REPORT TO THE BOARD OF DIRECTORS OF THE

SECURITIES INVESTOR PROTECTION CORPORATION

by the

SIPC ASSESSMENTS TASK FORCE

on the

FUND LEVEL AND FUTURE ASSESSMENT STRUCTURE

SEPTEMBER, 1977

SIPC Assessments Task Force

September 30, 1977

The Honorable Hugh F. Owens
Chairman
Securities Investor Protection
Corporation
900 17th Street, N.W.
Washington, D.C. 20006

Dear Mr. Chairman:

On behalf of the SIPC Assessments Task Force I am pleased to submit herewith the report on the Fund Level and Future Assessment Structure.

The Task Force members, after considering the diverse factors and opinions on this matter, unanimously support the recommendations contained in the report.

I take this opportunity to express my appreciation to the members of the Task Force for their contributions to the development of the concepts and ideas expressed in the accompanying report and recommendations. A special note of thanks is due to Messrs. Robert M. Bishop, Thomas L. Kempner, and Frank J. Wilson, who served as Chairmen of three committees which studied specific areas relating to the future of SIPC's assessment program and developed recommendations for consideration by the full Task Force.

We appreciate the opportunity you have given us to be of service to SIPC and the securities industry.

Respectfully submitted,

Lloyd W. McChesney

Lloyd W. McChesney, Chairman
SIPC Assessments Task Force

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INTRODUCTION

On December 30, 1970, the President of the United States signed into law the Securities Investor Protection Act of 1970 ("1970 Act") "to provide greater protection for customers of registered brokers and dealers and members of national securities exchanges." The Act created the Securities Investor Protection Corporation ("SIPC"), a non-profit membership corporation of which (with certain limited exceptions)* all registered brokers and dealers and all members of national securities exchanges became members by operation of law.

The 1975 amendments to the Securities Exchange Act of 1934 provided, in part, that non-bank municipal bond dealers were required to register and thus they became SIPC members.

Statutory Requirements Concerning the SIPC Assessment Structure

The 1970 Act required SIPC to build a fund from assessments on its members based upon their gross revenues from the securities business. That fund is used for the protection of investors who are securities customers of members liquidated under the provisions of the Act. The SIPC Fund at any time consists of the aggregate of cash on hand or on deposit, amounts invested in the United States Government or agency securities, and during the Fund build-up period, confirmed lines of credit.

The Act contemplates two phases of assessments with respect to the SIPC Fund, one to build the Fund and another to maintain it.

The build-up phase is to continue until the SIPC Fund reaches $150,000,000.** During this phase, assessments are set by the Act at not less than 1/2 of 1 percent of the gross revenues of the securities business of each member. Assessments may be made in excess of 1/2 of 1 percent, but not in excess of 1 percent, if SIPC determines, subject to Commission approval, that such rate will not have a materially adverse effect on the financial condition of its members or their customers.

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*Exempt from SIPC membership pursuant to Section 3(a)(2) of the 1970 Act are:

> ...persons whose business as a broker or dealer consists exclusively of (i) the distribution of shares of registered open end investment companies or unit investment trusts, (ii) the sale of variable annuities, (iii) the business of insurance, or (iv) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts.

**Or such other amount as the Commission may determine in the public interest.

Once the $150,000,000 balance has been reached, the Fund maintenance provisions go into effect as follows:

> At any time the Fund is less than $100,000,000,* or there is outstanding borrowing by SIPC, the assessments as set by the Act are identical with those outlined above for the build-up phase.
>
> If the Fund drops below $150,000,000* but is over $100,000,000* (exclusive of lines of credit) and there is no outstanding borrowing by SIPC, that "SIPC shall endeavor to make assessments in such a manner that the aggregate assessments payable by its members...shall not be less than 1/4 of 1 percent per annum of the aggregate gross revenues from the securities business for such members...."

The 1970 Act provides that when the Fund exceeds $150 million, SIPC shall impose such assessments as it deems necessary and appropriate to maintain the Fund. SIPC has, therefore, broad authority to vary assessments among classes of members. Section 4(c)(2) reads in pertinent part,

> "...any such assessment upon the members, or any one or more classes thereof, may, in whole or in part, be based upon or measured by (A) the amount of their gross revenues from the securities business, or (B) all or any of the following factors: the amount or composition of their 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."

<u>Growth of the SIPC Fund</u>

Early in 1976 it became apparent that with a continuing decline in SIPC liquidations and the concommitant reduction in costs, coupled with a continuation of relatively high assessment revenues and mounting interest income, a Fund balance of $150 million could be reached in late 1977 or early 1978.

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*Or such other amount as the Commission may determine in the public interest.

From the inception of SIPC (December 30, 1970) through July of the current year, the Fund increased as follows:

The SIPC Fund
as of December 31 (in 1977 as of July 31)
(000's omitted)

	1971	1972	1973	1974	1975	1976	1977
Cash	$ 6,653	$ 5,520	$ 4,572	$ 3,619	$ 185	$ 693	$ 1,670
U.S. Gov't. Sec.	19,852	44,458	35,213	56,546	81,494	115,461	136,074
Lines of credit	65,000	55,000	45,000	35,000	-	-	-
Totals	$ 91,505	$104,978	$ 84,785	$ 95,165	$ 81,679	$116,154	$137,744

Based on the growth of the Fund during the first seven months of 1977 (averaging $3.1 million per month), the balance is projected to be approximately $150 million by November, 1977.

Solicitation of SIPC Members' Views

In May, 1976, Chairman Owens solicited the views of the membership on SIPC's future assessment policies. About 75 members and self-regulatory organizations replied. The most common suggestions made by respondents was that firms which introduce their accounts or otherwise do not handle customers cash or securities should pay no assessments. The next most numerous suggestions were (1) to vary rates among members, depending on the business they conduct, and (2) to keep the present assessment structure, but reduce rates.

THE SIPC ASSESSMENTS TASK FORCE

Chairman Owens organized the SIPC Assessments Task Force in September, 1976. In order to obtain broad representation for consideration of this subject, a seventeen member Task Force was appointed:

Six are SIPC members.
Five represent self-regulatory organizations.
Two represent trade associations.
Three are from U.S. Government organizations.
One is from the SIPC staff.

Members' names and their affiliations are given at the end of the report.

Responsibilities of the Task Force

The Task Force was charged with the responsibility of making recommendations to the SIPC Board of Directors in two broad, but related areas: first, the SIPC Fund level that should be required for the future, and second, the assessment structure that should be established when the Fund level is in excess of $150 million and, therefore, not subject to the statutory assessment rate requirements.

Task Force Organization

At its first meeting in October, 1976, the Task Force formed three working committes, each to study specific areas and make recommendations to the full Task Force. The three committees and their chairmen were:

> Committee to consider the Fund level and the procedural aspects of the SIPC assessments: Thomas L. Kempner - Chairman
>
> Committee to consider variable rates based on risks: Frank J. Wilson - Chairman
>
> Committee to consider SIPC assessments on a non-actuarial basis: Robert M. Bishop - Chairman

The committees met periodically from October, 1976, to July, 1977. They considered the relevant provisions of the 1970 Act, the statistical data related to SIPC's history, the potential effects of SIPC's proposed amendments to the 1970 Act, the results of earlier liquidations conducted by and/or under the supervision of self-regulatory organizations and their special trust funds, changes in the securities industry, and the comments received from SIPC members and self-regulatory organizations.

FINDINGS AND RECOMMENDATIONS

In arriving at its finding and recommendations, the Task Force focused on the following:

I. Should the level of the SIPC Fund be more than the $150 million set by the 1970 Act? If so, how much more?

II. If the SIPC Fund level is to be higher than $150 million, what should be the assessment structure while it is attaining the higher level?

III. Once the new level is reached, what should be the assessment structure?

IV. Future Courses of Action

I. <u>Should the level of the SIPC Fund be more than the $150 million set by the 1970 Act? If so, how much more?</u>

Recommendation

The Task Force recommends a SIPC Fund level above $150 million, which will be that amount accumulated by the end of the calendar quarter in which the Fund reaches $150 million, plus the amount added in the succeeding two calendar quarters employing a reduced assessment rate of 1/4 of 1% of each member's gross revenues from the securities business, plus the amounts realized thereafter from the excess of revenues - principally interest income - over expenses.

Findings

Five major areas were considered by the Task Force in the development of this recommendation:

History of Advances by the Securities Exchanges and SIPC

The New York Stock Exchange advanced approximately $100 million from 1968 through 1976 to assist customers of fourteen of its members. The largest net amount advanced in a single year was $35 million.

The Midwest, Pacific and Philadelphia Stock Exchanges advanced $1.6 million to aid customers in eight liquidations.

SIPC advanced a net of $53.5 million in 123 liquidations from inception (December 30, 1970) through July, 1977. The largest net amount advanced in a single year was $35 million.

The net advances made from 1968 through July, 1977, by securities exchanges and their special trust funds, plus SIPC's net advances, totaled approximately $155 million.

The consensus was that the recent history of the exchanges and SIPC should be a major factor for projecting a maximum exposure for the SIPC Fund and for forming a recommendation with respect to a Fund level.

Effect of Increasing Limits of Customer Protection from $20,000/$50,000 to SIPC's Proposed $40,000/$100,000

The proposed increased limits of customer protection would have resulted in additional advances of $2 million from SIPC to trustees. In the 123 liquidations started to date, there were 163 customers in 39 liquidations having residual claims of approximately \$2.5 million over the current \$20,000/\$50,000 limits. Only 21 of those customers in 13 liquidations would have had residual claims of \$575,000 over the proposed \$40,000/\$100,000 limits.

The consensus was that the higher limits of protection will increase investor confidence without having a significant impact on the Fund. The Task Force supports the \$40,000/\$100,000 limits of customer protection which were recommended to the Congress by SIPC.

Recent Developments Having Potential Impact on the SIPC Fund

Although a number of recent developments could eventually have a significant, negative impact on the SIPC Fund, the Task Force took particular note of three. One was listed options, the latest growth segment of the industry. While controls have been established, the state of the art is too new to conclude that problems of some magnitude will not arise. A second was the inclusion of non-bank municipal bond dealers in SIPC membership since December, 1975, thereby extending SIPC protection to their customers. Well publicized urban problems indicate that municipal securities today have greater potential for negatively affecting the Fund than might previously have been the case. A third development involves changes in the competitive environment, such as the elimination of fixed commissions and the softening, and possible future elimination, of restrictions on off-board trading by exchange members. These have increased, and will continue to increase, the degree of competition and, thereby, the risk of weaker firms failing.

The Task Force found that these factors, which cannot at this time be accurately evaluated in terms of their potential impact on the Fund, should be monitored and their importance in this respect reviewed again in two years. (See Recommendations under IV. Future Courses of Action, P. 11)

Improved Rules, Surveillance and Operations

The Task Force believes that many of the new rules and regulations covering the operations of the securities business, such as SEC Rules 15c3-3 and revised 15c3-1; the development of depository trust companies, the increased use of sophisticated data processing equipment and systems, and improved surveillance and reporting have contributed to the decline in new liquidations. The numbers of liquidations begun each year were: 1971 - 24; 1972 - 40; 1973 - 30; 1974 - 15; 1975 - 8; 1976 - 4; 1977 - 4 (as of September 30).

The consensus was that there will be no repitition of the nearly industry-wide inability to handle securities volume similar to that which occurred during the 1967-1970 period.

The Task Force recognizes that the securities industry, like others, will always be faced with the possibility that fraud will occur and cause the failure of some firms.

Should the Size of the Fund Be Related to the Measurement of Total Risk?

For use with their programs of insuring deposits, the FDIC and FSLIC have reserve funds similar to the SIPC Fund. The FDIC and FSLIC reserves are measured against the total of insured deposits of their respective members.

If SIPC were to take a similar approach, it would be necessary to ascertain the total value of securities and cash at risk. Due to the unavailability of complete data it is impossible to arrive at an accurate figure, so an approximation was obtained. Starting with the approximate value of securities held by depository trusts - $65 billion; the credit balances in accounts of New York Stock Exchange members during the past 13 years - a high of $3.7 billion; and the number of customer accounts of those firms - 4.5 million on average - the committee arrived at a rough working estimate of $100 billion as the total of securities and cash at risk. The FDIC and the FSLIC have reserves in excess of 1% of their respective insured deposits. Applying a 1% factor to the $100 billion above would suggest a $1 billion Fund level.

The securities industry has a very restricted use of customer property - securities and cash. Customers' fully paid and excess margin securities must be placed in the possession and control of the broker. Customers' credit balances must be segregated or utilized only to finance customers' margin debts and other customer-related activities as permitted by SEC Rule 15c3-3.

The Task Force found that a fund as proportionately large as that in the banking and savings and loan industries is not appropriate for the securities industry, nor is the use of the total value of cash and securities at risk appropriate as the basis for determining the SIPC Fund level.

Conclusions

The Task Force concluded that no analytical basis exists for setting any one SIPC Fund level which would definitely be optimal, due to the unpredictable nature and amounts of possible losses. Risk factors leading to the failure of securities firms have changed even in the few years since SIPC's founding. No longer are operational problems, inadequate minimum capital requirements and, in some instances, lack of sufficient control systems considered to be significant risks. Two relatively uncontrollable factors, fraud and misconduct, appear to be the primary causes of recent broker-dealer failures. In the past three years, the failures of 13 of the 20 SIPC members placed in liquidation under the 1970 Act were due primarily to fraud or misconduct.

The size of the potential liabilities is indeterminate. The Task Force believes that customers' property under the control of SIPC members appears to have little relationship to past loss experience on a company or industry basis. Comparison with federal deposit insurance programs does not appear to be appropriate due to the distinctions between the securities industry and the FDIC and the FSLIC. The most practical basis for judging the adequacy of the fund level appears to be past loss experience with failed firms, although loss experience has recently moderated in line with the changed risks previously described.

The Task Force concluded, therefore, that a modest rise in the Fund level above the statutory requirement of $150 million will suffice.

II. <u>If the SIPC Fund level is to be higher than $150 million, what should be the assessment structure while it is attaining the higher level?</u>

Recommendations

The current assessment rate of 1/2 of 1% should be reduced to 1/4 of 1% of each member's gross revenues from the securities business, beginning immediately after the calendar quarter in which the SIPC Fund reaches $150 million.

The assessment rate of 1/4 of 1% of gross revenues from the securities business should remain in effect for two calendar quarters.

After two calendar quarters at the above assessment rate, assessments should be suspended for the balance of the calendar year for all SIPC members.

Findings

In determining what the assessment structure should be once the Fund reaches $150 million, the Task Force considered two general alternatives: variable rates among classes of members based on risk or a uniform assessment rate.

Whether rates among members could be varied depending on the risk they pose to the SIPC Fund was studied from two approaches: actuarial and non-actuarial.

Rates Determined on an Actuarial Basis

One approach was that of determining rates actuarially. After conferring with a consulting actuary and with a representative of the Federal Savings and Loan Insurance Corporation, which is currently undertaking a study on the risks for the savings and loan industry, the Task Force determined that an actuarial approach to variable rates was not feasible for SIPC members. The major reason was that a statistically significant data base - which is essential to an actuarial approach - is not available due to the relatively short time SIPC has been in operation.

Rates Determined on a Non-Actuarial Basis

The second approach was to determine whether there were identifiable risks among classes of members which could be used to vary rates on a non-actuarial basis. Various factors were considered, including the number and exposure-value of customer accounts; firms doing a public or non-public business; carrying versus introducing firms; firm size in terms of gross revenues from the securities business; years of experience in the business; distribution of a firm's business among various kinds of activities, such as exchange commissions and "riskless" trades; and customer-related versus principal transactions. Whether variable rates should be established for foreign members and for foreign subsidiaries of domestic members was also considered.

The Task Force found that there may be merit in varying rates among classes of members. The matter was considered in depth at the committee level, but a delineation of the factors which might be employed in a variable rate structure was not made by the Task Force as a whole. Given the short time an assessment rate would be in effect under the Task Force's recommendation on the Fund level, as well as the relatively modest amount of money to be raised, the creation of a possibly complex assessment structure would be impractical.

The Task Force also considered the question of whether new SIPC members should pay assessments at 1/2 of 1 % of their gross revenues from the securities business for a period of years comparable to that paid by members who have paid assessments from the inception of SIPC, or be required by means of some other assessment structure to make some comparable contribution to the Fund. After considerable discussion, the Task Force concluded that new members should not be subjected to special assessments. Factors contributing to this decision were: 1) New members would be at a competitive disadvantage if required to pay higher assessments than other SIPC members; 2) the definitional problems and costs of administration for the members and the collection agents outweigh the equities of special assessments for such members; 3) the amount of money to be raised by assessments on new members would not be material to the SIPC Fund; and, 4) SIPC should not give the appearance of erecting an obstacle to the entry of new firms into the industry.

Uniform Assessment Rate

The continuation of a uniform rate has distinct advantages. A uniform rate would be administratively simple for members and collection agents alike, in that it would require no complex changes in assessment forms and instructions. The recommended rate of 1/4 of 1% would meet the statutory requirements without incurring a change in the assessment structure should the SIPC Fund drop below $150 million while the rate is in effect. Finally, as noted above, the relatively modest amount to be raised and the short time involved strongly support a continuation of uniform rates.

Conclusions

The Task Force concluded that assessment rates determined actuarially were not practical, but there may be merit in varying rates among members on a non-actuarial basis. A variable rate structure, however, would be impractical, given the relatively modest increase in the Fund level being recommended.

The Task Force concluded that a uniform rate of 1/4 of 1% of gross revenues from the securities business to be employed for two quarters after the Fund reaches $150 million would raise the Fund level to approximately $160 million. A continuation of a uniform rate will pose no new administrative burdens for members or collection agents and will require no change in the rate should the Fund level drop below $150 million while the recommended rate is in effect.

The Task Force recognized the financial burden the membership has borne in building the SIPC Fund. The Task Force also noted that the majority of SIPC members have fiscal years ending at the end of the calendar year or a calendar quarter. In view of the above, the Task Force concluded that any assessment reductions should begin immediately after the calendar quarter in which the SIPC Fund reaches $150 million.

It should be noted that, if the Fund reaches $150 million during the fourth quarter of 1977, and if after six months of an assessment rate of 1/4 of 1%, assessments are then suspended, the net effect would be a 75% reduction in the 1978 member assessments from those of 1977.

III. Once the new level is reached, what should be the assessment structure?

Recommendation

Beginning on January 1 of the year following the year in which assessments are suspended, each SIPC member should be required to pay a uniform assessment of $25 for each calendar year, or any part thereof, that it is a SIPC member.

Alternate Recommendation

If the amendments to the 1970 Act, which provide for a minimum assessment, have not been enacted by the time the preceding recommendation is to take effect, the Task Force recommends a minimum assessment of

> the lesser of \$25 or 1% of each member's gross revenues from its securities business for each calendar year, or any part thereof, that it is a SIPC member.

Findings

As has been noted, it is anticipated that reducing the assessment rate to 1/4 of 1% for a period of six months after the Fund reaches \$150 million will result in a new level in the range of \$160 million. At that level the interest income from investments in U.S. Government securities will be substantial. At an assumed rate of approximately 6%, the annual income would exceed \$9 million. This amount alone would have covered SIPC's annual costs - advances to trustees and administrative expenses - in every year except 1973. It can be expected, therefore, that the Fund will continue to grow after the six-month period.

To suspend assessments indefinitely after that period may seem attractive on the surface, but it would create serious administrative problems. An annual assessment would provide a means of maintaining current membership rolls, which would be essential if a reversion to higher assessments becomes necessary sometime in the future. The collection system, which involves nine self-regulatory organizations, would fall into disuse and could prove difficult to restore quickly to a high level of efficiency if the need should arise. The Task Force found, therefore, that at least a minimum assessment is advisable.

Amendments to the 1970 Act, as proposed in H.R. 8331, now under consideration by Congress, would give SIPC the authority to levy minimum annual assessments of \$25 to \$150 per member. Under the current statute, the assessment on a single member is limited to a maximum of 1% of its gross revenues from the securities business. Based on the size of SIPC membership at the end of 1976, a minimum assessment of \$25 would produce annual revenues of approximately \$130,000.

Conclusions

In view of the need to maintain the membership rolls and keep the collection system operative, the Task Force concluded that there should be a minimum assessment.

IV. Future Courses of Action

Recommendations

> The Task Force should be reconvened for the purpose of developing variable rates for SIPC members based on risks and other relevant factors if the SIPC Board of Directors or the Securities and Exchange Commission propose a Fund level higher than that recommended by this Task Force.

A new SIPC Assessments Task Force should be appointed in approximately two years to review the SIPC Fund level, the assessments structure, and whether any changes are warranted in the level of customer protections under the 1970 Act and any amendments thereto.

Findings

The recommendation to reconvene the Task Force is prompted by the finding stated earlier that, although there may be merit in an assessment structure which includes variable rates, the period of time and the relatively modest amount of money to be raised as recommended by the Task Force do not make the creation of such a structure practical at this time. That would not necessarily be the case if a higher Fund level were to be proposed, necessitating assessments either higher or for a longer period of time, or both, than the Task Force has recommended. If the amount to be raised becomes of considerable economic consequence to a large portion of the membership, variable rates might well be called for.

The recommendation for a new Assessment Task Force reflects the Task Force members' recognition that the Fund level recommended as adequate today warrants a review after two additional years of experience. Enactment of the amendments to the 1970 Act and some of the new developments described briefly in section I, above, may require a re-evaluation of the adequacy of the Fund.

Some members of the Task Force also expressed the opinion that, in the coming years, given a continuation of the decline in the demand on the SIPC Fund, a further increase in the limits of protection - higher than those pending before the Congress - may be in order.

The Task Force recognizes, of course, that after an assessment reduction or suspension of assessments becomes effective, SIPC will have the authority to suspend such actions at any time for justifiable financial reasons, such as a significant reduction in the SIPC Fund.

SUMMARY OF RECOMMENDATIONS

<u>Fund Level</u>

1. The Task Force recommends a SIPC Fund level above $150 million, which will be that amount accumulated by the end of the calendar quarter in which the Fund reaches $150 million, plus the amount added in the succeeding two calendar quarters employing a reduced assessment rate of 1/4 of 1% of each member's gross revenues from the securities business, plus the amounts realized thereafter from the excess of revenues - principally interest income - over expenses.

Assessment Structure

2. The current assessment rate of 1/2 of 1% should be reduced to 1/4 of 1% of each member's gross revenues from the securities business beginning immediately after the calendar quarter in which the SIPC Fund reaches $150 million.

3. The assessment rate of 1/4 of 1% of gross revenues from the securities business should remain in effect for two calendar quarters.

4. After two calendar quarters at the above assessment rate, assessments should be suspended for the balance of the calendar year for all SIPC members.

5. Beginning on January 1 of the year following the year in which assessments are suspended, each SIPC member should be required to pay a uniform assessment of $25 for each calendar year, or any part thereof, that it is a SIPC member.

5. (Alternative) If the amendments to the 1970 Act, which provide for a minimum assessment, have not been enacted by the time the preceding recommendation is to take effect, the Task Force recommends a minimum assessment of the lesser of $25 or 1% of each member's gross revenues from its securities business for each calendar year, or any part thereof, that it is a SIPC member.

Future Courses of Action

6. The Task Force should be reconvened for the purpose of developing variable rates for SIPC members based on risks and other relevant factors if the SIPC Board of Directors or the Securities and Exchange Commission propose a Fund level higher than that recommended by this Task Force.

7. A new SIPC Assessments Task Force should be appointed in approximately two years to review the SIPC Fund level, the assessments structure, and whether any changes are warranted in the level of customer protection under the 1970 Act and any amendments thereto.

Acknowledgements

The Task Force gratefully acknowledges the expert advice of Mr. Frank Evans of the Federal Savings and Loan Insurance Corporation, and of Mr. J. Ross Hanson, consulting actuary. Their contributions were of material assistance in dealing with the question of the actuarial determination of assessments.

The Task Force urges favorable consideration of these recommendations by the SIPC Board of Directors.

Respectfully submitted,

Lloyd W. McChesney
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Chairman, SIPC Assessments Task Force

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