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Article

How to Fix Unpaid Arbitration Awards

Per Jebsen*

Investors face many perils when they entrust their savings with an errant brokerage firm or broker. The hazards are often limited primarily by ingenuity: the firm or broker may put the money in unsuitable investments, squander it through excessive trading, or simply steal it outright. Even after the misuse is detected, the investor must bring a claim, proceed through arbitration, and obtain a favorable verdict. But a painful obstacle may be reserved for last: in a significant fraction of cases, an investor with a duly obtained award is simply never paid, usually because the errant brokerage firm or broker has gone out of business. As recently as four years ago, one out of three arbitration awards was never paid, and up to one-half of the award amounts went unsatisfied.[1] Since then, apparently because of new rules imposed by regulators, these rates may have been halved.[2] Nonetheless, for many investors, the arbitration payment process has a casino-like quality: usually you get paid, but every sixth time, you do not. These investors, having potentially put at stake their life savings, are denied satisfaction of their duly-obtained awards because they were unable to perceive in

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1. U.S. GEN. ACCOUNTING OFFICE, FOLLOW-UP REPORT ON MATTERS RELATING TO SECURITIES ARBITRATION, GAO-03-162R, at 3 (Apr. 11, 2003), *available at* http://www.gao.gov/new.items/d03162r.pdf [hereinafter GAO 2003].

2. *See A Review of the Securities Arbitration System: Hearing Before the Subcomm. on Capital Markets, Ins. and Gov't-Sponsored Enter., H. Fin. Servs. Comm.*, 109th Cong. 1 (2005) (testimony of Linda D. Fienberg, President, NASD Dispute Resolution), http://financialservices.house.gov/hearings.asp?formmode=all&comm=1 (follow Mar. 17, 2005 hyperlink) [hereinafter *Hearing*].

advance something that also eluded regulators; namely, that a particular broker-dealer was destined in one, two or more years to fail.

This Article focuses on how to fix the problem of unpaid securities arbitration awards. Arbitration, a more informal approach to dispute resolution that securities firms almost always make mandatory for individual investors, has attracted much commentary as to whether it is fair and efficient.[3] The arbitration *payment* process has been the subject of far less scrutiny.[4] Yet, as an objective matter, it is unfair and inefficient in the sense that, year after year, a noteworthy number of investors who have been vindicated never receive the money to which they are entitled. The Article examines why the situation deserves to be remedied and proposes solutions that would take the non-payment rate as close as possible to zero.

Section A of this Article sets forth and discusses data concerning the extent of unpaid awards. Section B describes the steps that have been taken (principally) by NASD, a self-regulatory organization (SRO) that regulates America's securities industry,[5] to reduce unpaid awards since

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3. *See, e.g.*, Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415 (2003); Barbara Black & Jill Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991 (2002); David S. Ruder, *Elements of a Fair and Efficient Securities Arbitration System*, 40 ARIZ. L. REV. 1101 (1998); Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327 (1996).

4. Marilyn Blumberg Cane & Marc J. Greenspon, *Securities Arbitration: Bankrupt, Bothered & Bewildered*, 7 STAN. J.L. BUS. & FIN. 131 (2002), discuss both unpaid awards and the lack of written reasons given for the factual and legal basis to an arbitration award. More generally, commentators have noted a comparative dearth of academic literature with respect to either the Net Capital Rule or SIPA, which are discussed at length in this Article. *E.g.*, Francis J. Facciolo, *Father Knows Best: Revised Article 8 and the Individual Investor*, 27 FLA. ST. U. L. REV. 615, 678 n.348 (2000) ("The law review literature that focuses on the uniform net capital rules is even less extensive than that for the SIPC."); Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1074 n.7 (1999) (referring to academic literature addressing the SIPA scheme as "limited"). (With respect to written reasons, NASD has filed with the SEC a proposed rule change allowing customers to require a written explanation of the arbitration panel's decision. *E.g.*, Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto, to Provide Written Explanations in Arbitration Awards Upon the Request of Customers, or of Associated Persons in Industry Controversies, Exchange Act Release No. 34-52009, 70 Fed. Reg. 41,065 (July 15, 2005)).

5. NASD is "the primary private-sector regulator of America's securities industry." NASD, About NASD, http://www.nasd.com/web/idcplg?IdcService=SSGET_PAGE &nodeId=608 (last visited Dec. 11, 2005).

the issuance of several reports earlier in this decade by the United States Government Accountability Office (GAO) examining the problem.[6] Section C lays out several arguments as to why the problem of unpaid awards should be fixed. Section D considers approaches to reducing the problem that would go beyond those fixes that have been implemented. Finally, Section E provides a conclusion.

Among other arguments, Section C asserts that allowing arbitration awards to remain unpaid has the potential to undermine investor confidence and is, in any case, a blemish on the reputation of the U.S. capital markets. The Section also suggests that ignoring the problem amounts to shifting the burden for regulatory failure with respect to defunct broker-dealers to those least able to shoulder the burden: individual investors essentially chosen at random.

Section D examines several approaches to reducing the rate of unpaid arbitration awards. These approaches are: (1) establishing an SRO-administered fund or imposing an insurance or bond-posting requirement; (2) making stricter aspects of a rule established by the Securities and Exchange Commission (SEC) that is known as the "Net Capital Rule";[7] and (3) expanding the duties of the Securities Investor Protection Corporation (SIPC), the non-profit corporation that in certain instances oversees the liquidation of failed broker-dealers. The Section also discusses considerations that would apply in drafting statutory language to give SIPC the ability to cover unpaid awards.

In particular, this Article emphasizes an increased role for SIPC. It does so for several reasons. SIPC's enabling statute, the Securities Investor Protection Act of 1970 (SIPA),[8] was born of a desire to restore investor confidence shaken by the failure of broker-dealers, and thus has

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6. U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS, GAO/GGD-00-115 (June 15, 2000), *available at* http://www.gao.gov/new.items/gg00115.pdf [hereinafter GAO 2000]; U.S. GEN. ACCOUNTING OFFICE, EVALUATION OF STEPS TAKEN TO ADDRESS THE PROBLEM OF UNPAID ARBITRATION AWARDS, GAO-01-654R (Apr. 27, 2001), *available at* http://www.gao.gov/new.items/d01654r.pdf [hereinafter GAO 2001]; GAO 2003. (At the time these reports were issued, GAO was called the United States Government Accounting Office.). Each of the reports states that it was written in response to requests from Congressmen John D. Dingell and Edward J. Markey. *E.g.*, GAO 2000 at 1 (stating that the report was written in response to requests from Dingell and Markey dated as of July 30, 1998 and September 23, 1998). In addition to the GAO reports, this Article has benefited from the article by Thomas W. Joo, *supra* note 4.

7. Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2005).

8. Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa-78lll (2005). SIPC's status as a non-profit "membership" corporation is provided for at § 78ccc(a).

a genesis similar to that which would stimulate reducing unpaid awards.

Second, SIPA elevates for special treatment a class of claims that pertain to investors and failed broker-dealers, and therefore creates a "precedent" for doing so again. Third, SIPC's established competence in liquidating failed broker-dealers to satisfy certain claims of individual investors makes it a logical candidate for administering unpaid awards. Finally, SIPC already possesses a sizeable fund that could be tapped, and readily augmented, in order to appropriately compensate individual investors with such awards.

A. Unpaid Awards Remain a Significant Problem

In 1998, about 64% of NASD-administered arbitration awards were not fully paid.[9] Also in that year, about 80% of the $161 million awarded to investors in all forums, but almost entirely NASD, went unpaid.[10]

The non-payment rate then dropped: in 2001, about 33% of NASD-administered awards were not fully paid, and about 55% of the $100.2 million awarded was unpaid.[11] The reduced rate of non-payment may have reflected new NASD award-monitoring procedures introduced since 1998 or a difference of methodologies used to measure the rate: the

9. GAO 2000, *supra* note 6, at 34; GAO 2003, *supra* note 1, at 9. NASD administers the great majority of arbitration cases. In 1998, NASD arbitrators decided 92% of customer-initiated arbitration cases, while New York Stock Exchange (NYSE) arbitrators decided 6%. GAO 2000, *supra* note 6, at 24-25. In 2004, there were 8,201 NASD arbitration cases filed compared with 1,002 NYSE cases filed. NASD, Dispute Resolution Statistics, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12 (last visited Dec. 11, 2005) [hereinafter NASD, Dispute Resolution Statistics]; NYSE, 2004 Arbitration Statistics, http://www.nyse.com/Frameset.html?displayPage=/arbitration/1022221393057.html (last visited Nov. 1, 2005). Other arbitration forums include the American Arbitration Association, the Chicago Board Options Exchange, and the Pacific Exchange. GAO 2000, *supra* note 6, at 25. Not only does NASD administer most arbitration cases, but nearly all, or all of the cases involving unpaid awards, arise in NASD arbitrations. *Id.* at 5, 7. "Securities regulations require every broker-dealer . . . [with] public customers to register with, and be a member of, NASD." *Id.* at 26. Thus, "NASD members include the newer, less established or less capitalized broker-dealers" while "NYSE members must be able to pay the [potentially million-dollar plus] cost of a seat on the exchange." *Id.*

10. GAO 2000, *supra* note 6, at 34; GAO 2003, *supra* note 1, at 9.

11. GAO 2003, *supra* note 1, at 3. In 2001, out of the 236 awards that were not fully paid, nothing was paid on 216 of the awards and 20 of the awards were partially paid. *Id.* at 9. Of the approximately $55 million that was not paid in 2001, about $12 million was not due because "respondents had requested a hearing, filed for bankruptcy, or filed a motion to vacate." *Id.* at 3.

1998 figures were based on a GAO survey while the 2001 figures were based on NASD data.[12] In 2002, about 30% of NASD arbitration awards were not fully paid, according to one estimate.[13] The great majority of unpaid awards are the result of broker-dealers leaving the industry.[14]

The most recent publicly-available figure for the extent of unpaid arbitration awards is that about 15% of NASD arbitration awards through the first half of 2004 went unpaid.[15] It is unclear, however, whether this figure reflects only awards that were completely unpaid, or includes those that were partially paid.[16] It is also unclear how much of the aggregate award amount went unpaid for the time period. The 15% figure, if it holds for the rest of 2004, would suggest that the rate of unpaid awards on a per-award basis has been halved from 2001. NASD attributes the improvement to steps it has taken to reduce unpaid awards.[17] (These steps are described below in Section B.)

However, even with an apparently reduced rate of unpaid awards, the increased numbers of arbitration cases and award amounts, which may reflect the bull market and its aftermath, suggest that as an absolute matter, the problem has remained particularly significant through 2004. A review of NASD statistics is illustrative. Total arbitration cases filed

12. *Id.* The 1998 figures had a sampling error of plus or minus 7 or 8%. GAO 2000, *supra* note 6, at 34.

13. Securities Industry Association, Arbitration is Fair, Fast, And Economical for Investors (updated on Jan. 29, 2004), http://www.sia.com/press/pdf/Arbitration TalkingPoints2003.pdf [hereinafter SIA, Arbitration]. The SIA release states that GAO is set to issue a report "that is expected to show a significant drop in the percentage of unpaid arbitration awards." *Id.*

14. In 2001, 192 out of 236 awards that were not fully paid were attributed to brokers that had terminated their NASD membership. GAO 2003, *supra* note 1, at 9. A more recently provided statistic is that with respect to about 85% of unpaid awards, "the party responsible for the damages was a broker-dealer firm or individual broker that had left the securities industry." *Hearing, supra* note 2 (testimony of Linda D. Fienberg).

15. GAO 2003 recommends that NASD provide data on the extent of the non-payment rate on its website. GAO 2003, *supra* note 1, at 3. This recommendation was seconded by the Securities and Exchange Commission, *id.* at 18, and by Congressmen John Dingell and Edward Markey in a letter commenting on GAO 2003. Letter from John D. Dingell, Ranking Member, Comm. on Energy and Commerce, and Edward J. Markey, Ranking Member, Subcomm. on Telecomm. and the Internet, to William H. Donaldson, Chairman, SEC and Linda D. Fienberg, President, NASD Dispute Resolution (May 12, 2003), http://www.house.gov/commerce_democrats/press/index.shtml#letters.

16. Partially-paid awards comprised almost one-fifth of the total given for the 1998 not-fully-paid figure. GAO 2000, *supra* note 6, at 34. Partially-paid awards dropped to under 9% for the 2001 not-fully-paid figure. *See* GAO 2003, *supra* note 1, at 9 (noting that, in 2001, out of 236 awards that were not fully paid, 20 were partially paid).

17. *Hearing, supra* note 2 (testimony of Linda D. Fienberg).

rose to 8201 in 2004 and 8945 in 2003 from 6915 in 2001.[18] Arbitration cases closed rose to 9209 in 2004 from 5582 in 2001. Cases decided by arbitrators rose to 2423 in 2004, up from 1669 in 2001.[19] All customer cases decided rose to 2019 in 2004 from 1365 in 2001, and customer cases with damage awards rose from 725 in 2001 to 1113 in 2004.[20] Finally, total damages awarded rose to $194 million in 2004, up from $97 million in 2001.[21]

A 15% non-payment rate, to the extent it related solely to the figure for customer cases with damage awards, would mean that about 167 investors or investor households (assuming no single investor or investor household had multiple unpaid awards), after having identified a misuse, proceeded through arbitration, and received a favorable judgment, had nonetheless failed to receive the award (or had only received part of the award) to which they were entitled. Thus, while the non-payment rate may have been halved since 2001, on an absolute basis, the number of unpaid awards has been reduced by a little less than one third.[22] (And, of course, the 15% non-payment rate is a provisional figure for the first half of 2004.) Furthermore, for each of these approximately 167 investors, the unpaid award amount is likely to have been personally significant: the average award amount for 2004 was about $174,000.[23]

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18. NASD, Dispute Resolution Statistics, *supra* note 9. This year, the number of new case filings through October has dropped from 7010 to 5017 for the same period last year. *Id.*

19. *Id.* NASD figures show that 1073 of the cases closed in 2004 were resolved for catchall reasons including "bankruptcy of critical party," indicating that the figure for cases with damage awards might have been higher but for these bankruptcies. *Id.*

20. NASD, Dispute Resolution Statistics (as updated for Mar. 2005) (copy on file with author). The statistics update for October shows that "all customer *claimant* cases decided" (emphasis supplied) rose to 1894 in 2004 from 1172 in 2001, and that "all customer *claimant* cases" (emphasis supplied) with damage awards rose to 888 in 2004 from 637 in 2001. NASD, Dispute Resolution Statistics, *supra* note 9. These figures were apparently not provided in NASD's update for March. The October update notes that the "[p]ercentage of customer claimant award cases has been recalculated to reflect only instances in which investors as claimants recovered monetary damages or non-monetary relief." *Id.*

21. NASD, Dispute Resolution Statistics (as updated for March 2005) (copy on file with author). NASD's website apparently did not provide damage award figures in its statistics update for October. *See* NASD, Dispute Resolution Statistics, *supra* note 9.

22. As mentioned above in notes 11, 14, there were 236 awards that were not fully paid in 2001. GAO 2003, *supra* note 1, at 9. To the extent that there has been a drop in the number of arbitration cases in 2005, *see supra* note 18, then the reduction in the number of unpaid awards on an absolute basis is likely to have been greater this year than last.

23. In 2004, a total of $194 million was awarded in 1113 customer cases. *Supra* notes 20-21 and accompanying text.

Moreover, in 2001, as in 1998, the rate of unpaid aggregate award amounts was higher than the rate of unpaid cases (in other words, the overall amount of money *not* collected was greater as a fraction of the whole than the number of unpaid cases).[24] Applying the 15% non-payment ratio to a 2004 total damages figure of $194 million would yield an annual aggregate non-payment amount of roughly $29 million.[25] However, if the ratio in 2001 between unpaid award amounts and unpaid cases (either slightly more than or just under one half to slightly less than one third)[26] were to have persisted in 2004, then about one quarter of the aggregate amount would have been unpaid, or roughly $48.5 million. That figure is not much less than the $55 million that went unpaid in 2001.[27] (Also, a higher proportion of unpaid award amounts may indicate that the average unpaid award amount might have been even higher than $174,000.)

Another way of considering the 15% non-payment rate is that it diminishes an element of the argument that the arbitration process is fair. A statistic that has been cited is that in about 55%, or more than half, of arbitration cases, investors receive an award.[28] However, when unpaid awards are included, the statistic for investor compensation drops to less than half, or about 47%.[29]

In other words, even now, after the NASD has implemented steps to reduce the number and amount of unpaid awards, less than half of investors who proceed through arbitration are actually paid for their

24. "In 2001 about 55%, or $55 million, of the $100.2 million NASD arbitrators awarded to investors was unpaid." GAO 2003, *supra* note 1, at 9. In 1998, about 80%, or about $129 million of the $161 million awarded was unpaid. GAO 2000, *supra* note 6, at 34.

25. *See supra* note 21 and accompanying text.

26. The exact fraction for the 2001 unpaid award amount depends on how one treats the $12 million figure that was not required to be paid. If all of the $12 million is subtracted from the $55 million that was required to be paid, then the percentage of unpaid awards is 43%, which is still significantly higher than the less-than one-third ratio for unpaid cases. However, of this $12 million, at least some part of it was unpaid for reasons—*i.e.*, bankruptcy—that were beyond the control of investors, and thus the percentage of unpaid awards would be higher. *See* GAO 2003, *supra* note 1, at 3 n.6.

27. GAO 2003, *supra* note 1, at 9.

28. *Hearing*, *supra* note 2 (testimony of Linda D. Fienberg). SIA, Arbitration, *supra* note 13 (noting 54% payment rate through December 2003 for that year).

29. This figure is arrived at by subtracting the 15% non-payment rate from the total of paid awards and adding it to the figure for unpaid awards. Figures currently provided on NASD's website suggest that customers receive awards in just 47% of arbitration cases, and that therefore, once the 15% non-payment rate is factored in, the statistic for investor compensation would drop to about 40%. *See* NASD, Dispute Resolution Statistics, *supra* notes 9, 20.

claims. And, of course, given that non-payment rates were higher in previous years, the figure for awards with actual payment would be even less when calculated over a recent multi-year span. Finally, non-payment statistics may fail to capture the extent of the problem given that the likelihood of non-payment, which presumably would be apparent where a broker-dealer is failing or has failed, would deter lawyers from taking a case.[30]

B. Unpaid Awards Persist Despite NASD Steps to Address Problem

NASD has taken a wide variety of steps to improve the arbitration payment process since the issuance of GAO 2000.[31] Thus, apparently during 2000, both NASD and the SEC on their websites began to caution investors against the dangers of an unpaid award.[32] In September 2000,

30. *See* GAO 2003, *supra* note 1, at 10. *See also Hearing*, *supra* note 2 (testimony of Rosemary Shockman, President, Public Investors Arbitration Bar Association) ("Abused investors often cannot find lawyers to represent them in cases against broker-dealers when the ability to collect is uncertain.") Proponents of arbitration note that many cases are settled prior to arbitration and that investors receive compensation when they do settle. *Hearing*, *supra* note 2 (testimony of Linda D. Fienberg); *see also* SIA, Arbitration, *supra* note 13.

31. Most but not all of these steps are summarized in GAO 2003, *supra* note 1, at 11. In GAO 2000, GAO recommended that NASD take several actions to rectify the problem of unpaid awards. These included requesting that the parties to arbitration inform NASD by the end of the 30-day payment period about the payment status of any monetary award. GAO 2000, *supra* note 6, at 45. In the report, GAO said NASD had committed to undertake various initiatives to encourage prompt payment of unpaid awards. *Id.* These initiatives were: (1) require member firms to notify NASDR when they have satisfied an award; (2) require that claimants notify ODR if they haven't been paid; (3) propose to NASD Board that a firm that has been terminated, suspended or barred be prohibited from enforcing a pre-dispute arbitration agreement clause; (4) advise claimants in writing of the status of a firm so that they can evaluate whether to continue with arbitration; and (5) propose a rule amendment to provide default proceedings where the terminated or defunct member or associated person doesn't answer or appear, but the claimant affirmatively elects to pursue arbitration. *Id.* at 67-68.

32. GAO 2003, *supra* note 1, at 12. In its report, GAO said NASD and SEC began these website cautions following a GAO request made in June 2000. NYSE has included information regarding unpaid awards in its Users Guide to Arbitration, *available at* http://www.nyse.com/pdfs/Guidelns2.pdf; *see also* GAO 2001, *supra* note 6, at 5 (noting that NYSE had made information available in its Users Guide). The NYSE otherwise apparently has not taken steps comparable to NASD. *Cf.* GAO 2003, *supra* note 1, at 18 (appended letter from SEC noting NASD rule changes and stating that NYSE (and SEC and NASD) educational materials had been amended to reflect risk of unpaid awards, but making no mention of any further NYSE steps). Presumably, this is because the NYSE has not had a significant problem with unpaid awards, which in turn would reflect the greater capitalization of NYSE members. *See supra* note 9. For its 1998 survey, GAO agreed that the NYSE had not had any unpaid awards. *See* GAO 2000, *supra* note 6, at

NASD required broker-dealers to certify that they have paid or otherwise complied with an award against them within 30 days after the award has been served; and it also began to ask claimants who won awards to notify it if an award has not been satisfied.[33]

In April 2001, NASD, with SEC approval, amended its code of arbitration procedure to preclude a suspended broker-dealer from enforcing a predispute arbitration agreement in NASD's arbitration forum.[34] In June 2001, NASD began to advise claimants in writing of the status of broker-dealers so that the claimants could evaluate whether to continue with the arbitration.[35] In July 2002, the SEC approved a proposed NASD rule change providing for streamlined default proceedings against a defunct broker-dealer who does not appear.[36] Also, NASD officials said they had begun reviewing arbitration claims as they arrived, so as to identify potentially troublesome members.[37]

More recently, in February 2004, the SEC approved various NASD rule amendments whose effects included making it more difficult for firms to avoid their arbitration payment obligations.[38] Also, in June

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47; *see also id.* at 35, and accompanying text (discussing whether an award had been partially paid); *id.* at 73-74 (appended letter from NYSE stating that award had been fully paid).

33. GAO 2003, *supra* note 1, at 10.

34. Order Approving Proposed Rule Change by NASD, Inc. Relating to Amendments to Rule 10301 of the Code of Arbitration Procedure to Prohibit Terminated, Suspended, Barred or Otherwise Defunct Firms From Enforcing Predispute Arbitration Agreements in the NASD Arbitration Forum, Exchange Act Release No. 34-44158, 66 Fed. Reg. 19,267 (Apr. 6, 2001).

35. GAO 2003, *supra* note 1, at 11.

36. Order Approving a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Situations in Which a Suspended, Terminated, or Otherwise Defunct Member or Associate Person Fails to Answer or Participate in an Arbitration Proceeding, Exchange Act Release No. 34-46221, 67 Fed. Reg. 48,237 (July 17, 2002). *See* GAO 2003, *supra* note 1, at 11.

37. GAO 2003, *supra* note 1, at 11 (It is not clear from GAO 2003 when this began).

38. Order Granting Approval of Proposed Rule Change by the NASD, Inc. to Amend Rules 1011, 1014 and 1017, Exchange Act Release No. 34-48969, 68 Fed. Reg. 75,681 (Dec. 22, 2003). NASD announced that it had approved the proposed amendments for comment on August 6, 2002. News Release, NASD, NASD Board Approves Proposed Amendments to Strengthen Authority in Member Application Reviews (Aug. 6, 2002), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE &ssDocName=NASDW_002919. Among the amendments, NASD clarified that pending arbitration claims against an applicant are considered as part of the application process, and created a new standard of admission explicitly identifying as decisional criteria unpaid arbitration awards. NASD, *Membership Application and Continuation Rules*, Notice to Members 04-10, at 94 (Feb. 2004), *available at* http://www.nasd.com

2004, the SEC approved NASD by-law amendments that would allow NASD to institute suspension hearings within two years against a former broker seeking to reenter the securities industry when that broker has failed to pay awards.[39] Indeed, to the extent that NASD has omitted to take steps with respect to unpaid awards, the most discernible omission is a failure to make readily available better statistics delineating the extent of the problem.[40]

As mentioned, an NASD official has stated that the halving of the non-payment rate achieved in the first half of 2004 reflects the success of the steps NASD has taken.[41]

C. Why It Makes Sense to Reduce Non-Payment of Arbitration Awards

Before determining *how* best to reduce or eliminate non-payment of arbitration awards, it is useful to consider *why* one should do so. Several rationales suggest themselves.

First, even though the non-payment rate has been decreased, the incidence of unpaid awards remains sizeable. As described in Section A,

/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_003276&ssSourceNodeId=467 (follow "View Full Notice" hyperlink).

39. Order Granting Approval of Proposed Rule Change by NASD, Inc. Regarding Failure to Pay Arbitration Awards, Exchange Act Release No. 34-49845, 69 Fed. Reg. 33,968 (June 10, 2004). More generally, NASD and SEC have acted on various recommendations from GAO on how better to inform investors of SIPC's policies. *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: UPDATE ON MATTERS RELATED TO THE SECURITIES INVESTOR PROTECTION CORPORATION, GAO-03-811, (July 2003), *available at* http://www.gao.gov/new.items/d03811.pdf [hereinafter GAO SIPC UPDATE].

40. Among the statistics that would help inform a discussion concerning unpaid arbitration awards are the following: (a) exactly how many awards have gone unpaid for each year since 2001; (b) how many awards have been partially paid; (c) a breakdown of when these awards arose (*e.g.*, prior to bankruptcy, arising prior to but concluded after bankruptcy, or arising after and concluded after bankruptcy); (d) to the extent that the awards had arisen because of a broker termination of its NASD membership, whether the broker had self-liquidated, self-liquidated under NASD auspices, or been liquidated under SIPC auspices; (e) whether the unpaid award pertained to a clearing or an introducing firm; and (f) the size of the brokerage firm to which the unpaid award related (if it related to a firm rather than an individual), measured by criteria such as revenues.

41. *Hearing*, *supra* note 2 (testimony of Linda D. Fienberg). In Congressional testimony earlier this year, NASD Dispute Resolution President Linda Fienberg pointed to the following changes among others as having led to the improvement in the non-payment rate: (a) requiring brokerage firms to certify compliance with awards within 30 days; (b) asking investors to notify NASD if awards have not been paid; (c) requiring brokerage firms to certify that their employees have paid their awards; (d) beginning of suspension proceedings within 30 days from the date the award is issued absent certain steps by the firm or individual broker; and (e) streamlined default proceedings. *Id.*

about 167 investors or investor households will not have been paid for awards made in 2004, based on extrapolated figures. This number is, as an absolute matter, only one third less than the number of unpaid awards four years ago.[42] The losses from these unpaid awards are likely to have been significant to these investors or investor households assuming an average award size of $174,000.[43] The problem may be greater than the statistics indicate to the extent that some lawyers are or have been deterred from taking cases because of the very prospect of non-payment.[44] Moreover, even if the provisionally reduced arbitration award non-payment rate more closely approximates any typical non-payment rate for judicial judgments, arguments presented in this section (*e.g.*, preserving confidence in the capital markets, immediately below) support seeking to further diminish the arbitration non-payment rate.[45]

Second, non-payment of a significant fraction of unpaid awards has the potential to undermine confidence in the capital markets and in the processes of investor justice. Permitting continued non-payments provides an unfortunate contrast with efforts to make the arbitration process fair and efficient and constitutes a waste of NASD resources.[46] Non-payment undermines the promise of improved arbitral process implicit in cases such as *Shearson/American Express v. McMahon*,[47] the Supreme Court case that upheld the enforceability of pre-dispute arbitration agreements in broker-customer contracts.[48]

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42. *See supra* note 23 and accompanying text (The ongoing decline in the number of arbitration cases in 2005 from 2004 suggests that on an absolute basis the reduction in the number of unpaid awards would be greater in 2005 than in 2004).

43. *See supra* note 23 and accompanying text.

44. *See supra* note 30 and accompanying text.

45. It would be worthwhile to compare the non-payment rate for arbitration awards with non-payment rates for various types of judicial judgments. It seems likely that the 33% non-payment rate for 2001 (number of awards) would exceed such rates for many types of judicial judgments (or such judgments generally). At the provisional 2004 rate of 15%, however, such assurance may prove to be less warranted. As an initial matter, the inquiry would need to establish the comparability of different categories of non-payment rates (*e.g.*, unpaid awards versus other forms of (mainly) bankruptcy-generated non-payment rates, or unpaid awards versus judicial judgments concerning brokerage firms). In any case, as this section suggests, even if the arbitration non-payment rate is similar to or less than other non-payment rates, several compelling arguments exist for remedying the arbitration rate, such as preserving confidence in and enhancing the reputation of the U.S. capital markets, or compensating for defects in a regulator-sanctioned arbitration system.

46. GAO 2003, *supra* note 1, at 13.

47. 482 U.S. 220 (1987).

48. The *McMahon* court in part rested its holding on a reassessment of a prior decision, *Wilko v. Swan*, 346 U.S. 427 (1953). The Court stated that "the mistrust of

Third, reducing the non-payment rate to near-zero would benefit the image of the U.S. capital markets, often touted as the best in the world.[49] Such action would contribute to the restoration of trust in the markets shaken by corporate accounting and Wall Street scandals.[50] Moreover, making absolutely sure the arbitration process works as well as possible might foster increased public participation in shareholding, which benefits the securities industry.[51] Industry participants praise arbitration as superior to judicial litigation.[52] A perfected arbitral system would improve their case. (One can more readily demonstrate why arbitration is preferable if the payment rate for arbitration awards is provably better [as opposed to on par with or worse] than for judicial judgments.)

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arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time." *McMahon*, 482 U.S. at 233. The *McMahon* court also reasoned that "[e]ven if *Wilko*'s assumptions regarding arbitration were valid at the time *Wilko* was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority." *Id.* In *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), the Court vacated *Wilko. Id.* at 484. The Court said: "To the extent that *Wilko* rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes." *Id.* at 481.

49. *Cf.* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394 (2004) (examining challenge posed by Enron scandal to widely held beliefs that the U.S. corporate governance and disclosure systems are the best in the world, and that the U.S. capital markets are highly efficient).

50. *Cf., e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 302 (2004) (asserting "gatekeeper" failure as reason for wave of accounting and financial scandals surfacing in 2001-2002); Jon Jordan, *Corporate Issuers Beware: Schering-Plough and Recent SEC Enforcement Actions Signal Vigorous Enforcement of Regulation FD*, 58 U. MIAMI L. REV. 751, 774 (2004) (noting that Enron scandal caused massive loss of investor confidence in marketplace); *but c.f.* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1546 (2005) (describing how massive market decline had preceded enactment of Sarbanes-Oxley legislation but questioning value of such legislation to investors).

51. *Cf.* INVESTMENT COMPANY INSTITUTE, 2004 ANNUAL REPORT TO MEMBERS 9 (2005) (noting that mutual fund industry's success rests on the confidence of the 92 million shareholders, representing half of all the nation's households, that have entrusted more than $7.5 trillion to mutual funds), *available at* http://www.ici.org (follow "Statements & Publications" hyperlink; then follow "Annual Reports & Policy Papers" hyperlink). Research reports profiling equity ownership available on the Investment Company Institute's website include INVESTMENT COMPANY INSTITUTE AND THE SECURITIES INDUSTRY ASSOCIATION, EQUITY OWNERSHIP IN AMERICA (2005), *available at* http://www.ici.org (follow "Statements & Publications" hyperlink; then follow "Research Newsletters & Reports" hyperlink).

52. *E.g.*, *Hearing*, *supra* note 2 (testimony of Mark Lackritz, President of the Securities Industry Association) ("Arbitration continues to be a far more efficient and cost-effective dispute resolution mechanism than traditional court-based litigation.").

Fourth, allowing a significant fraction of arbitration awards to remain unpaid amounts to unfair burden-shifting of the consequences of regulatory failure. Regulators, not individual investors, supervise broker-dealers; and regulators, not individual investors, are charged with attempting to forestall or warn of impending broker-dealer delinquency.[53] Yet randomly chosen individual investors currently must shoulder the financial burden when bankruptcy occurs, even after they have pursued regulator-sanctioned arbitral procedures.

Arguing against fixes to the non-payment problem on the basis of cost to broker-dealers or investors in the aggregate amounts to a willingness to let losses stemming from imperfections in the regulatory scheme rest with a few unlucky investors. This willingness is unfair because these few investors are the least able to guard against the imperfections (and may even be unaware of their existence).[54] Moreover, even as these investors suffer losses that are likely to be personally significant, the scheme that has led to their losses confers many benefits on broker-dealers and investors in the aggregate.[55] Furthermore, cost-based arguments are less compelling to the extent that the non-payment problem recently has been reduced somewhat in size.

Fifth, enough time has passed to gauge the effectiveness of NASD's reforms initiated since the issuance of the GAO reports. For instance, more than four years have passed since approval of precluding broker-dealers from enforcing pre-dispute arbitration clauses, and more than three years have passed since streamlining of default proceedings.[56] Every increment of time that passes without further solutions consigns some number of individual investors to frustrated hopes of financial recompense. Each month, even with the reduced rate of non-payment, about fourteen investors or investor households are, on average, unable to recover losses averaging much more than $100,000.

Sixth, further "easy" improvements, those that do not involve actual compensation, may well be beyond the reach of regulators. NASD may

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53. For example, under the "Early Warning Rule," whenever any securities exchange or NASD learns that a member has failed to file a notice or report required by the rule, it must give notice to the SEC of this failure. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 8-B-1c(iii) (3d ed. 2004) [hereinafter LOSS & SELIGMAN]. This rule is discussed *infra* at notes 139-40 and accompanying text.

54. *See, e.g.*, Net Capital Rule, Exchange Act Release No. 34-31511, 57 Fed. Reg. 56,973, 1992 SEC LEXIS 3163 at *11 (Nov. 24, 1992) (customers of broker-dealers are "in most instances, incapable of assessing the financial condition of custodian firms.").

55. *See generally infra* Section D.3.c.

56. *See generally* Section B.

have exhausted the effective procedural steps it can take.[57] For instance, as a hypothetical example, shortening the 30-day notification of non-payment period may be impractical and achieve little at the margin. Moreover, NASD's rule amendments seem on their face to be comprehensive and well thought out. Thus, to reduce the 15% non-payment rate to near-zero at this point requires *compensatory*, as opposed to "procedural," solutions.

Seventh, fixing the problem of unpaid awards is unlikely to create an unwanted "moral hazard" effect, in which, for instance, investors fail to exercise appropriate scrutiny of the broker-dealers they select or make ill-advised, risky investments.[58] As a general matter, individual investors may fail to apply much scrutiny in the first place, especially with respect to broker selection (and thus any moral hazard would produce no greater absence of scrutiny on their part). Moreover, investors may have been lulled into a false sense of security with respect to the solvency of particular broker-dealers for reasons unrelated to a guarantee of arbitral payment, such as a broker-dealers' use of the SIPC logo.[59] Furthermore, exercising the appropriate degree of scrutiny, sufficient in advance to reliably detect which broker-dealers will fail, may be impossible for individual investors.[60] Thus, imposing a "market discipline" of potential non-payment, in the hope of conditioning investors not to choose poorly capitalized broker-dealers, is unwarranted and likely to prove ineffective. Finally, it seems unlikely that investors would opt for riskier investments

57. Moreover, NASD has argued that the problem of unpaid awards is not specific to the SRO-administered arbitration system but rather is a collection problem with respect to defunct firms that would exist when investors bring their claims to court. GAO 2000, *supra* note 6, at 66.

58. "Moral hazard" is "the economic principle, fundamental to insurance . . . that a person or firm that is insured against a risk has an incentive, unless blocked by contract or law, to increase that risk if it will increase his income or reduce his costs, since he will get to keep the benefit of the greater risk while the insurer will bear the costs." Phelps Dodge Corp. v. Schumacher Elec. Corp., 2005 U.S. App. LEXIS 14318, at *6 (7th Cir. 2005); *see also, e.g.*, A.M.I. Diamonds Co. v. Hanover Ins. Co., 397 F.3d 528, 530 (7th Cir. 2005) ("Moral hazard refers to the effect of insurance in causing the insured to relax the care he takes to safeguard his property because the loss will be borne in whole or part by the insurance carrier."); Steven Shavell, *On Moral Hazard and Insurance*, 93 Q.J. ECON. 541 (1979).

59. *See* Joo, *supra* note 4, at 1123 (noting that brokers' use of the SIPC insignia may lull investors into a false sense of security); U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: STEPS NEEDED TO BETTER DISCLOSE SIPC POLICIES TO INVESTORS, GAO-01-653, at Ch. 5 (May 2001), *available at* http://www.gao.gov/new.items/d01653.pdf [hereinafter GAO SIPC STEPS] (noting that investors may confuse SIPC protections with other financial guarantee programs).

60. *See* Net Capital Rule, *supra* note 54.

simply, or even in substantial part, because they knew that they would be paid (a) if they reached the point where they entered into arbitration and won an award and (b) the broker proved incapable of paying. (One can imagine more immediate reasons for selecting riskier investments, such as a desire for higher returns.) Normative judgments of whether investors engaged in reckless investing behavior (or even broker selection) are best left to the arbitral process itself, rather than being imposed in a random and draconian fashion once this process has been concluded.[61]

Eighth, because arbitration awards in some instances arise out of an involuntarily chosen dispute-resolution process, greater care should be directed towards defects in this process such as non-payment of awards. Arbitration is in effect forced upon investors through broker-dealer imposed standard form contracts. Investors cannot employ the services of broker-dealers unless they agree to arbitration in the event of dispute.[62] Moreover, the most active arbitration forums are administered by self-regulating organizations such as NASD, which directs many aspects of broker-dealer behavior. In general, the courts and NASD itself have held that NASD does not constitute a "state actor" whose authority is synonymous with that of the government.[63] Yet, while the federal government may not as a legal matter bear responsibility for the

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61. To the extent that a "moral hazard" effect is possible, it seems most likely to occur with respect to whether investors would avail themselves of the regulatory fixes implemented by NASD, such as notification to NASD when a claim has not been satisfied. Knowing that an award would ultimately be paid, investors and/or their advocates might feel less inclined to take any intermediate steps, and their failure to do so might increase costs at the margin.

62. *See Hearing*, *supra* note 2 (testimony of Rosemary Shockman); Constantine N. Katsoris, *The Resolution of Securities Disputes*, 6 FORDHAM J. CORP. & FIN. L. 307, 357 (2001); Kenneth R. Davis, *The Arbitration Claws: Unconscionability in the Securities Industry*, 78 B.U. L. REV. 255, 324 (1998) ("[C]ustomers must submit all claims to arbitration, or they may not open accounts with brokerage houses."); Richard E. Speidel, Symposium, *Securities Arbitration: A Decade After McMahon, Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. Rev. 1335 (1996). *Cf.* Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174 (1983) (discussing form contracts).

63. *E.g.*, Perpetual Sec., Inc. v. Tang, 290 F.3d 132, 138 (2d Cir. 2002) ("It is clear that NASD is not a state actor and its requirement of mandatory arbitration is not state action."); D.L. Cromwell Ivs. v. NASD Regulation Inc., 279 F.3d 155, 162 (2d Cir. 2002); Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999). In *Fairness in Securities Arbitration: A Constitutional Mandate?*, 26 PACE L. REV. 73 (2005), Sarah Rudolph Cole argues that while federal courts have concluded that no state action is present in securities arbitration, SROs are nonetheless state actors when they require employees to participate in arbitration of employment disputes. *Id.*

plight of investors with unpaid awards, from a broad policy perspective, the government has permitted the creation of the regulatory framework that leads to the outcome of non-payment.[64]

In other words, the government has created the regulatory framework for one of its key functions, overseeing the securities markets, that has led to the NASD-supervised arbitration approach in which, as a predictable matter, some investors never recoup savings that were lost because of their trust in NASD-supervised broker-dealers. To this extent, the government bears a responsibility for the plight of investors with unpaid awards to a degree that is absent from run-of-the-mill claims on the general estate of a bankrupt company or broker-dealer. This responsibility attaches even if the arbitration system operates more reliably or produces better outcomes than judicial litigation in securing awards because arbitration is mandatory.[65]

NASD's adoption of a rule prohibiting defunct broker-dealers from enforcing pre-dispute arbitration clauses cures much but not all of the unfairness in imposing on investors a compulsory process with a predictable outcome of non-payment. In approving the rule, regulators stated that defunct firms had a "significantly higher incidence of non-payment of arbitration awards than do active firms."[66] However, "active" or non-defunct firms are, under the rule, still able to enforce pre-dispute arbitration clauses, and thus the overall system in this non-trivial respect retains its involuntary character with respect to individual investors. Moreover, it is unclear, at least from the written discussions underpinning regulators' adoption of the rule, whether the higher

64. The Federal Arbitration Act, 9 U.S.C. § 1 (2005), expresses a policy judgment against disfavoring arbitration clauses. *See, e.g.*, Doctor's Assoc. Inc. v. Casarotto, 517 U.S. 681, 687 (1996) ("By enacting § 2 [of the Federal Arbitration Act], we have several times said, Congress precluded States from singling out arbitration provisions for suspect status, requiring instead that such provisions be placed 'upon the same footing as other contracts.'"(citation omitted)).

65. For a discussion of whether the law continues to play a role in the resolution of brokers' customer disputes despite the enforceability of pre-dispute arbitration clauses, see Barbara Black & Jill Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991 (2002). Black and Gross also comment on the relative merits of arbitration and judicial litigation, and note that investors "may well be better off in a[n] [arbitration] system where less attention is paid to the law and more to the equities of the actual dispute before the arbitration panel." *Id.* at 995.

66. Order Approving Proposed Rule Change by NASD, Inc. Relating to Amendments to Rule 10301 of the Code of Arbitration Procedure to Prohibit Terminated, Suspended, Barred or Otherwise Defunct Firms From Enforcing Predispute Arbitration Agreements in the NASD Arbitration Forum, Exchange Act Release No. 34-44158, 66 Fed. Reg. 19,267 (Apr. 6, 2001).

incidence of non-payment by defunct firms is in some measure attributable to defunct firms that were in fact active at the time an arbitration claim was brought.[67] Said differently, because arbitration takes a while, a firm may be active when a claim is brought but defunct by the time a claim is ratified.

As regulators noted in approving the rule, the purpose of precluding defunct firms from enforcing arbitration clauses is to give to investors the option of availing "themselves of any judicial remedies available under state law, including those that might prevent the dissipation of assets."[68] Investors with claims against active broker-dealers might equally desire to avail themselves of such remedies.[69] Their continued inability to do so is another reason to take special measures to address the problem of unpaid awards.[70]

D. Several Good Approaches Exist for Curtailing Unpaid Awards

Perhaps a final reason for fixing the problem of unpaid awards is that several good approaches exist for doing so. In theory, any number of methods could be devised to compensate investors. For instance,

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67. Moreover, the data on which the rule is based is from GAO 2000, which cited figures from 1998. *See* GAO 2000, *supra* note 6, at 33. Of course, as the 1998 data put the arbitration non-payment problem as being worse than it was in 2001, this reliance would tend to amplify the effect of the omission of active-to-inactive non-payment figures. *See supra* notes 9-11 and accompanying text.

68. Order Approving Proposed Rule Change by the NASD, Inc. Relating to Amendments to Rule 10301 of the Code of Arbitration Procedure to Prohibit Terminated, Suspended, Barred or Otherwise Defunct Firms From Enforcing Predispute Arbitration Agreements in the NASD Arbitration Forum, Exchange Act Release No. 34-44158, 66 Fed. Reg. at 19,267 (Apr. 6, 2001).

69. NASD notes that almost invariably investors with claims against defunct firms have chosen the arbitration process over judicial litigation. *Hearing*, *supra* note 2 (testimony of Linda D. Fienberg). The investors' preference may well reflect the superiority of arbitration over judicial litigation even with respect to securing assets. On the other hand, it may also reflect considerations such as an inability of poorly funded claimants to risk the greater upfront costs of judicial litigation, or even simply ignorance of the existence of better measures for securing assets.

70. Again, it is possible, if the investors had not been forced into arbitration, and had had the ability to opt for judicial litigation of the claims leading to their unpaid awards, that they would have been able to employ a different toolset of remedies. This different toolset might have led to a swifter outcome before a broker-dealer's failure, or perhaps permitted some form of effective provisional remedy, such as attachment of assets, that would have better secured their claim. Even if judicial litigation would not provably have resulted in a better outcome, the foreclosure of a judicial option that *might* have resulted in such an outcome is an arguable basis for justifying special treatment of investors with unpaid awards.

Congress could simply create a fund outright to satisfy unpaid awards. The solutions that are discussed in this Section have already been proposed by lawyers representing investors and rejected by the officials whose views were summarized in the GAO reports.[71] As the discussion will endeavor to show, the rejections were premature.

The potential steps are: (1) establishing a separate fund to cover unpaid awards, to be administered by an SRO, or imposing insurance or bonding requirements; (2) toughening the Net Capital Rule, which is intended to ensure that broker-dealers have sufficient capital to liquidate in an orderly fashion; and (3) broadening the responsibilities of SIPC to include the payment of unpaid awards. These steps are considered in turn.

1. Establishing SRO-Administered Fund or Imposing Insurance or Bonding Requirement

One approach would be to establish a fund managed by an SRO, presumably NASD as it oversees most securities arbitrations.[72] In the proposal discussed in GAO 2000, the SRO fund would cover compensatory as opposed to any punitive damages.[73] The fund would be variously financed with interest derived from the SIPC Fund,[74] charges on investor transactions, fees on broker-dealers, or funds obtained from NASD money penalties.[75] Another approach would be to require broker-dealers to carry insurance or else post a bond for unpaid awards.[76]

Criticisms of the SRO-fund concept include that it would increase broker-dealer and investor costs and lessen investor vigilance and, to the

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71. GAO 2000 contains a relatively detailed discussion of possible solutions that would compensate investors with unpaid arbitration awards. GAO 2000, *supra* note 6, at 39-43. The report summarizes the views of SEC, NASD, SIPC and other officials dismissing these solutions. *Id.* at 40. GAO 2001 comments briefly on the insurance proposal, and GAO 2003 comments further on this proposal and also on a possible bonding requirement. GAO 2001, *supra* note 6, at 7-8; GAO 2003, *supra* note 1, at 11-12.

72. *See supra* note 9.

73. Coverage would be limited to awards that were deemed "uncollectible" because the liable party had left the securities industry. GAO 2000, *supra* note 6, at 41.

74. The Fund finances SIPC's expenditures. 15 U.S.C. § 78ddd(a)(1) (2005). It is discussed further *infra* at notes 242-59 and accompanying text.

75. GAO 2000, *supra* note 6, at 41.

76. *Id.* at 43. A variation on the insurance proposal is, in addition to requiring insurance, to make clearing firms (which carry customer accounts) liable for the acts of introducing brokers. *See* GAO 2001, *supra* note 6, at 7; *see also* Cane & Greenspon, *supra* note 4, at 139-41 (discussing insurance proposal).

extent paid for from interest derived from the SIPC Fund, deplete the fund's principal.[77] The critique of insurance or bonding is similar: namely, that these requirements would increase costs of broker-dealers industry-wide and ultimately to investors.[78] Moreover, it is not clear how much insurance would be needed and whether insurers would be willing to underwrite the coverage.[79] Finally, insurance coverage would fail to deter fraudulent practices or punish unscrupulous brokers.[80]

These criticisms suffer from some of the general defects that weaken arguments against reducing unpaid awards. For instance, while providing for an SRO fund would increase costs to broker-dealers and/or investors in the aggregate (assuming principally that they were to pay for such a fund), the costs of unpaid awards are currently borne by an unfortunate few investors. The rebuttal to cost-based criticisms of the insurance or bonding requirements is likewise one of appropriate burden-shifting: who should pay for investor losses suffered at the hands of an irresponsible broker-dealer that subsequently goes out of business? While an insurance or a bonding requirement might in a general fashion raise costs to broker-dealers or other investors, the costs of irresponsible broker-dealer operations are currently being borne by randomly chosen investors (not to mention other general creditors of these broker-dealers). Also, well-capitalized, responsible brokers that are not at fault for payment failures might nonetheless benefit, even if they were to shoulder some additional burden because of a systemic solution, from the increased investor confidence in the capital markets that would accrue if the arbitration payment process were to be improved.

Establishing an SRO-administered fund or an insurance or bonding-requirement is unlikely to lessen investor vigilance, especially given the inability of most investors to adequately predict a broker-dealer's future solvency. Leaving the current system in place burdens comparatively unsophisticated individual investors with a difficult, if not impossible, fact-intensive inquiry every time they consider reposing their savings with a broker-dealer. This misplaced burden (in which, theoretically, investors are to differentiate between brokers based on their prospective soundness) has the potential to erode investor confidence in the capital markets, and inflicts possibly catastrophic financial loss on investors otherwise adjudged to have legitimate claims. Related, the argument

77. GAO 2000, *supra* note 6, at 41.

78. *Id.* at 43.

79. *Id.*

80. GAO 2001, *supra* note 6, at 8.

against these potential solutions based on their inability to deter fraudulent practices or punish unscrupulous brokers misconceives those who properly should be charged with these tasks: regulators or the industry as a whole, rather than a few, randomly-chosen investors.

Both the SRO fund and the insurance or bonding requirement offer some advantages over the other proposed solutions. For instance, an SRO fund would avoid the costs associated with relying on SIPC to address the problem, such as the need to amend SIPA and potential interference with SIPC's core mission of liquidating certain failed broker-dealers and satisfying specified customer claims.[81] Of course, an SRO fund might itself need enabling authority and might likewise interfere with the SRO's core mission of regulation and enforcement.

An NASD-administered fund is appealing because virtually all broker-dealers are required to be members of NASD,[82] and NASD already supervises broker-dealers in so many different facets of their behavior.[83] As NASD oversees the NASD-administered arbitration forum, which is the principal forum for securities arbitration cases,[84] there is a natural fit for NASD to become guarantor of last resort in the event duly-won arbitration awards are never paid. NASD already has mechanisms in place for assessing broker-dealers, and therefore it would have the levying apparatus necessary to generate the monies required for an unpaid award fund.[85] NASD oversees many broker-dealer self-liquidations, giving it practical experience in dealing with the circumstances that cause most unpaid awards.[86] Finally, NASD

81. *See generally infra* Section D.3.

82. *See* 15 U.S.C. § 78o(b)(8) (2005) (requiring every registered broker-dealer to be a member of a registered national securities association unless it effects transaction solely on a national securities exchange of which it is a member); 17 C.F.R. § 240.15b9-1 (2005) (exempting certain exchange members). NASD is the only registered national securities association. Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493, 1495 n.3 (2001).

83. The NASD Conduct Rules exhaustively regulate broker-dealer behavior. Ruder, *supra* note 3, at 1102 n.4. The rules can be accessed through NASD Manual Online, http://nasd.complinet.com/nasd/display/index.html (last visited Dec. 11, 2005).

84. *See supra* note 9.

85. *See, e.g.*, Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg 71,256, 71,268-71,275 (Dec. 8, 2004) (discussing SRO funding sources). The SEC noted that it had approved NASD's recent establishment of a "Trading Activity Fee" because of "NASD's broad responsibilities with respect to its members' activities." *Id.* at 71,269. Several years ago, NASD was financing its arbitration system through "a combination of arbitrator related fees and general assessments on all member firms." Ruder, *supra* note 3, at 1106.

86. SIPA contemplates SRO assistance in or oversight of broker-dealer self-

ultimately might welcome an NASD-administered SRO-fund because such a fund would make NASD as opposed to another organization the guarantor of last resort where NASD-supervised arbitral procedures had proven incapable of securing payment on an investor's vindicated claims.[87]

Similarly, insurance and bonding deserve a closer look. Enough time has passed, about five years, since NASD began to implement its unpaid award reforms to warrant considering additional measures.[88] While improved, the non-payment rate remains significant.[89] The absence of a systematic inquiry into the feasibility of insurance is not an argument against its use but rather suggests the need for further exploration.

A review of "excess" SIPC insurance is instructive because of its similarities with coverage for unpaid awards. Such private insurance satisfies customer claims that exceed the overall SIPC limits of $500,000.[90] Excess SIPC coverage resembles unpaid award insurance in

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liquidations. 15 U.S.C. § 78eee(a)(2) (2005). In 1987 and 1988, "while there were only eight SIPC liquidations . . . there were more than twice as many self-liquidations under the auspices of the NASD Washington headquarters staff." During this period, there were 18 such self-liquidations with NASD overseeing the distribution of more than $250 million in customer property. Net Capital Rule, Exchange Act Release No. 34-27249, 54 Fed. Reg. 40,395, at text following note 20 (Oct. 2, 1989). *See* Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069, at note 312 (2002) and accompanying text [hereinafter Jamroz, *Customer Protection Rule*]. In its 1992 release amending the Net Capital Rule, the SEC said NASD staff had advised it that even the smallest self-liquidation required two to three NASD employees on premises for a minimum of two weeks, while, by contrast, a large liquidation had required approximately 25 NASD employees on premises for almost ten weeks. Net Capital Rule, 57 Fed. Reg. 56,973, at *13 (Dec. 2, 1992).

87. On the other hand, NASD has argued that it does not bear responsibility for unpaid awards as these primarily relate to collecting monies from brokers that have gone out of business. *Supra* note 57. In addition, NASD might resist overseeing an unpaid award fund for reasons that would include the heightened possibility of a moral hazard-type response to the protections it has already instituted with respect to securing investors' awards (as outlined *supra* in Section B). In other words, investors might be more inclined not to avail themselves of such protections knowing that ultimately they need only apply to the NASD-administered fund for payment. Such a fund, then, should only be available where the investor had explored all other potential remedies before applying for reimbursement.

88. NASD began in 2000 to implement initiatives adverted to in its response to GAO 2000. *See supra* notes 32-33 and accompanying text. In GAO 2003, GAO said SEC staff believed that expanding insurance and bonding requirements would not be appropriate and that NASD's remedies "should be given time to work." GAO 2003, *supra* note 1, at 11.

89. *Supra* Section A.

90. GAO SIPC UPDATE, *supra* note 39, at 1.

that both concern customer accounts of broker-dealers that fail. A GAO report noted that three out of the four major insurers offering excess coverage in 2002 stopped underwriting these policies beyond 2003 for reasons including low premium return and high potential risk.[91] On the other hand, certain securities firms surveyed by GAO suggested that they would want to continue to offer excess insurance to increase customer confidence and compete for high net worth clients.[92] Importantly, one of the major insurers, Lloyd's of London, continued to provide such insurance.[93] Furthermore, in December 2003, a consortium of 14 NYSE member firms organized and capitalized CAPCO, a New York state licensed insurance company, to provide excess coverage.[94]

One can envision insurance for unpaid awards having a variety of features that would make it more palatable to insurers than excess SIPC coverage. Such features would include the creation of a claims history (at the time of the GAO report, no one had put the excess coverage to use)[95] given the recurrent nature of unpaid awards; a capped amount to the awards (excess coverage having sought to protect against unlimited loss);[96] and a greater guaranteed market for such insurance as broker-dealers would be required to carry it.[97]

With respect to bonding, NASD already requires that broker-dealers maintain a "blanket fidelity bond."[98] This bond protects against losses

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91. *Id.* at 24.

92. *Id.* at 26-27.

93. *See* U.S. GEN. ACCOUNTING OFFICE, FOLLOW-UP ON GAO RECOMMENDATIONS CONCERNING THE SECURITIES INVESTOR PROTECTION CORPORATION, GAO-04-848R, at 8 (July 9, 2004), *available at* http://www.gao.gov/new.items/d04848r.pdf [hereinafter GAO 2004 FOLLOW-UP].

94. *Id.*

95. GAO SIPC UPDATE, *supra* note 39, at 24.

96. *See id.* According to the GAO report, the one major insurer that intended to continue to provide excess coverage generally limited the amount of coverage per firm. *Id.* at 26. In its 2004 follow-up, GAO noted (without specifying which) that one of the insurers had capped both the amount of coverage per customer as well as its overall exposure, while the other insurer did not set any specific dollar limits. GAO 2004 FOLLOW-UP, *supra* note 93, at 8.

97. A proponent of the insurance approach has claimed that it would be relatively inexpensive to implement. Cane & Greenspon, *supra* note 4, at 140-41.

98. NASD Rule 3020 (2005), *available at* http://nasd.complinet.com/nasd/display/index.html (follow "Conduct Rules" hyperlink). The rule applies to each NASD member required to join SIPC who has employees and who is not a member in good standing of a stock exchange such as the American Stock Exchange or New York Stock Exchange. Rule 3020(c) (2005). The exchanges have similar rules. *E.g.*, NYSE Rule 319 (2005), *available at* http://rules.nyse.com/NYSE/NYSE_Rules/ (follow "Admission of Members" hyperlink).

caused by an officer or employee for actions such as fraudulent trading.[99] However, the bond is limited in its protection to the broker-dealer (as opposed to a customer-claimant)[100] and the coverage amounts are in any case potentially insufficient, especially for smaller brokers, to satisfy unpaid awards.[101] Nonetheless, the existence of the bond requirement, pertaining to broker actions that also could give rise to customer claims leading to unpaid awards, indicates that a similar bond could be required that would directly cover such awards (much as excess SIPC coverage points to the feasibility of insurance for unpaid awards).[102]

2. Enhancing the Net Capital Rule Would Reduce Unpaid Awards

Revising the Net Capital Rule is an attractive option for dealing with unpaid awards because of the rule's close association with broker-dealer failure, the principal cause of unpaid awards. Furthermore, as this

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99. NASD Rule 3020 requires that an NASD member maintain a bond providing against loss and covering at least: "Fidelity," "On Premises," "In Transit," "Misplacement," "Forgery and Alteration," "Securities Loss," and "Fraudulent Trading." NASD Rule 3020(a)(1) (2005). The bond is required to be in a form substantially similar to the standard form of "Brokers Blanket Bond" promulgated by the Surety Association of America. *Id.*

100. In other words, only the broker-dealer can file a claim for such damages. *See* GAO 2000, *supra* note 6, at 43. In a bankruptcy, the bond would have a beneficial effect (from the perspective of a customer claimant with an unpaid award) only in the sense of increasing the size of the general estate (and thus, the ability of general creditors including those with unpaid awards to satisfy their claims), rather than providing direct compensation to the customer-claimant.

101. With respect to fraudulent trading, the rule imposes a minimum coverage figure of not less than $25,000 or 50% of an amount determined with reference to the broker-dealer's net capital requirement, up to $500,000, whichever is greater. NASD Rule 3020(a)(4) (2005); *see also* GAO 2000, *supra* note 6, at 43 (noting inadequacy of bond coverage amount). In 1998, NASD added section (c)(4) which allows for an exemption from the requirement of section (c) that the coverage amount be determined with reference to the broker-dealer's highest applicable net capital amount in the immediately preceding 12-month period. NASD, SEC Approves Amendment To Rule On Fidelity Bond Requirements, Notice to Members 98-67 (Aug. 1998), *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_004444 (follow "View Full Notice" hyperlink).

102. The blanket fidelity bond itself may be unsuitable as a candidate for covering unpaid awards given its historical association with providing an employer with coverage against the acts of its employees. To incorporate a payment procedure in which a customer claimant could benefit directly from the bond might change the nature of the bond so that it was no longer recognizable as a blanket fidelity bond, and might (a) unduly complicate the operation of the bond (which may be intended, for instance, only to operate with respect to an active firm); (b) have other undesired or unanticipated side effects; and/or (c) meet with resistance from insurers who otherwise would routinely supply such bonds.

option would require a rule change rather than a new statute or even a fund, it may prove easier to accomplish than some of the other proposals. Altering the rule has been mentioned this year by a high-level regulator as one of several possible solutions to the problem of unpaid awards.[103] Two approaches that could be employed either separately or in combination are: (a) making the rule tougher by requiring broker-dealers to retain more capital; and (b) adding an escrow provision targeted at unpaid arbitration awards.

A number of difficulties suggest themselves when considering the Net Capital Rule as a means to combat unpaid awards. The rule is based on a "liquidity" principle[104] that may conflict with satisfying claims such as those for unpaid awards that do not pertain to immediately available cash or securities. The rule requires registered broker-dealers to maintain specified minimum levels of capital, and therefore seeks to enable broker-dealers to liquidate in an orderly fashion if they fail.[105] This orderly liquidation is to be accomplished through the satisfaction of a broker-dealer's "current indebtedness, particularly the claims of customers."[106] Revising the rule to cover unpaid awards may well be construed as going beyond the ambit of satisfying current liabilities, and beyond the intended application of the liquidity principle. A revision perceived to be at odds with the Net Capital Rule's traditional underpinnings is likely to meet with resistance given the rule's long-standing nature (it was first formulated in 1942),[107] its complexity,[108] and

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103. *Hearing*, *supra* note 2 (testimony of Linda D. Fienberg) (stating that "NASD is exploring additional measures to decrease the instances of unpaid awards such as increases in net capital requirements," as well as "increased surveillance of marginally capitalized firms with pending claims, and enhanced education for investors on how to recognize the risks that a firm may go out of business."). *Id.* at 9.

104. *See, e.g.*, LOSS & SELIGMAN, *supra* note 53, § 8-B-1(c) ("The Net Capital Rule, in short, is not a solvency rule but a liquidity rule.").

105. Net Capital Rule, Exchange Act Release No. 34-31511, 57 Fed. Reg. 56,973, 56,974 (Nov. 24, 1992) (The rule "requires registered broker-dealers to maintain sufficient liquid assets to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding."); *see also* Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW 863 n.3 (1992) [hereinafter Jamroz, *Net Capital Rule*]; *see generally* Steven L. Molinari & Nelson S. Kibler, *Broker-Dealers' Financial Responsibility Under the Uniform Net Capital Rule—A Case for Liquidity*, 72 GEO. L.J. 1 (1983).

106. Molinari & Kibler, *supra* note 105, at 18.

107. JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS AND REGULATION UNDER SECURITIES AND COMMODITIES LAWS, § 4:2 (Release No. 4, Nov. 2004) [hereinafter MARKHAM & HAZEN]; Joo, *supra* note 4, at 1100 n.153. *See* LOSS & SELIGMAN, *supra* note 53, § 8-B-1(c)(i).

108. NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION, § 18.02 [A][1]

potentially settled expectations as to its current contours.

Other objections include the argument that establishing reserves against unpaid awards would require a substantial increase in the rule's minimum requirements, in particular because the reserves would need to be large enough to cover all general creditor claims.[109] Such a sizeable increase "would force many small broker-dealers out of the industry, and unduly penalize those broker-dealers operating in a responsible manner."[110] In addition, the cost of maintaining additional capital could eventually be passed on to investors, at least in part, and the barrier to entry posed by the increased capital requirement "could hurt investors by limiting their choice of broker-dealers."[111] Furthermore, broker-dealers are supposed to immediately book liabilities when they receive an adverse award, and also must do so when they believe a claim is both likely to succeed and the amount of the pending award is reasonably certain.[112] Thus, broker-dealers are supposed to maintain sufficient capital to cover the amount of an arbitration award.[113] Finally, an objection to the escrow proposal would be that the Net Capital Rule is based on accounting principles and is not equipped to create reserves against possible future adverse arbitration awards.[114]

a. Making the Rule Tougher

The Net Capital Rule imposes minimum requirements that seem surprisingly low.[115] Indeed, these requirements were established well

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(3d ed. 2005) [hereinafter POSER, BROKER-DEALER LAW] ("[T]he Rule is the longest and probably the most complex in the entire SEC rulebook."). *Id.* at 18-4; MARKHAM & HAZEN, *supra* note 107, § 4:1, 4-4 (The Rule is "so dense and so turgid that few persons, other than specialized accountants and a few industry participants, can pierce its complexities.").

109. GAO 2000, *supra* note 6, at 42. The term "general creditor" refers to an unsecured creditor who lacks rights against specific property of the debtor. *See* BLACK'S LAW DICTIONARY (8th ed. 2004). General unsecured creditors are afforded a low priority by the Bankruptcy Code. *See* 11 U.S.C. § 507 (2005); *id.* § 726(a).

110. GAO 2000, *supra* note 6, at 42.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. Other commentators have also noted the Net Capital Rule's potentially inadequate requirements. Joo states that a broker-dealer may have complied with the rule yet nonetheless its capital may prove to be inadequate when the broker-dealer becomes insolvent. Joo, *supra* note 6, at 1102. Maintaining an adequate capital cushion may be difficult given the volatile nature of the securities industry. *See id.* *Cf.* John M. Bellwoar, Note, *Bar Baron at the Gate: An Argument for Expanding the Liability of*

over a decade ago (in 1992), and they permit a broker-dealer, depending on the nature of its business, to retain anywhere from as little as $5000 to $250,000.[116] The low minimums suggest that the rule could be strengthened in a way that would better accomplish its goal of ensuring orderly liquidation while having the effect of leaving more money to pay for claims including unpaid awards.

The rule requires every broker or dealer to have and maintain net capital no less than the greater of the highest minimum applicable under either "ratio requirements" or "minimum requirements."[117] Under the ratio requirements, a broker or dealer must meet either an "aggregate indebtedness standard" or an "alternative standard." Net capital is defined as a broker or dealer's "net worth," which is subject to various potentially complex adjustments.[118]

Under the aggregate indebtedness standard, a firm is required to maintain net capital such that its aggregate indebtedness to all other persons does not exceed 1500% of its net capital.[119] Stated differently, a firm must maintain net capital equal to 6 ⅔% of its aggregate indebtedness. Aggregate indebtedness is defined as "the total money liabilities of a broker or dealer arising in connection with any transaction whatsoever," subject to certain exclusions.[120] Under the alternative standard, a broker or dealer is required to maintain net capital that is not less than the greater of $250,000 or 2% of "aggregate debit items."[121]

Securities Clearing Brokers for the Fraud of Introducing Brokers, 74 N.Y.U. L. Rev. 1014, 1033 (1999) (stating that the Net Capital Rule's $50,000 requirement for introducing brokers pales in comparison with the "millions that introducing brokers can obtain via fraud").

116. In certain instances, the Net Capital Rule may impose requirements higher than $250,000. For instance, a "market maker," defined in part as a dealer who regularly publishes bona fide competitive bid and offer quotations in a recognized interdealer quotation system with respect to a particular security, 17 C.F.R. § 240.15c3-1(c)(8) (2005), may be required to maintain minimum capital of up to $1 million. *Id.* § 240.15c3-1(a)(4).

117. 17 C.F.R. § 240.15c3-1(a) (2005). In addition, a broker or dealer is required to maintain net capital of not less than its own minimum net capital requirement plus the sum of broker's or dealer's subsidiary or affiliate minimum net capital requirements. *Id.*

118. 17 C.F.R. § 240.15c3-1(c)(2) (2005); POSER, BROKER-DEALER LAW, *supra* note 108, § 18.02[A]. Adjustments relating to "the market value of securities and commodities held in the broker-dealer's proprietary accounts" are known as "haircuts." *Id.*

119. 17 C.F.R. § 240.15c3-1(a)(1)(i) (2005).

120. *Id.* § 240.15c3-1(c)(1). Money liabilities include, "among other things, money borrowed, money payable against securities loaned," and customers' free credit balances. *Id.*

121. *Id.* § 240.15c3-1(a)(1)(ii). The aggregate debit items are to be computed in

The alternative standard is most commonly used by large broker-dealers in part because it precludes a broker from employing the minimum requirements where these requirements are *less* than $250,000.[122]

Under the minimum requirements, which serve as a minimum or floor for the Net Capital Rule,[123] a broker or dealer that carries customer, broker, or dealer accounts and receives or holds funds or securities for those persons (a "carrying" or "clearing" firm) is required to maintain net capital of not less than $250,000.[124] A $50,000 minimum applies to a broker or dealer that (a) "introduces" customer transactions and accounts to another broker-dealer that carries such accounts on a "fully-disclosed basis," and that (b) receives but does not hold customer or other broker or dealer securities.[125] However, a minimum of only $5000 applies where the introducing firm does not receive or hold securities for customers and does not carry accounts for customers.[126] Other requirements include that a "dealer" must maintain net capital of not less than $100,000,[127] while a broker or dealer that acts as a broker or dealer

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accordance with a formula for the determination of reserve requirements for brokers and dealers. *Id.* The "debit items in the . . . formula represent monies owed the broker-dealer in relation to customer transactions." LOSS & SELIGMAN, *supra* note 53, § 8-B-1.c(ii).

122. POSER, BROKER-DEALER LAW, *supra* note 108, § 18.02[B][2][b].

123. *Id.*

124. 17 C.F.R. § 240.15c3-1(a)(2)(i) (2005). A broker or dealer that carries customer accounts need only maintain net capital of not less than $100,000 if it meets the following conditions: (i) does not carry margin accounts; (ii) promptly transmits all customer funds; (iii) does not otherwise hold customers' funds or securities; (iv) does not owe money or securities to customers; and (v) effectuates all financial transactions through a specially designated bank account. POSER, BROKER-DEALER LAW, *supra* note 108, § 18.02[B][1]. Generally speaking, a "carrying" or "clearing" broker is one that performs various services for an "introducing" broker, such as the maintenance of books and records and the receipt, custody, and delivery of customer securities and funds, as well as clearing transactions (*e.g.*, paying for securities purchased). Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 BUS. LAW. 841 (1993).

125. 17 C.F.R. § 240.15c3-1(a)(2)(iv) (2005). An introducing broker is one that retains all functions that relate to direct personal customer contacts, such as soliciting customer accounts and making investment recommendations to customers, and accepting their orders for the purchase or sale of securities. Minnerop, *supra* note 124, at 843. A "fully-disclosed" clearing agreement is one in which the name of the clearing firm and of the customer are disclosed to each other. Such an arrangement contrasts with the "omnibus" agreement, in which neither the clearing firm nor the introducing firm's customers are advised of each other's identities. *Id.*

126. 17 C.F.R. § 240.15c3-1(a)(2)(vi) (2005).

127. *Id.* § 240.15c3-1(a)(2)(iii). A dealer is defined as a broker or dealer that endorses or writes non-standardized options or that effects more than 10 transactions in any one calendar year for its own investment account. *See id.*; POSER, BROKER-DEALER LAW, *supra* note 108, § 18.02[B][1].

with respect to the purchase, sale and redemption of "redeemable shares of registered investment companies" must maintain net capital of not less than $25,000.[128]

The SEC provided a rationale for these figures in its 1992 release adopting the current minimum requirements (and raising them from prior, lower levels).[129] With respect to clearing firms, the Commission said requiring additional capital would serve "as a fund from which the expenses associated with liquidation can be paid," and that the "greater sum will act as a more reliable cushion against the use of SIPC money to liquidate a failed broker dealer."[130] The Commission said that "[i]n most instances, a $250,000 minimum net capital requirement should prove to be a sufficient cushion for a reasonably conducted self-liquidation before a broker-dealer's insolvency."[131] Among the expenses the Commission identified as arising during a self-liquidation were the salaries of a firm's employees retained during the liquidation for purposes such as the transfer of customer accounts, and the costs associated with transferring securities and maintaining the premises of the firm.[132] The Commission also noted that 109 out of 458 NASD firms that cleared customer accounts or held customer property would need to raise an additional $120,520 to comply with the $250,000 requirement.[133] Thus, the Commission specifically contemplated that many firms would have to raise money to meet the new requirement (albeit, as the Commission pointed out, firms that represented only one percent of total clearing firm revenues at about the time of the release).[134] The Commission provided a somewhat similar rationale and analysis for the other minimum requirements addressed in its release.[135] In other words, the 1992 release

128. 17 C.F.R. § 240.15c3-1(a)(2)(v) (2005). A broker or dealer that acts as a broker or dealer with respect to the purchase, sale and redemption of "interests or participations in an insurance company separate account directly from or to the issuer on other than subscription way basis" also falls within this category. *Id.*

129. Net Capital Rule, Exchange Act Release No. 34-31511, 57 Fed. Reg. 56,973 (Nov. 24, 1992). Previously, for instance, clearing firms using the aggregate indebtedness standard had been required only to maintain minimum capital of $25,000. *Id.* at 56,975.

130. *Id.*

131. *Id.* at 56,975.

132. *Id.*

133. *Id.* at 56,976.

134. *Id.* The Commission suggested that those firms unable to meet the newly raised clearing minimum could change the nature of their business by introducing their customer accounts to another clearing firm. *Id.* at 56,977.

135. The Commission stated that for introducing firms, the increased minimums (of $50,000 for an introducing firm that receives customer securities, and of $5000 for a firm

makes clear that at least when it imposed the new requirements, the SEC expected that the minimum figures would in fact be the operative net capital levels for a significant fraction of broker firms. These smaller firms to which the minimums would apply are likely to be those firms that, because of their lesser capitalization, have a greater potential to generate unpaid awards.

While the Net Capital Rule may impose surprisingly low minimum requirements, there is also substantial opinion that the rule has worked well to forestall broker-dealer bankruptcy under the expensive auspices of SIPC.[136] For example, in its most recent annual report, SIPC attributes the scarcity of SIPC-overseen liquidations in that year (there were just two in 2004) to the successful operation of the Net Capital Rule, as well as the "Customer Protection Rule."[137] Indeed, there are several rules that are intended to promote the "financial responsibility" of brokers.[138] The "Early Warning Rule"[139] provides, among other things, that a registered broker or dealer must give notice to the SEC on the same day when its net capital falls below the required minimum amount.[140] The Customer

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that neither receives nor holds customer securities) would increase the likelihood that a firm, if it were failing, could quickly find a purchaser for its assets and avoid an NASD-supervised self-liquidation. *Id.* at 56,979. It said that the heightened minimums also would lessen the likelihood that an introducing firm failure would weaken a clearing firm. *Id.* at 56,980. The Commission noted that, based on NASD data, 919 firms accounting for 6.1% of total introducing firm revenues had net capital of less than $50,000. *Id.*

136. *See, e.g.*, Net Capital Rule, Exchange Act Release No. 34-39456, 62 Fed. Reg. 68,011, 68,012 (Dec. 30, 1997) ("The Commission believes the Rule has worked well over the years. The Commission and the self-regulatory organizations . . . have generally been able to identify at early stages broker-dealers that are experiencing financial problems and to supervise self-liquidations of failing securities firms. This early regulatory intervention has helped to avoid customer losses and the need for formal proceedings under [SIPA]."); Jamroz, *Net Capital Rule*, *supra* note 105, at 864 ("By setting the liquidation threshold at a level at which a broker-dealer will have adequate liquid assets to satisfy customer claims, the Net Capital Rule, together with the other financial responsibility rules, promotes orderly self-liquidations of financially distressed broker-dealers and reduces the likelihood that the failed broker-dealer will have to be liquidated pursuant to [SIPA].").

137. *See* SECURITIES INVESTOR PROTECTION CORP., 2004 ANNUAL REPORT 3 (2005), *available at* http://www.sipc.org/pdf/2004Annual_report.pdf [hereinafter SIPC 2004 ANNUAL REPORT]. The Customer Protection Rule is found at 17 C.F.R. § 240.15c3-3 (2005).

138. In addition to the "Customer Protection Rule" and the "Early Warning Rule" (discussed immediately following) the financial responsibility rules include the following: "Free Credit Balances," "Quarterly Box Counts," and "Hypothecation of Customers' Securities." LOSS & SELIGMAN, *supra* note 53, § 8-B-1(c).

139. 17 C.F.R. § 240.17a-11 (2005).

140. *Id.* § 240.17a-11(b)(1). The Early Warning Rule imposes a variety of rapid

Protection Rule, which requires broker-dealers to operate in a fashion that provides strict safeguards for customer's securities and cash,[141] has been deemed especially important.[142] Of course, where there is fraud, none of the financial responsibility rules is likely to prove very effective.[143]

Thus, it may be that despite its low minimums, the Net Capital Rule operates successfully in at least two broad classes of cases. The first case is where the ratio requirements have the effect of imposing substantial

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notification requirements for net capital, recordkeeping, or reporting violations. LOSS & SELIGMAN, *supra* note 53, § 8-B-1.c.iii. For instance, notification to the SEC is required within 24 hours where a broker-dealer subject to the aggregate indebtedness standard makes a computation showing that its aggregate indebtedness is in excess of 1200% of its net capital, or a broker or dealer which has elected the alternative standard makes a computation showing that its net capital is less than 5% of aggregate debit items. 17 C.F.R. § 240.17a-11(b)(2)(c)(1-2) (2005). In addition, when a national securities exchange or national securities association learns that a member broker or dealer has failed to send a notice or transmit a report as required by the rule, it must give notice to the SEC of this. *Id.* § 240.17a-11(f).

141. The rule requires, among things, that a broker or dealer promptly obtain and thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers, 17 C.F.R. § 240.15c3-3(b) (2005), and that a broker or dealer maintain with a bank or banks a "Special Reserve Bank Account" separate from any other bank account of the broker or dealer. *Id.*

142. *See, e.g.*, Jamroz, *Customer Protection Rule*, *supra* note 86, at 1070 ("The Customer Protection Rule plays a primary role in the Commission's financial responsibility program by safeguarding and restricting the use of customer investment assets by the broker-dealer in its business activities.").

143. Fraudulent schemes leading to SIPC-administered broker-dealer liquidations "have included not only the officials of carrying firms who illegally violated the customer protection and net capital rules but also officials at introducing firms who stole customer property that should have been sent to the carrying firms for the customers." U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: THE REGULATORY FRAMEWORK HAS MINIMIZED SIPC'S LOSSES, GAO/GGD-92-109, at 29 (Sept. 1992), *available at* http://www.gao.gov/new.items/147624.pdf [hereinafter GAO 1992]. *Cf.* DELOITTE & TOUCHE, STUDY OF THE FAILURE OF MJK CLEARING, THE SECURITIES LENDING BUSINESS AND THE RELATED RAMIFICATIONS ON THE SECURITIES INVESTOR PROTECTION CORPORATION (May 2002) (considering the operation of financial responsibility rules with respect to the collapse of MJK Clearing, discussed *infra* at notes 230, 253 and accompanying text, and stating, at 22, that "any discussion of whether the financial responsibility rules fell short necessarily presumes that the rules were complied with in the first place"), *available at* http://www.sipc.org/media/statements-hill.cfm; FITCH RISK MANAGEMENT, REVIEW OF SIPC RISK PROFILE AND PRACTICES: THE MJK CLEARING EVENT, THE SECURITIES LENDING EXPOSURE, RISK MANAGEMENT PRACTICES AND CAPITAL REQUIREMENTS § 5 (Jan. 31, 2003), *available at* http://www.sipc.org /media/statements-hill.cfm. While fraud may cause the rules to prove ineffective, the existence of the rules make the commission of fraud more difficult.

net capital requirements.[144] The second case is where the rule operates in conjunction with the other financial responsibility rules, but success is defined as avoidance of liquidation under the auspices of SIPC.[145] However, in operating successfully in this latter regard, the rule may nonetheless fail sufficiently to forestall or ameliorate liquidations that prejudice customer claims including those for unpaid awards. This seems likely given the longevity of the rule in its current form (or more particularly, the longevity of the rule's current minimum impositions),[146] the rough "rule of thumb" aspect that underpins those minimum requirements that have been mandated,[147] and the existence of sizeable numbers of unpaid awards (whether in 1998 or more recently) even years after the rule with its current minimums had been adopted.[148]

After all, the non-payment of arbitration awards can itself be taken as a metric of the success or non-success of the broker self-liquidations that occur, because it provides an indicator of the extent to which general creditor claims against brokers have or have not been satisfied. Given the necessary variability of the expenses associated with self-liquidation (for instance, even in 1992, the SEC in its release neither identified nor established the salary levels of employees intended to oversee a

144. The existence of such a case depends upon a number of assumptions: that the rule in fact imposes substantial requirements, something difficult on its face to ascertain given the rule's complexity; and that where the requirement is substantial, the capital reserve either has an effect tending to forestall bankruptcy or else renders satisfaction of current claims more complete than might otherwise have been expected.

145. *See supra* note 136 (authorities emphasizing how Net Capital Rule promotes self-liquidation and avoids SIPC-administered liquidation).

146. It is worth noting that the SEC in 1992 increased the carrying broker minimum ten-fold from its prior level of $25,000, which had been set in 1972, or 20 years previously. *See* Net Capital Rule, Exchange Act Release No. 34-27249, 54 Fed. Reg. 40,395, n.14 (Oct. 2, 1989) (to be codified at 17 C.F.R. pt. 240). Given that 13 years have passed since the 1992 increase, a proportionate increase in the minimum (with the 13 years the numerator and 20 years the denominator of the fraction) would yield a more than six-fold increase at this time, or a carrying broker minimum of $1.625 million. This is not to suggest that $1.625 million is the appropriate figure for a potential revision, but rather to give a sense that with the passage of a similar amount of time, a new, higher minimum may well be appropriate.

147. The apparent care and sophistication with which certain aspects of the Net Capital Rule have been considered or formulated provides a contrast with the arbitrary quality of the rule's floor requirements. *See, e.g.*, Net Capital Rule, Exchange Act Release No. 34-39456, 62 Fed. Reg. 68,011 (Dec. 30, 1997) (to be codified at 17 C.F.R. pt. 240) (posing questions on extent to which statistical models should be used in setting the capital requirements for a broker-dealer's proprietary positions); Molinari & Kibler, *supra* note 105, at 22 ("[T]he levels of net liquid assets required under the net capital rule appear arbitrary since there is no demonstrable statistical logic to the levels chosen.").

148. *See generally supra* Section A.

particular broker's self-liquidation),[149] there must likewise be a variability with respect to whether such a liquidation depletes only the net capital extant, or also depletes some portion of the general estate as well. In the latter case, the Net Capital Rule can be said to have failed in its application, and by failing, to have prejudiced the claims of general creditors including those with unpaid awards.

The potential meagerness of the minimum net capital requirements indicates that these requirements could be raised without causing undue hardship to broker-dealers (and suggest that the rule as a whole should be revisited with respect to the adequacy of its strictures).[150] Requiring firms to retain more minimum net capital would cause the rule to be more successful with respect to ensuring adequate broker-dealer liquidity. It might also have a number of beneficial side effects. By leaving the broker-dealer with more capital in reserve, a toughened minimum requirement might reduce in some degree the number or amount of unsatisfied customer claims including those for unpaid awards.[151] A toughened requirement would also ripple through to other rules pegged to the Net Capital Rule causing, for instance, a stiffened fidelity bond requirement,[152] and triggering the operation of the Early

149. The Commission, for that matter, also did not identify the costs to be expected in maintaining the premises of the failing firm, or of transferring customer securities, and furthermore stated that "[s]elf-liquidation costs incurred by the self-regulatory authorities are difficult to measure." Net Capital Rule, Exchange Act Release No. 34-31511, 57 Fed. Reg. 56,973, 56,975 (Nov. 24, 1992) (to be codified at 17 C.F.R. pt. 240). With respect to the imposition of the $250,000 requirement for clearing or carrying brokers, the Commission stated that it believed this requirement would function well "in most instances," but, of course, not all. *Id.* at 56,975.

150. A significant portion of the Commission's analysis in its 1992 release pertains to whether the new minimums would unduly burden smaller broker-dealers. In part, the Commission concluded that where such brokers were unable to operate under the new minimums, they could revise their form of business so that they would fall within a category requiring a lower minimum. *See, e.g.*, *id.* at 56,980. The Commission also stated that the cost of the capital required to meet the higher minimums for introducing brokers constituted "a *slight* insurance premium in light of the benefits that would be derived from the increase." (emphasis supplied). *Id.* at 56,980.

151. In theory at least, heightened net capital requirements (whether with respect to the minimum requirements or the rule as a whole) would also increase the number of (cheaper) broker-dealer self-liquidations, and reduce the number of SIPC-administered liquidations. This is important because, while SIPC-administered liquidations are relatively infrequent, they are nonetheless comparatively expensive when they occur. *See infra* notes 217-18 and accompanying text. By further forestalling broker-dealer failure, and by reducing the number of SIPC-administered liquidations, a stricter Net Capital Rule would thus also result in fewer unpaid awards.

152. *See supra* note 101. The blanket fidelity bond amounts are calculated based on the Net Capital Rule, and therefore a strengthened rule would, unless the calculations

Warning Rule at an earlier stage.[153]

Of course, as a practical matter, determining the right amount of extra capital to be required would be difficult given the uncertainties involved in determining an adequate capital cushion. An increase in the minimum capital standard that would reliably cover all unpaid arbitration awards for a given broker-dealer is likely to be impracticable because such an increase would have to provide as well for all other general creditor claims, given that general creditor claims are satisfied on a ratable basis.[154] An increase in the rule's requirements to the point where it would have a substantial impact on unpaid awards would have to be based upon a calculation estimating the number of awards likely to be extant for a particular type of broker-dealer (with the less well-capitalized brokers presumably having the highest number of such potential claims outstanding).

Finally, the argument against a raised minimum capital requirement that is based on broker-dealers booking liabilities when they receive an adverse award or believe an arbitration claim is likely to succeed can be addressed as follows. First, most unpaid awards are likely to arise against a broker-dealer that is either in declining health or else has gone out of business at the time an award is issued.[155] Yet the booking of liabilities is likely to be effective only in the limited class of claims against broker-dealers that are financially healthy when the award is made. Second, broker-dealers may well be disinclined to assess a claim against them as likely to succeed, and therefore the increase in capital for such an eventuality would operate effectively only (a) in what would again be a limited number of cases where a prospective adverse outcome (for the broker-dealer) is too obvious to be denied and (b) again, where the broker-dealer is in sufficient financial health when judgment for the

were revised, result in higher amounts being required. *See, e.g.*, NASD Rule 3020(a)(3) (2005) (setting broker-dealer's required minimum coverage for "Fidelity," etc., at not less than 120% of its required net capital under the Net Capital Rule).

153. *See supra* note 140. Because notice to the SEC of a broker's financial difficulties is triggered by a deficiency with respect to the broker's net capital, such notice would have to be made sooner where the deficiency had arisen sooner because the required net capital had been higher.

154. *See* 11 U.S.C. § 726(b) (2005) (providing for pro rata payment of claims within classes of claim in Chapter 7 liquidations); Begier v. IRS, 496 U.S. 53, 58 (1990) ("creditors of equal priority should receive pro rata shares of the debtor's property."); Alec P. Ostrow, *The Animal Farm of Administrative Insolvency*, 11 AM. BANKR. INST. L. REV. 339, 341 (2003). SIPA incorporates § 726(b) through 15 U.S.C. § 78fff(b) (2005). Unpaid arbitration awards would qualify as general creditor claims. See *infra* note 188.

155. *See supra* note 14 and accompanying text.

claim is rendered.

b. Requiring Escrow for Unpaid Awards

Under this approach, the Net Capital Rule would be revised to require additional broker-dealer capital to be set aside for a period in escrow.[156] This revision would ensure that the additional capital would be available to pay for awards in the event that a broker-dealer goes out of business.[157]

The escrow approach would be "cheaper" to accomplish than a toughening of the net capital requirements that had an appreciable impact on the number and quantity of unpaid awards. The amount of escrow would be targeted to include unpaid awards but no more, and as such, would presumably require reserving far less capital (assuming, of course, that the quantum of unpaid awards is significantly less than the sum of all general creditor claims other than unpaid awards).

However, an escrow-based revision would have to surmount concerns as to why the rule had been changed to elevate a particular class of general creditor claims above others. Why not include escrow for any number of the rest? A broad answer is that a particularly compelling rationale for favoring unpaid awards is the same rationale as underpins the Net Capital Rule: namely, the preservation of confidence in the capital markets.[158] Just as inadequate liquidity has led to disorderly broker-dealer liquidation,[159] so too does a failure to pay investors their

156. A two-year period was suggested in the GAO report describing proposed solutions to unpaid awards. GAO 2000, *supra* note 6, at 41-42.

157. *Id.*

158. *See, e.g.*, Touche Ross & Co. v. Redington, 442 U.S. 560, 570 (1979) (The Net Capital Rule is "the principal regulatory tool by which the Commission and the Exchange monitor the financial health of brokerage firms and protect customers from the risks involved in leaving their cash and securities with broker-dealers." (footnote omitted)); MARKHAM & HAZEN, *supra* note 107, § 4:1 ("The effect of the net capital rule goes beyond the question of broker-dealer solvency as it also is designed to increase investor confidence."). Markham and Hazen quote from Guy D. Marranette, 11 S.E.C. 967, 970-71 (1942) for the proposition that: "[c]ustomers do not open accounts with a broker relying on suit, judgment and execution to collect their claims—they are opened in the belief that a customer can, on reasonable demand, liquidate his cash or securities position." MARKHAM & HAZEN, *supra* note 107, § 4:1. Conversely, an investor who has proceeded through "suit, judgment," yet finds "execution" stymied for reasons beyond his or her reasonable control will no doubt prove less willing to invest in the future, and where such "execution" is stymied for a sizeable group, a deleterious impact on investor confidence in the aggregate may ensue.

159. MARKHAM & HAZEN, *supra* note 107, § 4:1 ("[T]he net capital requirements for broker-dealers were an effective response to justifiable alarm over many spectacular

adjudicated awards undermine general confidence in entrusting broker-dealers with capital. In the latter case, of course, the threat to investor confidence is diffuse rather than dramatic, and corrosive rather than immediate in its impact. But this investor-confidence rationale serves to elevate unpaid awards above run-of-the-mill general creditor claims, and would help to justify the segregation of such awards within the confines of the rule on the principles that already animate the rule.

Arriving at an appropriate escrow size would pose technical challenges and require trade-offs. A per-broker flat rate amount might be both under- and over-inclusive, in the sense of requiring too little or too much of the smaller brokers, and vice versa for the larger brokers. Similarly, a sliding scale based on criteria such as revenues or accounts served might have the effect of saddling the larger brokers who pay their awards anyway with an excessive capital requirement. An escrow amount calculated on risk might better capture unpaid awards yet have a negative effect on the ability of smaller brokers to function. Finally, appropriately-sized escrow requirements that were embedded in the Net Capital Rule might present a lopsided quality, unless the net capital minimum requirements were also raised. In other words, if the minimums were left intact, a given broker might have an escrow requirement of $500,000 with respect to unpaid awards, yet retain minimum net capital of just $5000 or $50,000.

Nonetheless, as a collective matter, these obstacles appear to be surmountable. For instance, the sliding scale amount could be adjusted not only in terms of a broker's size but also its risk of generating unpaid awards; a pure risk metric might be justifiable precisely because of smaller brokers' lesser ability to function, just as riskier drivers pay higher insurance premiums, without necessarily having regard to the proportionate economic hardship that the riskier drivers suffer because of these greater premiums.

c. Historical Justification

Revising the Net Capital Rule to target unpaid awards, whether through a general toughening of the rule or through an escrow requirement, would find further grounding if such a revision were made as part of an expansion of SIPC's responsibilities, which is discussed in Section D.3 below. In particular, if SIPC were chosen as the appropriate entity for reducing unpaid awards, it would be logical to consider

firm failures.").

changing the Net Capital Rule to reinforce SIPC's added mission. This is because the Net Capital Rule and SIPC share a close historical tie, and the rule and SIPC operate in relation to each other.

The enactment of SIPA in 1970 (creating SIPC) also included an amendment to the Securities Exchange Act of 1934[160] that directed the SEC to establish rules with respect to the financial responsibility of brokers.[161] In response, the Commission made changes to its net capital rule (and also adopted the Customer Protection Rule).[162] The changes to the Commission's net capital rule (at the time, the New York Stock Exchange also had a net capital rule)[163] included an increase in the minimum net capital requirement and a limit on the ratio of permissible broker-dealer aggregate indebtedness.[164] Later, in 1975, in a further response to the crisis that had given rise to SIPA (the "back office" or "paperwork" crisis, discussed more fully in Section D.3 below), Congress amended the Exchange Act by directing the Commission to "establish minimum financial responsibility requirements for all brokers and dealers."[165] The Commission in turn adopted the "uniform net capital rule" (or, as used herein, the Net Capital Rule) which (allowing for subsequent amendments) is the rule in its current form.[166] SIPC and the Net Capital Rule operate in tandem in the sense that the rule is designed to reduce the likelihood of a SIPC-administered liquidation, given that broker-dealer self-liquidation is less costly than SIPC liquidation.[167]

Given this historical nexus and interlinked operation, it follows that if one were to alter SIPC to incorporate unpaid awards, one might also revise the Net Capital Rule to further effectuate the purposes of this alteration. While the converse to this proposition is true as well (*i.e.*, that if one decided to change the Net Capital Rule, one should consider revising SIPA, too), an expansion of SIPC's responsibilities is the more likely solution to unpaid awards given the compelling reasons discussed in Section D.3 below. But the cost of this expansion could be ameliorated in some degree by corresponding changes to the Net Capital

160. 15 U.S.C. §§ 78a-78mm (2005).

161. *Id.* § 78o(c)(3); Molinari & Kibler, *supra* note 105, at 10.

162. MARKHAM & HAZEN, *supra* note 107, § 4:2.

163. *See* Nicholas Wolfson & Egon Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603 (1972).

164. MARKHAM & HAZEN, *supra* note 107, § 4:2.

165. *Id.*

166. *See id.*

167. Jamroz, *Net Capital Rule*, *supra* note 105, at 864.

Rule. A willingness to revise the rule would then expand the options for appropriately balancing the costs of addressing the problem of unpaid awards where this solution relied on SIPC in the first instance. It is possible that the manner in which the costs were imposed might be made even more rational than with a "standalone" solution.

3. *Expanding SIPC Coverage Is Feasible and Sensible*

Of the potential solutions to the problem of unpaid arbitration awards, expanding coverage by SIPC to include unpaid arbitration awards may offer the most advantages. SIPC compensates investors for certain specified claims when a broker-dealer fails, just as it would if charged with handling unpaid awards. And SIPC, which has been in existence for 35 years, and has handled several hundred broker-dealer liquidations and hundreds of thousands of customer accounts, has an expertise that would fit closely with reducing unpaid awards.[168]

In addition, SIPC already has an underutilized fund of more than $1 billion that could be immediately applied to pay off unpaid awards (and SIPC itself has been arguably underutilized in recent years).[169] This fund, from whose interest SIPC easily finances its operations, has been maintained for almost a decade at a cost to each of SIPC's broker-dealer members of just $150 a year, the statutory minimum.[170] The flat rate of just $150 has been applied to each of SIPC's members irrespective of whether they are Wall Street giants or Main Street brokers.[171] Thus, increasing SIPC's annual financial burden by the approximately $30 million of unpaid awards (at the recent, provisional 2004 run rate) is unlikely to risk exhausting the SIPC fund.

a. SIPA/SIPC Background

Congress enacted SIPA[172] (the statute) and created SIPC[173] (the organization) following a rash of broker-dealer failures beginning in the late 1960s known as the "back office"[174] or "paperwork"[175] crisis. In

168. *See infra* notes 223, 229-30 and accompanying text.
169. *See infra* notes 234-35 and accompanying text.
170. *See infra* notes 246-47 and accompanying text.
171. *Id.*
172. Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (2005).
173. *Id.* § 78ccc(a)(1).
174. LOSS & SELIGMAN, *supra* note 53, § 8-B-5(a); Joo, *supra* note 4, at 1076.
175. *E.g.*, Bradford Nat'l Clearing Corp. v. SEC, 590 F.2d 1085, 1097 (D.C. Cir.

Securities Investor Protection Corp. v. Barbour,[176] the Supreme Court described SIPA's genesis as follows:

> Following a period of great expansion in the 1960s, the securities industry experienced a business contraction that led to the failure or instability of a significant number of brokerage firms. Customers of failed firms found their cash and securities on deposit either dissipated or tied up in lengthy bankruptcy proceedings. In addition to its disastrous effects on customer assets and investor confidence, this situation also threatened a 'domino effect' involving otherwise solvent brokers that had substantial open transactions with firms that failed. *Congress enacted the SIPA to arrest this process, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers.*[177]

One commentator has argued that much of the crisis stemmed from outright fraud.[178]

SIPA operates as a statutory carve-out from the Bankruptcy Code.[179] The statute addresses a particular class of claims, those for securities and cash held in a customer's account at the time a broker-dealer fails. These claims are called "customer"[180] claims for "net equity."[181] SIPA protects these claims in amounts of up to $500,000.[182] Of this amount, up to $100,000 may be paid for cash deposited for the purpose of trading.[183]

1978); Molinari & Kibler, *supra* note 105, at 12.

176. 421 U.S. 412 (1975).

177. *Id.* at 415 (citation omitted; emphasis supplied). SIPC describes its roots as follows: "(SIPC) had its origins in the difficult years of 1968-1970, when the paperwork crunch, brought on by unexpectedly high trading volume, was followed by a very severe decline in stock prices. Hundreds of broker-dealers were merged, acquired or simply went out of business. Some were unable to meet their obligations to customers and went bankrupt. Public confidence in our securities markets was in jeopardy." SIPC 2004 ANNUAL REPORT, *supra* note 137, at 4.

178. Joo, *supra* note 4, at 1084.

179. *See infra* note 212 and accompanying text.

180. SIPA defines "customer" as "any person . . . who has a claim on account of securities received, acquired, or held by the [failed broker-dealer being liquidated by SIPC] 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 the purposes of effecting transfer." 15 U.S.C. § 78lll(2) (2005).

181. SIPA defines "net equity" as "the dollar amount of the account or accounts of a customer." *Id.* § 78lll(11). This dollar amount is to be determined at the time of the debtor's liquidation, minus any debt of the customer to the failed broker-dealer, plus any payment by the customer towards such debt. *See id.*

182. *Id.* § 78fff-3(a).

183. *Id.* § 78fff-3(a)(1).

SIPC will seek to satisfy such claims in the first instance out of the bankrupt broker-dealer's estate.[184] If this is not possible, it will advance the monies to pay for the claims itself.[185] SIPC will not protect claims such as those arising out of fraud or a decline in the market value of securities,[186] nor will it cover unpaid arbitration awards.[187] Investors with such claims must satisfy them from the general estate along with other general creditors.[188]

By protecting investor claims related to securities and cash held at the time of a broker-dealer's failure, SIPA is intended to "boost investor confidence in each broker-dealer firm and in the broker-dealer industry as a whole."[189] As the *Barbour* court suggested, SIPA is also intended to protect against a "domino effect," in which one firm's failure leads to the failure of other broker-dealers.[190] Such an effect could arise either out of investor panic or incomplete transactions between a failed broker-dealer and other firms.[191] SIPA's emphasis on returning securities to an investor indicates that the statute is intended to keep investment capital in the securities markets.[192] Satisfaction of SIPC-protected claims can be swift. According to SIPC, "most customers can expect to receive their property in one to three months."[193]

184. 15 U.S.C. § 78fff-2(c)(1)(B) (2005) provides that the trustee in a SIPC-supervised liquidation shall allocate "customer property" to "customers of [the failed broker-dealer], who shall share ratably in such customer property on the basis and to the extent of their respective net equities." SIPA defines customer property as "cash and securities . . . at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer." *Id.* § 78lll(4); *see* Stephen P. Harbeck, *Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court Under the Securities Investor Protection Act*, 56 AM. BANKR. L.J. 277, 279 (1982) ("[SIPA] contemplates that customers' claims will be satisfied to the maximum extent possible from the assets of the defunct member firm.").

185. 15 U.S.C. § 78fff-3(a) (2005).

186. Securities Investor Protection Corp., *Answers to the 7 Most Asked Questions*, http://www.sipc.org/who/sipc3question.cfm (last visited Oct. 3, 2005).

187. *See* Joo, *supra* note 4, at 1096 n.135.

188. *Id.* at 1097.

189. *Id.* at 1106. *But see* SEC v. Packer, Wilbur & Co., 498 F.2d 978, 984 (2d Cir. 1974) ("[T]he objective of SIPA was to protect members of the investing public, not brokers.").

190. *See* Secs. Investor Prot. Corp. v. Barbour, 421 U.S. 412, 421 (1975); Joo, *supra* note 4, at 1114-17.

191. Joo, *supra* note 4, at 1110-11.

192. *Id.* at 1112-13.

193. Securities Investor Protection Corp., *Answers to the 7 Most Asked Questions*, http://www.sipc.org/who/sipc3question.cfm (last visited Oct. 3, 2005). *But see* Joo, *supra* note 4, at 1113 (stating that accounts are often frozen for months); *infra* note 214

b. Critiques of Expanding SIPC

Critics have charged that expanded SIPC coverage for unpaid awards would change SIPC's mission of ensuring orderly liquidation of a failed broker-dealer.[194] They have also argued that such an expansion would require amending SIPA, would increase SIPC's caseload, and would require SIPC to grow.[195]

The critics further argue that coverage of unpaid awards would increase the costs of both broker-dealers and investors, and might encourage frivolous claims and reduce investors' incentives to carefully choose their brokers and investments.[196] Using SIPC money would quickly exhaust the SIPC Fund.[197] The necessity of then replenishing SIPC's coffers would burden those few well-capitalized brokers that have largely paid for SIPC and which are not delinquent in paying arbitration claims.[198]

c. Why Expanding SIPC Works

However, despite these criticisms, SIPC remains an attractive vehicle for dealing with the problem of unpaid awards. Opposition to a SIPC solution based solely on generalized claims of excess costs is predicated on an unfair shifting of burdens more appropriately borne by those other than the few unlucky investors saddled with unpaid awards. Likewise, "moral hazard" type critiques are inappropriate in a context such as this where individual scrutiny is unlikely to be inappropriately changed (or even changed), and where heightened scrutiny that would evade the loss for which relief is sought is unlikely to be possible in any case. More specifically, expanded SIPC coverage is an inviting option for the reasons enumerated below.

First, SIPA's purpose is broadly similar to the purpose that would animate an attempt to reduce the number and amount of unpaid awards. In both cases, there is or would be a desire to return to investors the assets they would otherwise lose because of a broker-dealer's failure, so that other investors are willing to continue to commit their own assets to

(noting that individual account transfer process, where necessary, can slow down satisfaction of customer claims).

194. GAO 2000, *supra* note 6, at 40.

195. *Id.*

196. *Id.* at 40-41.

197. *Id.*

198. *Id.*

the capital markets.

Of course, distinctions exist between SIPA and seeking to remedy unpaid awards. SIPA arose out of a financial crisis involving a wave of broker-dealer failures, while the problem of unpaid awards presents no such dramatic crisis and, indeed, the problem has been somewhat reduced in recent years. Also, SIPA is very specific in defining those investor assets it seeks to protect: identifiable cash and securities, up to the specified limits, that were or should have been held in a customer's account at the time the broker-dealer went out of business. By contrast, arbitration awards are neither cash nor securities, but a claim (presumably) for cash arising out of a broker-dealer's acts prior to its failure. Indeed, SIPA excludes other investor claims including claims such as unpaid awards.[199] Moreover, court interpretations of SIPA, as well as SIPC's own materials, explicitly reject the notion that SIPC should cover claims for fraud.[200] Thus, to fit comfortably within the scheme of protection envisioned by SIPA, unpaid awards need to bear more in common with cash or securities than with claims for fraud. They do in that they are "adjudicated" claims against a broker-dealer, most likely with a monetary judgment attached, and thus come closer to cash or securities than they do to unresolved claims of wrongdoing against the broker-dealer.

In any case, unpaid awards need not be identical to cash and securities held in a customer's account for unpaid awards to merit inclusion within an amended SIPA. Rather, the question is whether an amended SIPA, amended for reasons additional and related to the policy reasons that animated SIPA's creation, would make sense as the statutory vehicle for reducing the number and amount of such awards. Here, elements of the legislative history and subsequent court interpretations of SIPA are helpful.

For instance, the House Report that accompanied the enactment of

199. *Supra* notes 186-87 and accompanying text.

200. *E.g.*, Miller v. DeQuine Revocable Trust, Nos. 01-CV-2812/2813, 2003 U.S. Dist. LEXIS 20459, at *15 (Bankr. S.D.N.Y. 2003); *In re* Oberweis Secs. Inc., 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) ("[C]laims based on fraud or breach of contract are not considered part of a customer's protected net equity claim."); Secs. Investor Prot. Corp. v. Executive Secs. Corp., No. 75 Civ. 733, 1980 U.S. Dist. LEXIS 11326, at *11 (S.D.N.Y. 1980) ("SIPA was not enacted to guarantee customers investments in the event of a broker-dealer fraud."); Secs. Investor Prot. Corp. v. Charisma Sec. Corp., 371 F. Supp. 894, 899 n.7 (S.D.N.Y.), *aff'd* 506 F.2d 1191 (2d Cir. 1974); Securities Investor Protection Corp., *Why We are NOT the FDIC*, http://www.sipc.org/who/notfdic.cfm (last visited Oct. 3, 2005) [hereinafter *Why We are NOT the FDIC*] .

SIPA in 1970 noted that broker-dealer failures stemming from the back office crisis "may lead to loss of customer's funds and securities with an inevitable weakening of confidence in the U.S. securities markets [and] [s]uch lessened confidence has an effect on the entire economy."[201] Of course, while this language referred to a rash of failures, it offers support for the notion that claims such as unpaid awards, which arise out of a loss of customer funds, may also contribute to a weakening of market confidence. As mentioned, the *Barbour* court stated that SIPA was intended to "restore investor confidence in the capital markets."[202] Moreover, the Court also noted that when customers find "their cash and securities on deposit either dissipated or tied up," the effect is "disastrous . . . on customer assets and investor confidence."[203] In other cases, the courts have emphasized SIPA's goal of accomplishing a return of investors' assets.[204] Thus, SIPA's legislative history and court interpretations can be read in a way that supports the notion that including unpaid awards does not so much change SIPC's mission as broaden it to a related area. This broadening would further SIPC's overall goal of maintaining investor confidence in the securities markets.

Amending SIPA to include unpaid awards is further justified because SIPA did more than create SIPC; it also, as noted previously, directed the SEC to enhance the "financial responsibility" of broker-dealers.[205] Adding unpaid awards, which arise within the context of broker-dealer irresponsibility and failure, to SIPC's responsibilities thus fits within SIPA's broader purpose.

Resistance to the unpaid award reform proposal based on the argument that SIPC was never intended to operate like the FDIC is

201. H.R. Rep. No. 91-1613, at 5255 (1970); *see also id.* at 5257 (stating that one of SIPA's "two aims" was to establish a reserve fund whose effect would be to "reinforce the confidence that investors have in the U.S. securities markets"; the other aim was to strengthen "the financial responsibilities of broker-dealers.").

202. Secs. Investor Prot. Corp. v. Barbour, 421 U.S. 412 (1975).

203. *Id.*

204. *See, e.g., In re* Gov't Sec. Corp., 972 F.2d 328, 331 (11th Cir. 1992) ("The purpose of SIPA is to return to customers of brokerage firms their property or money . . . Congress wanted more, not fewer assets available for customers of brokerage firms in financial distress."); SEC v. Packer, Wilbur & Co., 498 F.2d 978, 984 (2d Cir. 1974) ("SIPA thus looks to requiting investor-customers of the defunct house . . . ."); SEC v. Goren, 206 F. Supp. 2d 344, 348 (E.D.N.Y. 2002) (stating that "Congress ultimately created SIPA to protect small investors from failing broker-dealers that oftentimes misappropriate customer funds in their final operational days." (citation omitted)).

205. The SEC responded by developing the uniform Net Capital Rule and the Customer Protection Rule. *See supra* notes 161-67 and accompanying text.

inapposite. SIPC distinguishes itself from the Federal Deposit Insurance Corporation, which insures deposits in banks and thrift institutions for up to $100,000.[206] SIPC states that "insurance" for investment fraud does not exist in the United States, and that SIPC, "could not keep its doors open for long if its purpose was to compensate all victims in the event of loss due to investment fraud."[207] Again, however, unpaid awards are not the same thing as claims for fraud for which no judgment has been rendered; in the former case, investors, having reposed their trust in a regulator-sanctioned arbitration system, have pursued remedies for their losses to the point where their claims have been adjudicated and vindicated.

Moreover, adding unpaid awards to SIPC's responsibilities does not amount to refashioning SIPC into the FDIC. SIPC operates on a much smaller scale than the FDIC, and this scale would not be appreciably altered by SIPC's assumption of responsibility for unpaid awards.[208] Also, remedying unpaid awards pertains to customers, just like SIPC's protections (although, as discussed below, SIPC also ultimately bolsters the broker-dealer industry as a whole). By contrast, the FDIC, while insuring bank deposits, also seeks explicitly to return failing banks to health (while SIPC simply liquidates broker-dealers).[209]

Second, SIPC's enabling statute, SIPA, creates a preferential carve-out from the Bankruptcy Code for a particular class of investor claim arising out of the failure of a broker-dealer. The purpose of this carve-out is to maintain investor confidence. Moreover, SIPC itself serves as a vehicle for securing these claims. Thus, SIPA and SIPC are logical starting points for providing preferential treatment to a similar class of claims such as those for unpaid awards, which likewise stem from a broker's failure and whose existence otherwise might put investor confidence at risk.

Through SIPA, Congress has created a framework of liquidation

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206. *Why We are NOT the FDIC*, *supra* note 200 ("SIPC is not the securities world equivalent of FDIC-the Federal Deposit Insurance Corporation."); 12 U.S.C. § 1821 (a)(1)(A)-(B) (2005).

207. *See Why We are NOT the FDIC*, *supra* note 200.

208. SIPC has a staff of about 30. *Infra* note 227 and accompanying text. By contrast, the FDIC has a staff of about 5,200, insures more than $3 trillion of deposits in U.S. Banks and thrifts, and directly examines and supervises about 5,300 banks and savings banks. Federal Deposit Insurance Corp., *Who is the FDIC*, http://www.fdic.gov/about/learn/symbol/index.html (last visited Sept. 17, 2005).

209. *See* 12 U.S.C. § 1823(c)(1) (2005) (empowering FDIC to assist troubled insured banks); *see also* Joo, *supra* note 4, at 1105-06.

distinct in certain particulars from that of the Bankruptcy Code.[210] This framework elevates the claims of investors for their immediately available cash and securities over other claims on the estate of the defunct broker-dealer. In *Mishkin v. Peat, Marwick, Mitchell & Co.*,[211] Judge Milton Pollack wrote, "[t]he basic scheme of SIPA is to create a *preferred class of creditors*."[212] SIPA accomplishes this goal by giving SIPC the ability to satisfy customers' claims to the securities or cash that were supposed to have been immediately available, up to the specified limits.[213] SIPA enables SIPC in some cases to satisfy these claims quickly.[214] As mentioned, the potentially swift, compensatory power is intended to serve the goal of maintaining investor confidence, preventing a "domino" effect of failed broker-dealers, and also protecting investors

210. The distinctiveness is reinforced in that the Bankruptcy Code retains sections governing the liquidation of stockbrokers. *See* 11 U.S.C. §§ 741-52 (2005); Joo, *supra* note 4, at 1104. A SIPC-administered liquidation proceeds as follows: When SIPC determines that one of its (broker-dealer) members has failed or is in danger of failing, it applies to the appropriate United States district court for a "protective decree." If and when such a decree is either consented to (by the member) or granted (by the court), the proceeding is removed to a bankruptcy court, with a trustee having been specified by SIPC and appointed by the district court. SIPA provides for various procedures that are tailored to the unique nature of the securities industry and designed to shorten the length of time necessary to satisfy claims. *See* Harbeck, *supra* note 184, at 281-85. However, in general, the liquidation proceeding will follow the dictates of the Bankruptcy Code. *See* 15 U.S.C. § 78fff(b) (2005); Harbeck, *supra* note 184, at 285.

211. Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531 (S.D.N.Y. 1990).

212. *Id.* at 555 (emphasis supplied). To a certain extent, this preference preexisted SIPA. Section 60(e) of the Bankruptcy Act (enacted in 1938) allowed "cash customers" to reclaim cash or securities that could be specifically identified as their property. Moreover, cash or securities held for the account of customers but not identifiable, were to constitute a separate fund to be applied *pro rata* in satisfaction of customers' claims in priority to the claims of general creditors. Harbeck, *supra* note 184, at 278. SIPA enhanced the preferential treatment of such customers by providing for SIPC monies to augment the fund of customer property in which customers share to the exclusion of general creditors. *Id.* at 279-80. As Judge Pollack noted, SIPA's "roots are in section 60(e) of the old Bankruptcy Act" (citation omitted). *Mishkin*, 744 F. Supp. at 557.

213. *Mishkin*, 744 F. Supp. at 556 ("The ability quickly to pay off net equity claims of customers is the most important feature of SIPA.").

214. SIPC's ability to make quick transfers of a customer's accounts depends on a variety of factors, including whether the trustee acting on behalf of SIPC is able to make "bulk" transfers of customers' accounts from a given broker-dealer, either to the customers themselves or other broker-dealers. GAO 1992, *supra* note 143, at 32. However, where individual-by-individual account assessment becomes necessary, the process is significantly lengthened. *Id.* ("Payment of claims account by account can take months."). Because of the prevalence of fraud as an underlying cause of many SIPC-supervised liquidations, the proportion of bulk transfers is comparatively low. *Id.* at 33-34.

from losses because of the failure of the broker-dealers.[215] Treating investors with unpaid awards as members of a similarly preferred class would fit readily within SIPA's framework, especially as such investors were likewise victimized by the broker-dealer's collapse and especially as subsequent investors would take comfort from the protection afforded the prior investors.

An argument against expanding SIPC's role would be that the preferential treatment it provides is justified only because of the systemic risk SIPA seeks to alleviate. After all, since the back office crisis of the late 1960s gave rise to SIPA, only a crisis of similar proportions would justify the inclusion of an additional class of claims within the statutory framework, and no such crisis is extant.

However, from the perspective of today, it is difficult to determine whether the systemic risk that gave rise to SIPA persists. It may be that under current conditions, 35 years after the enactment of the statute, the risk is much less than it was. Presumably many of the technical deficiencies and even regulatory gaps that gave rise to the back office crisis have been cured, even apart from the functioning of SIPC.[216] If so, there is less reason for focusing on the failure of marginal broker-dealers while ignoring the harm done by an imperfect arbitration payment system. Even if the systemic risk remains considerable, that in itself does not exclude amending the statute in order to *enhance* the protection of other investors who are injured because of broker-dealer failure. The rationales for doing so would include a more generalized desire to alleviate systemic risk by boosting investor confidence and a wish to vindicate the rights of individual investors for reasons of equity.

There does not seem to be much of a principled reason why securities or cash held in account at the time of broker-dealer failure should be given greater protection than claims which have already been adjudicated through the arbitration system. If anything, one could as readily argue that carefully adjudicated claims should be more deserving because of the regulator-sanctioned nature of the attention that they have received. The current statutory scheme reflects a potentially debatable policy choice that it is more important to guard against short-term shocks

215. *See supra* notes 189-92; *see also Mishkin*, 744 F. Supp. at 555 ("In addition to the congressional report, the remarks of the individual senators and representatives show that the intent of the statute was to protect individual investors from losing their investments when broker-dealers failed.").

216. For instance, the back office crisis in part stemmed from technical backwardness in trade processing, which was subsequently corrected by the establishment of depositaries for securities certificates. Joo, *supra* note 4, at 1083.

than ensuring that the system of investor justice functions as investors would expect. Perhaps the calculus leading to this choice would change if the plight of the unlucky investors with unpaid awards were to become more widely known. At a minimum, such unfortunate investors deserve treatment equal to the unfortunate investors whose cash and/or securities went missing at the time of broker-dealer failure.

In relying on SIPA's "precedent" of elevating a certain class of customer claims over general creditor claims as a justification for similarly elevating unpaid awards, a note of caution is in order. This is the potential unfairness that permeates the SIPA scheme: specifically, that the liquidation approach requires the often high administrative expenses of a liquidation to be paid in the first instance from the general estate,[217] potentially exhausting the estate in the process, and therefore in many cases extinguishing deserving general creditor claims.[218] For such unpaid awards as would have fallen under the liquidating authority of SIPC, it would seem to compound this unfairness if one were simply to append the unpaid awards to the preference received by cash and securities on hand.[219] Rather, it would be better to take the SIPA precedent as reason to treat the unpaid awards as special, but not in a fashion that is at the expense of other general creditors.

Third, SIPC is a pre-existing organization that is well-versed in dealing with defunct broker-dealers. Augmenting SIPC's duties with unpaid awards would not require a new law, but rather amendments to an existing one. There would be no need for a new bureaucracy, but rather additional responsibilities for an organization that possesses the requisite expertise. Limited statutory amendments and added responsibilities are likely to be easier to justify and accomplish than a new law and a new

217. *See* 15 U.S.C. § 78fff(e) (2005) (administration and liquidation costs and expenses to be borne by the general estate); *see also id.* § 78eee(b)(5)(E) (providing that "allowances," compensation for costs and expenses incurred during liquidation proceeding, shall be charged against the general estate of the failed broker-dealer, and that SIPC shall advance funds for such allowances only if the general estate is insufficient to pay for the allowances in whole or in part).

218. Joo, *supra* note 4, at III.B.2; *see also* 6 COLLIER ON BANKRUPTCY P. 752.02[1] (15 ed. rev. 2005) at n.1 (noting that SIPC benefits because SIPA "permits the general estate to be exhausted by administrative expenses that would otherwise be borne by SIPC"). Joo notes that from 1970 to 1996, the general estates of SIPA debtors paid for over $171 million in administrative expenses, yet during the same period, distributions from the SIPC Fund for customer claims amounted to only $174 million. Joo, *supra* note 4, at 1117.

219. Given that few of the broker-dealers that go out of business do so under the auspices of SIPC, *see infra* note 222, the number of such awards may likewise be relatively few.

entity.

SIPC is well-positioned to handle unpaid awards. Almost all broker-dealers are already members of SIPC, giving both SIPC and the broker-dealer industry broad familiarity with each other.[220] Indeed, three out of SIPC's seven board members are required under SIPA to be representatives of the securities industry.[221] Although SIPC-administered liquidations are rare in comparison with the number of broker-dealers leaving the industry,[222] SIPC has handled many broker-dealer liquidations during its existence, and continues to handle such liquidations each year.[223] Moreover, those SIPC liquidations that do arise frequently involve allegations of fraud underpinning the broker-dealer's failure,[224] furnishing SIPC with experience in dealing with broker-dealers whose cultures may also make them prone to claims from their customers.[225] In addition to administering liquidations, SIPC has further familiarity with failing broker-dealers because of the reports it receives with respect to these broker-dealers from the SEC and SROs.[226]

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220. *See* 15 U.S.C. § 78ccc(a)(2)(A) (2005) (members of SIPC "shall be all persons registered as brokers or dealers under section 15(b) of the 1934 Act"). Exceptions are limited to persons whose principal business is conducted outside of the United States and persons whose business consists of the distribution of shares of registered open end investment companies or unit investment trusts; the sale of variable annuities, the business of insurance or the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts. *Id.*

221. *Id.* § 78ccc(c)(2)(C)(i). The three such directors are required not to be from the same geographical area. *Id.*

222. The 228 SIPC-administered liquidations that occurred between 1971 and 1991 amounted to about just one percent of the 20,344 SIPC members that went out of business or failed. GAO 1992, *supra* note 143, at 22.

223. Through 2004, SIPC had handled 313 proceedings under SIPA since its inception. Of these, 276 have been completed, 28 involved pending litigation matters, and claims in 9 are being processed. Two proceedings were initiated in 2004. SIPC 2004 ANNUAL REPORT, *supra* note 137. SIPC has received criticism for failing in certain respects to protect investors. In a 2001 report, GAO found among other things that SIPC and the SEC had failed adequately to inform investors of the importance of documenting unauthorized trading complaints. GAO SIPC STEPS, *supra* note 59, at 8. In subsequent reports, GAO found that SIPC and the SEC had largely implemented GAO's recommendations to fix this and other problems. GAO SIPC UPDATE, *supra* note 39, at 2-5; GAO 2004 FOLLOW-UP, *supra* note 93, at 2-3.

224. *See* GAO 1992, *supra* note 143, at 29 ("SIPC has had to liquidate 228 firms. SIPC officials estimate that fraud—which can prove difficult for the regulators to detect—was involved in more than half of the 228 liquidations and accounted for about 81% of SIPC's $236 million in liquidation expenses as of December 31, 1991.").

225. Leading types of controversies involved in arbitration claims in 2004 were breach of fiduciary duty, negligence, misrepresentation, failure to supervise, unsuitability and omission of facts. *See* NASD, Dispute Resolution Statistics, *supra* note 9.

226. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 4. In *Barbour*, the Supreme

While SIPC has a lean staff of about thirty,[227] the agency expands its effective staff size when it handles larger liquidations.[228] Thus, SIPC has experience in managing a greater workload than its everyday size implies. In any case, the added burden from handling unpaid awards is unlikely to be great relative to the volume of claims that SIPC has handled. For instance, through 2004, SIPC had satisfied 623,300 customer claims in completed or substantially completed cases during its (then) 34-year history.[229] In just one recent liquidation, albeit the largest in SIPC history, there were 173,465 customers receiving distributions (this liquidation, for MJK Clearing Inc., was initiated in late 2001).[230] These numbers are much greater than the roughly 150 NASD arbitration cases each year (at the recent, provisional rate) that result in an unpaid award.[231] Moreover, as unpaid awards have already been "adjudicated," the increased administrative workload (as opposed to financial burden) from SIPC assuming the new responsibility is likely to be slight.[232] In addition, because SIPC also oversees the liquidation of the general estate of a failed broker-dealer, it presumably has already had the experience of handling unpaid awards. (Although, ironically, such experience may be less than expected because the general estate is frequently exhausted by a SIPC-administered liquidation before general creditor claims such as unpaid awards are satisfied.)[233]

Finally, it may be that SIPC is currently underutilized. In its early years, in the immediate aftermath of the back office crisis, as many as 40 SIPA proceedings were initiated in a year.[234] Since then, there have only been 10 or more proceedings per year, approximately every five years.

Court noted that SIPC "maintains an early-warning system and monitors the affairs of any firm that it is given reason to believe may be in danger of failure." Secs. Investor Prot. Corp. v. Barbour, 421 U.S. 412, 421 (1975).

227. SECURITIES INVESTOR PROTECTION CORP., 2003 ANNUAL REPORT 4 (2004), *available at* http://www.sipc.org/pdf/2003_Annual_report.pdf.

228. Joo, *supra* note 4, at 1117 ("Larger liquidations require the retention of a professional trustee, attorneys, consultants, and accountants, as well as an administrative staff.").

229. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 7.

230. *Id.* at 23; *see also* SECURITIES INVESTOR PROTECTION CORP., 2001 ANNUAL REPORT 6 (2002), *available at* http://www.sipc.org/pdf/SIPCAnnualReport02.pdf.

231. *See supra* text accompanying note 22.

232. However, payment of claims account by account can be a relatively time-consuming process. *See* GAO 1992, *supra* note 137, at 33.

233. *See* Joo, *supra* note 4, at 1118-20; *see also supra* notes 217-18 and accompanying text.

234. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 6.

In 2004, SIPC had just two proceedings commenced.[235] Such numbers, while a proxy for actual workload, may indicate that SIPC is ready to take on new responsibilities.

The United Kingdom offers an example of a publicly-created body, the Financial Services Compensation Scheme (FSCS), operating in a fashion that is (roughly) similar to how an expanded SIPC might function, but on a much grander scale. The FSCS is the result of a fundamental reordering of Britain's financial regulatory regime.[236] The purpose of this reordering was to centralize regulatory functions, and to take a more pro-active stance toward protecting consumers of financial services products.[237] With respect to investments of the type that would result in unpaid arbitration awards, the FSCS provides compensation to investors with valid claims against a defunct broker-dealer in amounts of up to £48,000 (about $82,000).[238] The FSCS also covers a wider range of financial services products, such as bank deposits and mortgage loans,[239] and a broader class of claims. For instance, permissible claims concerning investments include those for "bad investment advice, poor investment management or misrepresentation."[240] The most important

235. *Id.*

236. The FSCS was established pursuant to the Financial Services and Markets Act 2000 (FSMA), a sweeping piece of legislation designed to modernize financial regulation and centralize supervisory functions in a single regulator, the Financial Services Authority (FSA). Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. 317, 329, 331 (2003). FSMA regulates activities including deposit taking, safekeeping of assets, and managing investments and providing investment advice. *Id.* at 330. The FSCS unified and replaced separate schemes for banks, building societies, insurance companies and securities and investment firms previously operated by separate regulators. *Id.* at 331.

237. FSMA rejected the traditional British approach of protection based solely on accurate disclosure and instead has sought to protect financial consumers from perils such as firm collapse, risk of fraud, misrepresentation and unsuitability. *Id.* at 334.

238. Financial Services Compensation Scheme, Compensation Limits, http://fscs.org.uk/consumer/key_facts/limitations_of_The_Scheme/compensation_limits (last visited Sept. 26, 2005) [hereinafter FSCS Limits]. Interestingly, in February 2004, SIPC and FSCS signed a memorandum of understanding providing for increased cooperation in the event of the failure of a broker-dealer operating in both the United States and the United Kingdom. *See* Press Release, Securities Investor Protection Corp., SIPC and Canadian Counterpart to Coordinate on Brokerage Firm Insolvencies in North America (Apr. 13, 2005), http://www.sipc.org/media/release13April05.cfm (noting that SIPC and FSCS had previously signed a similar accord).

239. In addition to investments, the FSCS provides maximum compensation of £31,700 per person for deposits and £48,000 per person for mortgage advice and arranging, among other compensations. FSCS Limits, *supra* note 238.

240. Financial Services Compensation Scheme, *When FSCS Is Triggered*,

point, however, is that the British approach provides support for seeking to protect investors who, through no fault of their own, suffer losses because a broker-dealer ceases business. This approach also suggests that an entity analogous to an expanded SIPC can operate in a manner that does not create negative economic effects.[241]

Fourth, SIPC possesses a sizeable fund that could be immediately applied to unpaid awards. At the end of 2004, the "SIPC Fund," which finances SIPC's expenditures,[242] stood at about $1.29 billion.[243] SIPC's experience in raising the monies for and managing a fund of this size again suggests that it would have the appropriate expertise for handling unpaid awards.

Critics of using the SIPC fund have argued that it would be quickly exhausted.[244] And they have argued that once the fund was depleted, its replenishment would unfairly depend on monies extracted from well-capitalized brokers who are not delinquent in paying arbitration awards.[245]

However, a closer look suggests that these criticisms are unjustified. The $1.29 billion fund is being maintained at a *de minimis* cost to SIPC's broker-dealer membership. The annual assessment for each broker-dealer, no matter how large, is currently $150, the statutory minimum.[246] SIPC has levied this *de minimis* amount every year since 1996.[247] Indeed, in 2004, SIPC derived only $1 million from its member assessments compared with $63.1 million from investments.[248] The $1 million in aggregate member assessments is a miniscule fraction of the

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http://fscs.org.uk/consumer/key_facts/limitations_of_the_scheme/when_fscs_is_triggered (last visited Dec. 12, 2005).

241. In December 2004, the Office of Fair Trading, Britain's antitrust agency, released a report reviewing the FSMA's impact on the markets to which it applies, including the market defined as "brokerage and fund management services for private customers." The report found that the FSMA had not had a negative impact on the structure of competition in these markets. Oxera, Competition Review of the Financial Services and Markets Act 2000 (Nov., 2004), *available at* http://www.oft.gov.uk/NR/rdonlyres/0DE3DC25-5575-4361-83F086F76F4F3181/0/oft757.pdf (Report prepared for the Office of Fair Trading). The report did not specifically address the functioning of the reimbursement scheme but rather was focused on whether the heightened regulatory costs associated with the act had deterred new entrants. *See id.*

242. 15 U.S.C. § 78ddd(a)(1) (2005).

243. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 3.

244. GAO 2000, *supra* note 6, at 41.

245. *Id.*

246. *See* 15 U.S.C. § 78ddd(c)(1) (2005) (setting statutory minimum assessment).

247. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 9.

248. *Id.* at 8.

securities industry's pre-tax profit (forecast) of $19.5 billion in 2004.[249] Just half of the yearly amount generated by SIPC's investments would satisfy the estimated $30 million or so of unpaid arbitration awards in 2004.[250] Thus, rather than deplete the fund, a new responsibility for unpaid awards is more likely to diminish the fund's growth, if the current minimum assessment level were to be maintained. And, in any event, SIPC's operations are unlikely to be strained by paying for unpaid awards: SIPC, the organization, costs comparatively little to operate, with just $11 million in expenses last year.[251]

In the past, SIPC has been able to increase the size of its fund rather quickly. After a decision by the SIPC board, the fund amount was raised to $1 billion in 1996 from $653 million in 1991, a gain of more than 50% in five years.[252] Similarly, the liquidation of MJK Clearing required SIPC to make net advances of $75.2 million from the liquidation's inception in September, 2001 through December 31, 2004.[253] Yet, during this period, and even as it made advances to customers because of other liquidations, SIPC was able to continue with its *de minimis* assessment rate. Even if SIPC were simply to fund the elimination of unpaid awards each year through direct assessments, the per-member cost would amount to roughly $5000.[254] Moreover, the manner of assessment as it pertains to payment for unpaid awards could be modified if necessary to ensure fairness among broker-dealers, perhaps in a fashion that better reflects a broker-dealer's risk of generating

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249. Securities Industry Association, Research/Statistics (last updated January 13, 2005), http://www.sia.com/research/html/key_industry_trends_html#pretax.

250. *See supra* note 25.

251. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 13 (the figure for expenses is about $20 million if a provision for estimated costs to complete customer protection proceedings in progress is included).

252. See GAO SIPC UPDATE, *supra* note 37, at 8 n.11 (fund balance reached $1 billion in 1996); GAO 1992, *supra* note 143, at 18 (decision to raise fund to $1 billion made in 1991; fund size at $653 million on Dec. 31, 1991); *Order Approving Proposed Bylaw Change Relating to SIPC Fund Assessments on SIPC Members*, Exchange Act Release No. SIPA-157, 56 Fed. Reg. 60,145 (Nov. 27, 1991) (approving change in SIPC assessment formula and target fund balance of $1 billion). Between 1992 and 1995, the assessment rate varied, but never exceeded 0.1% of members' net operating revenues; in 1996 (and thereafter), the assessment rate was set at the statutory minimum of $150 per member. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 9.

253. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 25. The annual report noted that the MJK Clearing net advance exceeded the net advances in the 228 smallest proceedings combined. *Id.* at 7.

254. This figure is roughly the sum that would be required if each of SIPC's 6,153 members, *id.* at 8, were to make an equal payment towards defraying an estimated $30 million of yearly unpaid awards.

unpaid awards. SIPC could take as a starting point the wide range of factors SIPA authorizes it to consider in making general member assessments.[255]

As the foregoing suggests, the risk posed to the SIPC fund by the assumption of an unpaid awards burden is inconsiderable. The current level of $1.29 billion is conservative in comparison with SIPC's historical needs. Through 2004, SIPC had expended just $570.1 million on liquidation proceedings during its 34-year history.[256] Thus, the current fund level, maintained with minimum statutory assessments, is more than twice all the monies SIPC has expended on customer claims since its inception. In addition to the fund, SIPC can, if necessary, draw upon both a $1 billion line of credit with the U.S. Treasury, as well as a $1 billion revolving line of credit with a consortium of banks.[257] In the event of a market "break," multiple billion-dollar plus broker-dealers failures might occur, but in such an extreme event, many other entities are likely to be involved in addition to SIPC.[258] In any case, the marginal added burden of dealing with unpaid awards is unlikely to have diminished SIPC's capacity to respond to unexpected financial burdens.

Increasing the burden on broker-dealers, and even responsible broker-dealers, because of an expanded SIPC mission is likely to be perceived as even more palatable to the extent that SIPC operates as a subsidy to the securities industry. As noted, SIPC has a $1 billion line of

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255. In determining member assessments, SIPC may consider: "the amount or composition of [a broker-dealer's] gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors." 15 U.S.C. § 78ddd(c)(2) (2005). Appropriately weighing these factors, such as both gross revenues and the nature of a broker's activities, might enable SIPC to devise a system with improved fairness.

256. Of this sum, $374.5 million represented customer advances, while $195.5 million represented administration expenses. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 7.

257. 15 U.S.C. § 78ddd(g)-(h) (2005); SIPC 2004 ANNUAL REPORT, *supra* note 137, at 14. A 1992 GAO study discussed, among other things, the adequacy of SIPC's fund with respect to possible future demands such as the failure of a large broker-dealer. GAO 1992, *supra* note 143, at 40-46. The study concluded that SIPC had adopted a responsible approach (setting a fund target sufficient to handle the liquidation of the largest broker-dealer in the industry) but that certainty was impossible and success ultimately depended the regulatory framework including the financial responsibility rules. *Id.* at 5, 43-46. More recently, SIPC said that "the adequacy of SIPC's financial resources is under constant review at all levels of the Corporation." SIPC 2004 ANNUAL REPORT, *supra* note 137, at 3.

258. *See* GAO 1992, *supra* note 143, at 44.

credit from the U.S. Treasury; the SIPC Fund, moreover, is not taxed.[259] The prospective "bailout" SIPC provides for broker-dealers in the event of their failure increases consumer confidence and therefore boosts business volume.[260] It is possible that this bailout "insurance" is provided at a discount.[261]

SIPC's mode of liquidation, in paying for the expenses of a liquidation of a broker-dealer out of the general estate, boosts the broker-dealer industry at the expense of investors and general creditors (because otherwise these expenses would be borne by SIPC and thus the industry).[262] SIPC notes that over the course of its 34-year history through 2004, cash and securities distributed for the accounts of customers totaled approximately $14.2 billion. Of that amount, $375 million came from the SIPC Fund, but *$13.8 billion* came from debtors' estates.[263] In the absence of SIPA (and the preference it accords to certain broker-dealer customers), those billions might have been distributed in greater proportion to general creditors (both customers and other creditors). Thus, if SIPC has the effect of subsidizing broker-dealers generally, it would be fair to ask broker-dealers to pay more for an expanded SIPC that satisfies unpaid arbitration awards.

d. Drafting Concerns in Amending SIPA

A key concern in revising SIPA to incorporate unpaid awards would be to include those awards arising outside of a SIPC-administered liquidation, since most awards are likely to be generated in other circumstances.[264] A worthwhile approach would be to provide a separate section dealing with unpaid awards.[265] Setting the amending language

259. 15 U.S.C. § 78kkk(e) (2005).

260. *Joo, supra* note 4, at 1106; *see also* SEC v. Packer, Wilbur & Co., 498 F.2d 978, 984 n.9 (2d Cir. 1974) ("To the extent that SIPA encourages the investor to stay in the market, it contributes to the well-being of the brokerage community" (citation omitted)).

261. Joo, *supra* note 4, at 1115.

262. *Id.* at 1121.

263. SIPC 2004 ANNUAL REPORT, *supra* note 137, at 6.

264. *See supra* note 222 and accompanying text (SIPC-administered liquidations amount to just one percent of all broker-dealer terminations of NASD membership).

265. *See generally* Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa-78lll (2005). The new section might follow immediately after § 78fff, as § 78fff sets forth the general provisions of a SIPC-administered liquidation proceeding including payment of customers. The placement of the new section would thus emphasize the section's similar operative nature (in the sense of dealing with and paying for claims). The preceding sections are either of general applicability or else, in the case of § 78eee,

apart would emphasize that the language is intended to operate beyond the confines of the SIPC-administered liquidation. It would also lessen the risk of interpretive ambiguities that might arise where language was grafted onto a section that had been focused solely on such a liquidation.

Another important concern would be to determine the appropriate coverage amounts. Likely options include: (a) unlimited coverage; (b) coverage that would include all but the largest unpaid awards (say, a ceiling of $500,000); (c) coverage targeted at a round number that included much but not all of an average unpaid award (say, $100,000); (d) or limited coverage (say, $20,000 to $50,000). Settling upon an appropriate amount would involve weighing various considerations. For instance, if one were concerned about the aggregate burden to be imposed upon SIPC, or desirous of restricting coverage to claim amounts typically brought by less well-heeled investors, one might seek a lower level of protection. Similarly, a wish to avoid "moral hazard" types of behavior might also militate in favor of less protection.[266] On the other hand, if one wanted to cover most unpaid awards, it would make sense to provide for coverage at some level substantially above an average unpaid award amount (of a projected $174,000 in 2004).[267] Coverage of up to $500,000 would have an appealing symmetry with the overall limit provided for elsewhere in SIPA with respect to customer claims for net equity.[268]

Related to the appropriate level of coverage is deciding how to pay for the coverage. Amending language should provide for direct payment of unpaid awards from the SIPC Fund, as opposed to first exhausting the

pertain more specifically to § 78fff. Thus, § 78aaa provides a short title, § 78bbb provides for incorporation of the Act into the Securities and Exchange Act of 1934, § 78ccc provides for the creation, membership, and powers of SIPC, and § 78ddd establishes the SIPC Fund and sets up the assessment scheme. In addition, § 78eee provides for the "protection of customers," meaning the identification of a failing broker-dealer and appointment of a trustee to administer the liquidation provided for in § 78fff. Likewise, the sections that would come after the new section are also of general applicability. Thus, current § 78ggg refers to various SEC oversight functions, § 78hhh provides for the filing of information to make member assessments, § 78iii establishes roles for SROs such as the collection of dues, § 78jjj details various prohibited acts, § 78kkk contains various miscellaneous provisions, and, finally, § 78lll, provides for definitions.

266. *See supra* note 58 and accompanying text (discussing "moral hazard").

267. *Supra* note 22 and accompanying text.

268. Statistical analysis of the distribution of unpaid awards would provide a more precise method of arriving at the proper coverage amount, if something short of unlimited coverage were desired.

broker-dealer's estate.[269] Such an approach would be necessary as well as equitable given that most unpaid awards would arise other than through a SIPC-administered liquidation.[270] The amending language would also have to provide a mechanism for the presentment to the appropriate SIPC official (as distinguished from the trustee appointed pursuant to the SIPC liquidation process) of a claim for unpaid awards.

It probably would not be necessary to enhance SIPC's ability to raise money to pay for unpaid awards. First, SIPC appears already to have enough statutory authority to raise the funds that would be needed to cover unpaid awards. For instance, §78ddd (pertaining to the SIPC Fund) gives to SIPC a broad authority to set assessment levels.[271] Second, as described in Section D.3.c, SIPC has been able to maintain a fund of more than $1 billion based on statutory minimum assessments of $150 per member. Third, the reduced non-payment rate means that the aggregate cost of paying for arbitration claims is not likely to be as large as it once might have been.

New definitions would follow almost inevitably from the inclusion of a new, separate section dealing with unpaid awards, especially as most of these awards are likely to arise outside the bounds of a SIPC-administered liquidation proceeding. Such new definitions would also better ensure that the amending language does not intrude upon SIPC's core function (of liquidating certain failed brokers) and would avoid potential complexities that might arise because the pre-existing terms have already been litigated in and defined by the courts.

For instance, a new term for "client," would avoid using the term "customer" in dealing with unpaid awards (important because "customer" has already been the subject of much interpretation).[272] And, in any case, another new term, for "unpaid arbitration award," would also be necessary.

269. *See supra* notes 184, 217-18 and accompanying text.

270. *See supra* note 222 and accompanying text.

271. 15 U.S.C. § 78ddd(c)(2) (2005) ("SIPC shall, by bylaw, impose upon its members such assessments as, after consultation with self-regulatory organizations, SIPC may deem necessary and appropriate to establish and maintain the fund . . . ."). However, SEC approval is required for SIPC's bylaw changes to become effective. *See id.* § 78ccc(e).

272. *See* LOSS & SELIGMAN, *supra* note 53, § 8-B-5(b) ("The scope of the SIPA, in large part, turns on the definition of 'customer.'"); *Id.* at n.417; Harbeck, *supra* note 184, at 285 ("It therefore comes as no surprise that the 'customer' definition has been the subject of a significant body of case law."). In 1978, the definition of "customer" was modified to codify several elements of case law. *Id.* at 280 n.17.

As the foregoing indicates, while amending the statute is not without its complexities, it nonetheless should prove possible to do.

E. Conclusion

The problem of unpaid securities arbitration awards, and the damage it causes to many individual investors, both deserves to be and can be solved with relative ease.

In recent years, NASD has taken significant steps to address the problem with the apparent exception of making public up-to-date, comprehensive statistics on its extent.[273] These steps, such as requiring brokerage firms to certify compliance with awards, have apparently helped to halve the non-payment rate.

Nonetheless, good reasons exist for seeking a further reduction that would bring the rate to near zero. Even as so far improved, the problem in absolute terms remains sizeable. Possibly more than 150 investors or investor households will have failed to receive their substantial awards in a given year even after having gone through the time and expense of pursuing and vindicating a claim. This significant non-payment rate, especially in light of the regulator-supervised nature of the arbitration process, has the potential to undermine confidence in the capital markets. A system of investor justice in which many investors are completely stymied *after* the system affirms their claims is not a system that inspires trust. Conversely, a system of investor justice refined to guarantee payment of legitimate claims would highlight the outstanding quality of the U.S. capital markets.

Arguing against a fix to the problem on the basis of cost, such as increased broker-dealer expenses, amounts to unfair burden shifting. As a practical matter, such arguments are less compelling now to the extent that the non-payment rate has been reduced (because the overall burden of the fix is proportionately reduced). Moreover, cost-based arguments are equivalent to saying that the burden of an imperfectly functioning arbitration payment system is better to be borne by a randomly chosen selection of unlucky investors rather than parties, broker-dealers or investors in the aggregate, that are much better situated to absorb this burden. The unfairness is made more acute because the securities arbitration system retains an element of compulsion and because the

273. Again, as discussed at *supra* note 40, developing and making publicly available detailed, up-to-date statistics would help to delineate the extent of the problem and also draw attention to it, especially since the number of arbitration claims has risen.

system is supervised by regulators.

Enough time has passed to judge that while the more procedural, "inexpensive" reforms implemented by NASD have proven very helpful, direct compensatory steps are necessary to reduce further or even eliminate the non-payment problem.

Moreover, it is doubtful that investor vigilance would be lessened in any meaningful fashion if a last-resort compensatory scheme for their valid claims were to be established. Most investors are, for obvious reasons, far less able than regulators to ascertain whether or not a particular broker-dealer is likely to fail. It seems unjust to expect that individual investors would have the resources or ability to make a forward-looking judgment as to the future financial viability of a broker-dealer. Indeed, if it were even possible for individual investors to correctly make such a judgment through inquiries like reviewing disciplinary records, then why would not regulators be in a better position to identify and protect against the irresponsible broker-dealers likely to default on arbitration awards? An inquiry that investors might undertake today, but not tomorrow, because of a last-resort compensatory scheme is unlikely to prove especially helpful.

Good options exist for further reducing or even eliminating the problem of unpaid awards. These options include establishing a separate SRO-administered fund, or a bonding or insurance requirement, and deserve further exploration. NASD would be an obvious candidate for administering a last-resort payment scheme given that it has manifold experience in supervising or assisting in the liquidation of broker-dealers, and given that it oversees the most extensive arbitration system. Likewise, the provision of excess SIPC insurance indicates that a market for insurance for unpaid awards could function.

Enhancing the Net Capital Rule is another worthwhile approach. The low minimum requirements suggest that the rule could be toughened in a way that better facilitates orderly liquidation of failed broker-dealers, while at the same time leaving more money over to pay for general creditor claims, including unpaid awards, than is currently the case. The low minimums (as little as just $5000) further suggest that the economic hardship on most broker-dealers is likely to be slight if the minimums were to be raised by less than orders of magnitude. Incorporating an escrow provision with respect to unpaid awards would provide a targeted means for reducing or eliminating such awards. In either case, the historical nexus between the rule and SIPA, and the complementary manner in which the rule and SIPC are intended to operate, provides a

further justification for updating the rule where broader principles such as investor confidence are at stake.

Finally, SIPA and SIPC are attractive vehicles for addressing unpaid arbitration awards for a variety of reasons. SIPA was enacted on the basis of concerns similar to those that would motivate rectifying the problem of unpaid awards. These concerns include a desire to protect investors whose assets are at risk because of a broker-dealer's failure. SIPA establishes a precedent of special treatment for such investors where broader systemic concerns are at issue. In SIPA's case, those concerns relate particularly to maintaining confidence in broker-dealers and the capital markets. A SIPA amended to cover unpaid awards would have broader concerns that also included the related goal of improving the process of investor justice.

At a practical level, SIPC makes sense as an entity for dealing with unpaid awards because it already exists. There would be no need for a new enabling statute or the establishment of a new bureaucratic entity, but rather amendments to an existing statute and additions to the responsibilities of an existing entity. SIPC, moreover, already has the relevant expertise because it oversees the liquidation of certain bankrupt broker-dealers. And, while SIPC has a lean staff, it has expanded its effective size for larger liquidations, giving it experience with having greater responsibilities.

SIPC has a sizeable fund of more than $1 billion. These monies could be immediately applied to satisfy unpaid awards. Moreover, SIPC's assessments on its member firms could be raised, especially as these assessments have been set for many years at a minimal level. Part of the rationale for raising assessment levels would rest on an understanding that SIPC serves as an indirect subsidy to the broker-dealer industry, and that a marginally increased SIPC assessment would constitute a fair compensation for this subsidy. Amending SIPA to give SIPC enhanced powers that would allow it to cover unpaid arbitration awards does not seem insurmountable from a technical drafting point of view. A key consideration would be how to incorporate unpaid awards arising outside of a SIPC-administered liquidation.

Perfecting the securities arbitration payment process to the point where individual investors who pursued regulator-sanctioned procedures did not face the random prospect of losing their savings would showcase the excellence of the U.S. capital markets. Such a "fix" is, moreover, within ready grasp: in particular, through an overdue revision to the Net Capital Rule and an easily-accomplished expansion of SIPC's

responsibilities.