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SEC embarks on first-of-its-kind lawsuit

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On Dec. 12, the U.S. Securities and Exchange Commission (SEC) filed a lawsuit against the Securities Investor Protection Corp., the small nonprofit corporation that oversees the liquidation of U.S. broker-dealers.

The lawsuit is the first of its kind. It follows a public haranguing of the corporation by a bipartisan contingency of southern congressmen. So what brought the Democrats and Republicans together and aligned them with the SEC and against the corporation? Allen Stanford.

Stanford purported to be a billionaire. He offered investors, most of whom were based in the South, certificates of deposits (CDs) issued by his Antigua-based bank. Stanford raised about $7 billion by selling his bank's CDs.

While certain SEC personnel harbored serious doubts about Stanford, the SEC did not take any particularly effective action with respect to the sale of the CDs in the U.S. until enough cracks appeared. The SEC then filed a complaint alleging that Stanford was operating a Ponzi scheme. Stanford's dozens of companies were forced into bankruptcy in February 2009.

One of those companies is Stanford Group Co. (SGC), a U.S. broker-dealer that marketed the CDs to investors. It is estimated that about 7,800 customers of SGC hold CDs with face values of about $3.5 billion. Those folks (and 20,000-plus other investors) were promised double-digit returns, but now hold worthless instruments.

While Stanford sounds like Bernie Madoff's twin, in contrast to the Madoff fraud, the corporation did not authorize a proceeding under the Securities Investor Protection Act (SIPA) and it did not appoint a trustee. Rather, in August 2009, the corporation declined coverage in part because SGC did not perform a custody function for its customers.

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So what brought the Democrats and Republicans together and aligned them with the Securities and Exchange Commission and against the Securities Investor Protection Corp.? Allen Stanford.

In the Madoff proceeding, the corporation admonished the parties that SIPA was not intended to address every possible loss by securities investors. A main purpose of SIPA is to ensure that customers do not lose cash and securities on deposit with their broker if the broker fails financially. There are limits, however, with SIPA authorizing coverage up to $500,000 (and only for $100,000 of cash) of the customer's assets on deposit. (Notably, at the outset of the Madoff matter, questions arose as to whether the volume of claims could cause the corporation to become insolvent. The corporation's funds for coverage come from assessments on its broker-dealer members and limited borrowing from the U.S. Treasury. Soon after Madoff, the corporation drastically hiked the assessment rates on its members.)

SIPA's limitations may have surprised Stanford's investors, particularly because the general description of their situation is strikingly similar to the Madoff investors' situation. Understandably, the investors would have liked the corporation fund to repay them some of their losses. They formed the Stanford Victims Coalition and hired a former SEC lawyer.

In June 2011, the SEC determined that based on the totality of the facts and circumstances, SGC failed to meet its obligations to customers and that there are SGC customers in need of the protections provided by SIPA. Whether the corporation agrees with the SEC's determination, the corporation appears to have independently determined that, legally, it is not required to initiate a SIPA proceeding and the corporation funds cannot be used to repay Stanford's investors for their losses.

The SEC's lawsuit asserts that the court should order the corporation to file an application for protective decree and, because SIPA empowers the SEC to supervise the corporation, the SEC can supersede a contrary judgment by the corporation. Thus, the protections afforded by SIPA are not the only issues raised. Equally front and center, at least according to the SEC, is its power to supersede those it purportedly supervises.

On a related note, while the court is addressing Stanford and the apparent turf battle between the SEC and the corporation, legislators may be reconsidering the entire customer protection scheme as a result of the recent MF Global bankruptcy.

MF Global is the U.S.-based commodities and securities brokerage firm, regulated as a futures commission merchant and a broker-dealer. Trading for its own account, MF Global made investments in European government debt and financed the positions by engaging in repurchase transactions to maturity.

In the summer and fall this year, the Financial Industry Regulatory Authority (FINRA) questioned the capital adequacy of the firm and required it to maintain additional capital. Additional twists and turns included press reports highlighting the capital call, a poor earnings report (attributed to a tax write-off) and ratings downgrades. Then, in the midst of trying to sell the firm, it was discovered that customer funds appeared to be "missing." That was the beginning of the end.

Within days of the discovery, MF Global entered insolvency proceedings under SIPA and Subchapter IV of Chapter 7 of the Bankruptcy Code (which governs futures commission merchants). Initial reports pegged MF Global's missing customer funds at about $600 million, and though the estimate was quickly revised to $1.2 billion, current "guesstimates" place the final number south of $1 billion.

In congressional hearings examining MF Global, legislators and regulators noted the different customer protection models afforded to futures and securities customers. MF Global was subject to the Commodity Exchange Act, which required it to hold futures customers' assets in segregated accounts. It also was subject to the Securities Exchange Act, which permits the use of securities customers' assets for certain purposes but requires a calculation of customers' assets and weekly deposits to a customer reserve account. SIPA's protections are available to broker-dealer customers (for their securities holdings) but not to futures commission merchant customers. Neither the futures or securities model is foolproof.

Whether the protections afforded by SIPA change due to legislation or court ruling remains to be seen. In the meantime, Stanford's investors will continue to hope that they will be reimbursed for their investment losses and MF Global's customers will continue to hope that they recover the full amount of the assets that were in their accounts.