 1841(a)(2) (1994). See also 12 C.F.R. § 225.31(d)(2)(ii) (1998). A common manager and five-percent ownership gives rise to a rebuttable presumption of control. See 12 C.F.R. § 225.31(d)(2)(iii) (1998). See also Broome, supra note 291, at 976. “Commonly controlled” institutions subject to the FIRREA cross-guarantee rule are institutions controlled by the same holding company. See 12 U.S.C. § 1815(e)(9) (1994).
349. The “source of strength” doctrine is, in effect, a vertical “cross-guarantee” obligation on holding companies. But whereas the cross-guarantee rule has been enacted by Congress, the “source of strength” rule exists only in the regulations of the Federal Reserve. Congress took a small step toward legislation of bank holding company guarantees with a requirement in the Federal Deposit Insurance Corporation Improvement Act of 1991 that the holding company guarantee a “capital restoration program” of an undercapitalized subsidiary bank. See 12 U.S.C. § 1831o(e)(2) (1994). This particular aspect of holding company liability is inapplicable in the SIPA context, where insolvency mandates liquidation and “capital restoration” is not an option.
It may be argued that the existing “corporate veil-piercing” doctrine adequately addresses abuses of holding company relationships. The conventional wisdom suggests that veil-piercing makes more economic sense when used to reach shareholders that are corporations than when used to reach individual shareholders.\(^{350}\) Nonetheless, Professor Thompson’s empirical study has indicated that “courts pierce the veil to get at individual defendants more often than they pierce to reach corporations.”\(^{351}\) The study also suggests that a vertical guarantee provision is necessary because courts do not aggressively apply the veil-piercing doctrine to reach holding companies. According to Professor Thompson’s data, courts are more willing to pierce the veil to reach a sibling corporation than to reach a parent.\(^{352}\)

Another weakness of the veil-piercing doctrine is that it requires proof of misconduct or undercapitalization. If analogized to the corporate veil-piercing doctrine, a rule requiring cross-guarantees from parent and affiliated institutions would have an effect similar to a presumption that the debtor and its parent or affiliates have abused the corporate form.\(^{353}\) The more pervasive abuse becomes, the more appropriate a stricter presumption, which is more likely to be accurate and dispenses with unnecessary transaction costs. “The key normative question would be whether abuse was pervasive enough to justify the strict rule.”\(^{354}\) In the SIPA liquidation context, empirical evidence indicates the pervasiveness of other kinds of misconduct when failures occur. SIPC would do well to conduct studies specifically designed to investigate the role of abuse of the corporate form in failures.

Even absent proof of pervasive abuse of corporate form, however, a cross-guarantee provision is justified in the absence of holding company “super-regulation.” Holding the entire corporate family liable for the costs of a broker-dealer’s failure should replace existing moral hazards with incentives for self-policing that can reduce the need to regulate broker-dealers’ parents and affiliates. It will create heightened incentives for

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350. See, e.g., EASTERBROOK & FISCHEL, supra note 255, at 56.
351. Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036, 1056-57 (1991). Professor Thompson notes that if small, one to three person corporations are discounted, courts seem to pierce the veil slightly more often with respect to shareholders that are corporations. See id. at 1056.
352. See id. at 1057 n.11.
354. Swire, supra note 87, at 534.
ownership to monitor broker-dealer conduct and discourage parents and affiliates from tapping a broker-dealer’s net capital. Furthermore, because evidence indicates that most failures occur due to deliberate misconduct, a cross-guarantee provision can serve a prophylactic purpose encouraging parent companies to impose greater discipline on broker-dealer firms.

Moreover, although modifying limited liability upsets the prevailing corporate law regime, as a historical and conceptual matter, the limited liability of shareholders does not follow inevitably from the corporate form. The SIPA scheme in its current form is a generous subsidy to the broker-dealer industry. If the state is to grant a special industry subsidy, the state is justified in placing its beneficiaries outside traditional corporation rules. Furthermore, it is unclear that the market could provide the protection provided by SIPA. Thus, even if the costs of SIPA were placed more heavily on the industry, the very existence of SIPC protection would likely still constitute a subsidy.

There are at least two special policy concerns with respect to broker-dealers and other financial intermediaries. First, they are believed to play a prominent role in macroeconomic resource allocation. Second, their


356. See Hillman, supra note 355, at 615 n.1 (“Contrary to popular perception, limited liability of shareholders did not flow automatically from the entity status of their corporations.”); Hansmann & Kraakman, *Unlimited Shareholder Liability*, supra note 355, at 1924-25 (describing nineteenth century state law regimes of unlimited shareholder liability). The rule of limited liability evolved before corporations were allowed to own other corporations. It has been argued that limited liability for corporations that own other corporations developed later only “as an historical accident.” See PHILIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* 56 (1987), quoted in Broome, supra note 291, at 986.

357. As SIPC Chairman Owen once observed, broker-dealers have “no common law right” to SIPC protection. See H.R. REP. No. 95-746, at 47 (1977).

358. As noted previously, there are some who doubt this theory. See supra note 199. Nonetheless, it is the prevailing theory.
customers face unusual risks of fraud from which the public requires protection.\textsuperscript{359} Both these concerns justify heightened state regulation of their activities. Because of the special status of financial institutions, there is significant historical precedent for applying expanded shareholder liability to them. In fact, past liability rules for bank shareholders were far more demanding than the current cross-guarantee scheme.

Prior to the establishment of deposit insurance in 1933, federal law subjected stockholders of an insolvent national bank to “double liability.” That is, they stood to lose not only their initial investment, as under a limited liability regime, but were additionally liable to creditors for up to the par value of their stock.\textsuperscript{360} Thirty-five states had similar laws for shareholders of state banks.\textsuperscript{361} After the Banking Act of 1933, double liability was phased out and eventually eliminated by 1953. Ironically, the Banking Act of 1933, which was supposedly intended to protect depositors, also limited the liability of bank owners and consequently reduced the role of market discipline that might have decreased the risks of depositor exposure, instead spreading that risk uniformly through the industry.\textsuperscript{362}

There were, admittedly, shortcomings in the double liability system: In the rash of bank failures leading up to the 1933 bank holiday, less than fifty percent of double liability assessments were collected. Assessments that were collected “often fell as a calamity upon the businessmen of an already stricken community.”\textsuperscript{363} Where the individual stockholder was no longer living, “the burden of payment was . . . thrust upon his widow and children.”\textsuperscript{364} Nonetheless, Professors Macey and Miller, based on an extensive empirical study, argue that the double liability system was successful in making restitution to depositors.\textsuperscript{365} The classic objections to shareholder liability are of minimal concern today because banks and brokerage

\textsuperscript{359} See Swire, supra note 87, at 510.


\textsuperscript{361} See Vincens, supra note 360, at 275. Certain states were even more demanding: Colorado subjected state bank shareholders to total additional liability of double par value, and California imposed unlimited liability. See id.

\textsuperscript{362} As noted above, however, these problems are being addressed by shareholder liability and risk-based deposit insurance assessments.

\textsuperscript{363} Vincens, supra note 360, at 276 (citing \textit{Banking Act of 1935: Hearings Before Comm. on Banking and Currency on H.R. 5357}, 74th Cong. 147-56).

\textsuperscript{364} Id.

firms alike are rarely owned by small individual investors and the generalized financial hardship of the early 1930s is nowhere in evidence.

V. CONCLUSION

It may have been justifiable in 1970 to initiate an ad hoc plan to prevent a catastrophic shock to the securities markets. Assuming that the position of the brokerage industry and capital markets was as precarious as Congress believed it to have been, it may be understandable that Congress did not place all the costs of the plan directly on the industry itself. But the immediate crisis of 1970 is long past. Encouraging public confidence in the securities markets is no longer a public policy imperative, if indeed it ever was. In fact, the opposite may be true.366

In its present form, SIPA may create overconfidence in at least some brokers by shifting the burdens of firm failure away from the brokerages and exchanges—the parties best suited to prevent failures. In addition, the SIPA scheme obscures from the investor the different levels of risk posed by different brokers. This Article has suggested that SIPC should play a more active role in gathering and disseminating risk-related information, that SIPC should hold self-regulatory organizations responsible for allowing their members to fail, and that a SIPC debtor’s corporate parent and affiliated corporations should be held liable for the debtor’s failure. Such reforms will focus SIPA on the problems of today rather than investor confidence, the problem of the 1970s.

In a recent essay, Professor Mark Roe suggests ways to apply the scientific concept of path dependence to legal analysis. He observes: “[O]nce an institution takes a particular approach to a problem—a path that may have been well-suited to conditions at the time the path was chosen—it may consider the costs of changing approaches too great even though the approach is no longer appropriate for changed conditions.”367 Our institutions are often said to “evolve” over time. Roe notes that, in light of current evolutionary theory, this analogy incorporates the path dependence concept: “Evolution is now often thought of not as a relentless drive to—

366. In response to the protracted bull market, the Chairman of the Federal Reserve delivered all but unprecedented public statements in early 1997 designed to discourage investment in equity securities.

367. See Mark J. Roe, Chaos and Evolution in Law and Economics, 109 HARV. L. REV. 641, 642-43 (1996). Other commentators, applying Professor Roe’s path dependence idea in a different context, have added, “Worse yet, in those instances in which the path that has been chosen has become entrenched, institutional actors may not even be able to imagine alternative paths that might be more efficient.” David B. Wilkins & Mitu G. Gulati, Why Are There So Few Black Lawyers in Corporate Law Firms? An Institutional Analysis, 84 CAL. L. REV. 493, 607 (1996).
ward efficiency, but as adaptation to survive a crisis and then to stay stable."

As Professor Roe’s analogy to evolutionary biology suggests, legal institutions tend to survive for the sake of their own survival. If we would maintain them instead to serve specific policy goals, constant diligence and revision are required. In particular, major legislative decisions are often brought on by crisis and therefore may constitute a misconceived immediate fix rather than a long term systemic solution. In the SIPA context, Congress lacked either the insight or the political courage to implement a long-term solution addressing the real causes of broker-dealer failure. With the perceived crisis in the securities industry and markets long behind us, we should rethink the SIPA scheme in a composed, long-term fashion with an eye toward curing the disease and not merely obscuring its symptoms.