THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 2, 2001

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
United States House of Representatives
Room 2322, Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Congressman Dingell:

Thank you for your letter of June 20, 2001 regarding the U.S. General Accounting Office ("GAO") report, Securities Investor Protection: Steps Needed to Better Disclose SIPC Policies to Investors (GAO-01-653, May 25, 2001). The report makes a number of recommendations to the Securities and Exchange Commission ("Commission") and the Securities Investor Protection Corporation ("SIPC"), which you have referenced in your letter. I am enclosing a memorandum from the Division of Market Regulation concerning how Commission staff is responding to the recommendations. It indicates that staff has implemented many of them and is giving due consideration to the rest.

We believe our responses to the GAO's recommendations will further our investor education and SIPC oversight efforts.

Sincerely,

Laura S. Unger

Laura S. Unger
Acting Chairman

Enclosure

MEMORANDUM

To: Laura S. Unger
Acting Chairman, Securities and Exchange Commission

From: Robert L.D. Colby *BC by HB*
Deputy Director, Division of Market Regulation

Re: General Accounting Office Recommendations Concerning the Securities Investor Protection Corporation

Date: August 1, 2001

I. BACKGROUND

In May, the U.S. General Accounting Office ("GAO") issued the report: Securities Investor Protection: Steps Needed to Better Disclose SIPC Policies to Investors (GAO-01-653, May 25, 2001) ("GAO Report"). The GAO Report arose from the GAO's examination of the Securities Investor Protection Corporation ("SIPC") and the Commission's oversight of that organization.

The thrust of the GAO Report is that, armed with better information about SIPC, investors would be aware of steps they can take while their broker-dealer is solvent to better ensure SIPC protection in the event the firm fails financially. Thus, if investors are aware of the importance of objective evidence to support an unauthorized trading claim in a SIPA liquidation, they will take the time to contemporaneously document in writing complaints about unauthorized transactions. Similarly, if they know that SIPC trustees may deny claims involving transactions with non-SIPC member affiliates of a broker-dealer, they will take more care to ensure their funds or securities are held by a SIPC member. The Commission staff agrees that investors would benefit from a comprehensive understanding of how SIPC protection works. As indicated below, the Commission has taken steps to improve its web site so that it will better convey the need for investors to take these precautions.

However, the extremely low probability that an investor will be involved in a SIPC liquidation makes investor education efforts difficult. We are asking investors to take the time to understand a process that is not likely to impact them, while at the same time, there are other risks associated with investing to which they are far more exposed, most notably market risk. It should also be pointed out that the unauthorized trading and affiliate cases were the result of frauds perpetrated by unscrupulous broker-dealers. The former arose from penny stock market manipulations, while the latter arose from pyramid (or Ponzi) schemes. SIPA protection does not provide coverage for fraud losses. Its purpose has always been to ensure the return of customer assets held by a failed broker-dealer. One of the difficulties with the unauthorized trading and affiliate cases is that they blur the distinction between losses caused by the broker-dealer's fraud and those caused by a failure in its custodial function.

II. GAO RECOMMENDATIONS

SEC

1. *Require SIPC member firms to provide the SIPC brochure to their customers when they open an account and encourage firms to distribute the brochure to its [sic] existing customers more widely*

The purpose of the rule proposed by the GAO is to inform investors about steps they can take, while their broker-dealer is solvent, to protect themselves in the event the firm ends up in a SIPC liquidation (a remote possibility for most investors). Specifically, the intent of the rule would be to inform investors that, if they want to better their chances of obtaining SIPC protection, they should complain about unauthorized transactions in writing at the time of the disputed transaction and take steps to ensure they are dealing with a SIPC member (as opposed to a non-member affiliate). It is beyond dispute that investors should know these facts.

Before adopting such a requirement, the Commission would consider the costs of such a rule as against the purported benefits. This process will include a consideration of the fact that the broker-dealers with the largest numbers of customers will incur significant costs to distribute brochures even though, as indicated in the GAO Report, the SIPC liquidations involving unauthorized trading or affiliate Ponzi schemes concerned firms with relatively few customers. Thus, the cost of distribution of SIPC brochures will be borne by the broker-dealers (or their customers) that are unlikely to end up in a SIPC liquidation involving these issues. The Commission must also consider whether it may be more appropriate and effective to use other means to educate the investing public about these facts.

2. *Review sections of the SEC's Web site and, where appropriate, advise customers to promptly complain in writing when they believe trades in their account were not unauthorized, including an explanation of SIPC's policies and practices and warnings about how to avoid ratifying potentially unauthorized trades during telephone conversations, and update the SEC Web site to include a full explanation of SIPC's policies and practices in liquidations involving nonmember affiliates*

We have made several changes to the "Investor Information" section of our web site to implement the GAO's recommendations. For example, we edited several pages—including online publications and topics in the "Fast Answers" data bank—to ensure that our educational materials clearly and consistently warn investors to put their complaints about unauthorized trading in writing and to send those complaints to the brokerage firms. The revised pages now emphasize that it is important for investors to put their complaints in writing to help prove that the transaction was unauthorized. The revised web pages also provide links to the "Fast Answers" topic on "Unauthorized Trading," which links to information concerning SIPC.

We also substantially revised our "Fast Answers" topic on SIPC so that it explains more fully SIPC's practices in cases involving unauthorized transactions and warns investors about the consequences of ratifying potentially unauthorized trades during telephone conversations. The revised "Fast Answers" topic warns investors never to write checks or make payments to an individual or to a firm that is not a member of SIPC. It also discusses the coverage problems that arise when investors place their cash or securities in the hands of a non-SIPC member, including an unregistered affiliate of a SIPC member. The Commission reiterated these concepts on the revised "Check Out Brokers and Advisers" page, encouraging investors to determine whether the firms they are considering belong to SIPC.

In addition, on the "Investor Alerts" page, we added a link to "SIPC Protection," an alert prepared by the National Association of Securities Dealers Regulation, Inc. ("NASDR") that discusses how SIPC treats unauthorized transactions, warns investors to put complaints in writing, and provides a checklist that investors should follow. We also have added a link on this page to SIPC's newly revised brochure, "How SIPC Protects You."

3. *In conjunction with the SROs, establish a uniform disclosure rule to require that clearing firms disclose on trade confirmations and/or other account statements that investors should complain in writing about unauthorized trades in a timely manner*

As the GAO noted in its report, many broker-dealers already include a notice in their confirmations and account statements advising customers to make a complaint if either is in error. The GAO recommends that all broker-dealers should be required to provide such notices, and that these notices should specifically advise customers to complain in writing about unauthorized trades in a timely manner. The GAO recognizes, however, that the benefits of these notices may be limited.

While we agree in principal that investors should be clearly informed of the importance of monitoring their accounts for unauthorized trades, we would not want to impose a regulatory requirement that could inadvertently create an evidentiary standard that would restrict when investors would be entitled to SIPC protection. Moreover, the Commission staff notes that even minor changes in confirmation and account statement requirements can impose substantial programming and other costs on regulated entities. We believe, therefore, that to minimize these costs, any proposal to amend the SEC's confirmation rule or the Self-Regulatory Organizations' account statement rules in response to the GAO's recommendation should be timed to coincide with other proposals to amend those rules. We would expect to solicit comment on the extent to which investors' rights might be affected at that time.

4. *Require firms that SEC determines to have engaged or are engaging in systemic or pervasive unauthorized trading to prominently notify their customers about the importance of documenting disputed transactions in writing*

We understand that the Commission staff will consider recommending such action on a case-by-case basis. However, this issue has not yet arisen.

5. *Ensure that the Office of Compliance, Inspections, and Examinations ("OCIE") and the Division of Market Regulation include in their ongoing SIPC examination a larger sample of liquidations involving unauthorized trading and nonmember affiliates claims*

Commission staff has implemented this recommendation by including additional liquidations that involve unauthorized and/or non-member affiliate to the on-going examination of SIPC.

6. *Require Market Regulation, OCIE, the Office of General Counsel, and Enforcement establish a formal procedure to share information about SIPC issues*

Commission staff has implemented a formal procedure to discuss and share information about SIPC. The divisions and offices listed above now hold quarterly meetings that began in June 2001.

<u>SIPC</u>

1. *As part of SIPC's ongoing effort to revise the informational brochure and Web site, include a full explanation of the steps necessary to document an unauthorized trading claim*

SIPC has made changes to its brochure and web site that address the concerns outlined in the GAO Report.

2. *Amend SIPC advertising bylaws to require that the official explanatory statement about a firm's membership in SIPC include a statement that SIPC coverage does not protect investors against losses caused by changes in the market value of their securities*

This recommendation arises from the GAO's concern that investors may be confusing FDIC protection with SIPC protection. More specifically, they may believe SIPC will protect them against market losses in their securities portfolios. The GAO reasons that depositors generally understand that if their bank fails, they will get back the amount of their deposits up to $100,000. The GAO, therefore, states that investors may believe that if their broker-dealer fails, they will get back the amount of money they invested in securities, rather than the securities themselves. The Commission and SIPC already have revised their web sites to include a discussion of SIPC coverage that, among other things, specifically addresses coverage for market losses. SIPC also has revised its brochure to expand its discussion of SIPC coverage for market losses. However, with respect to the specific recommendation, we share concerns SIPC has raised that it would be incomplete and perhaps misleading to simply add a short statement about market losses to the official language covered by the SIPC bylaw.