CIPF Podcast Series – Investor Protection in a Time of Crisis
No. 1 – Lessons Learned from Past Crises

Transcript[1]

Moderator: Martin Daigneault
Speakers: Kenneth Caputo and Rozanne Reszel

Martin Daigneault:

The current situation in Canada and the rest of world is facing due to COVID-19, a global health crisis, has upended the world as we know it. International borders closed and countries went into lockdown. The capital markets were rocked by the uncertainty and the economic downturn caused by this pandemic.

Martin Daigneault:

Hi, everyone, and welcome to the CIPF Podcast Series, Investor Protection in a Time of Crisis. I'm Martin Daigneault, Senior Vice President at Ernst & Young. It's my pleasure to be your host today. Our topic is Lessons Learned from Past Crises. While the global pandemic has been unprecedented in many ways, this is not the first financial crisis that SIPC and CIPF have experienced during their long history. During today's podcast, we'll explore with our guests lessons learned from past crises, and how those can help us navigate through the current COVID-19 developments. My guests today are Ken Caputo, General Counsel at SIPC, the US Securities Investor Protection Corporation, and Rozanne Reszel, President and CEO of CIPF, which is the Canadian Investor Protection Fund.

Martin Daigneault:

SIPC and CIPF are compensation funds in the US and Canada, respectively. They both aim to protect investors in the event of an investment dealer insolvency. It's great to have both of you in this podcast, Ken and Rozanne.

Rozanne Reszel:

Thanks very much.

Ken Caputo:

Good morning, Martin. Thank you.

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[1] This transcript has been edited for clarity and ease of reading. This podcast is for informational purposes only and is not intended to constitute advice of any kind.

Martin Daigneault:

On that note, we should get started immediately. I will put these questions to Rozanne and Ken. For those who are not familiar with SIPC and CIPF, can you both briefly describe the roles and mandates of your respective organizations?

Rozanne Reszel:

Thanks very much, Martin. It's Rozanne. CIPF was created about 50 years ago, actually 51 now, by the securities industry in Canada. It is overseen by the provincial regulators, and its mandate is to return property to clients of member firms if they become insolvent, and those member firms are members of our self-regulatory organization, IIROC, the Investment Industry Regulatory Organization of Canada.

Ken Caputo:

And thank you. SIPC provides protection to customers of SIPC member brokerage firms that fail financially and have to be liquidated. It oversees the liquidation proceeding and SIPC works with a court appointed trustee to return customers' securities and cash as expeditiously as possible, and we are in our 50th year, just behind our friends in Canada.

Rozanne Reszel:

Happy birthday.

Ken Caputo:

Thank you.

Martin Daigneault:

Thank you, both. Looking at SIPC and CIPF experience during the past financial crisis, would you say there's a connection between periods of market turmoil and member insolvencies?

Rozanne Reszel:

There seems to be a link in some cases, or maybe a bit of a lag. I'm reflecting on the insolvencies that CIPF has experienced. 1987 was a somewhat momentous year for CIPF because that was the failure of Osler. It was also the year of Black Monday. Osler was the largest insolvency that CIPF had experienced to that date. In subsequent times, following the tech boom, we did have two insolvencies. One, I think that was directly impacted by the downturn in the value of technology stocks, but since then, we've also had other periods where there's been market disruption, but not necessarily any insolvencies, particularly recently, and I'd attribute that basically to a very strong regulatory system and very frequent and robust reporting that goes on between the member firms and the self-regulator and ourselves.

Ken Caputo:

I would say that you could make the argument that there is a connection. In 1987, after the October market break, we were called upon to liquidate the only New York stock exchange member to fail, which was a firm called H.B. Shaine & Co. in Grand Rapids, Michigan. Then after the tragic events of 9/11 the markets closed, and when they reopened on the first day of trading, they fell around 7%, I think, and then by the end of the week, the Dow was down over 14%, the S&P lost more than 11%. And shortly thereafter, SIPC was called upon to commence its largest case ever up to that point, which was the liquidation of the clearing firm MJK Clearing in Minneapolis. And then, of course, many of us vividly recall the financial crisis of 2008, which saw the failure of Lehman Brothers, which became the largest broker dealer failure of all time, and of course the largest SIPC liquidation. So, I'd say yes, I think there is a correlation.

Rozanne Reszel:

I think I would add, though as well, that what's interesting to me is the challenge of event risks, which is so unpredictable and it can be anything from an external force to, tragically, fraud. And I think those are circumstances where we really don't get much of a heads up. It's just having to be ready to react.

Martin Daigneault:

Thank you very much, Rozanne and Ken. Looking more closely at the crisis we're facing today, how is this crisis different than the ones you faced in the past?

Rozanne Reszel:

I think when we think of crises, we think of markets in a severe downturn, and certainly we've had that in this instance, but a very sharp recovery with high volume of trading. And so, it's interesting that the market is strong and commission revenues are strong and retail revenues are strong. So, it's just a very different atmosphere, shall I say, from previous times, and we're all working remotely.

Ken Caputo:

I think what makes this crisis today so different is two things really. We have, just today, tremendous uncertainty. Pervasive uncertainty. People can't be certain about much of anything, whether they have a job, or pay the rent, or whether school's open or stay open, and I think the list goes on and on. And the main undercurrent today is this pervasive uncertainty about whether we'll even be safe. What about our parents? Our friends? Our loved ones? I can't remember a time when we were so uncertain about so many things, and the twist to that is that today, if you were just to look at the financial markets, they seem to be going along quite well. Markets remain fairly strong and there does not seem to be, at least at this point, any feeling of impending doom or crisis of confidence that we've seen in the past, in past crises.

Martin Daigneault:

Thank you, Ken and Rozanne. Going onto our next topic. Research has shown that in times of crises, responsive steps or actions taken can determine the severity and length of the crisis. Can you describe specific actions that CIPF and SIPC undertook during these past financial crises?

Rozanne Reszel:

I think every time there's a sort of shock to the system, one of the things that the SRO does is immediately gather more data and more frequent data from the members. So, that equips them and ourselves to be better informed on a current basis about the condition of each firm. From CIPF's perspective, we also use our credit based model to stress test the financial results of member firms, even beyond the early warning measures that are in place, and we also look at our fund size and our resources to try and make sure that, within the assumptions that we already have, and even on a stress basis, that we have enough resources should the need arise.

Ken Caputo:

I believe that one of the most important things that SIPC has done in past crises, like Lehman Brothers or the MJK Clearing case, is to facilitate the bulk transfer of accounts. In the Lehman case, the parent company filed its bankruptcy petition on a Monday, September 15, and we work with regulators and others throughout the week to prepare for the failure of the broker dealer on Friday. And then, after the bankruptcy court approved the sale order in the wee hours of Saturday morning, we worked throughout that weekend to begin the process of transferring, in bulk, the accounts of Lehman's customers to Barclays Capital and to another acquiring broker dealer called Neuberger Berman. So, it was largely as a result of those bulk transfers, and it should not go unnoticed, of course, certainly the excellent work performed by the trustee, Jim Giddens, and his great team at Hughes Hubbard, every one of the more than 110,000 Lehman customers with approved claims has received back the entire contents of their securities accounts and that totals more than $105 billion today. So, a bulk transfer provision, in our statute, gives us tremendous capability.

Martin Daigneault:

Well, I certainly agree with that. Some of the transactions I've been involved with, the best and fastest way to do this is through a bulk transfer and I totally agree with you that it facilitates and allows people to access their capital in a very rapid manner. Rozanne, did you want to add something?

Rozanne Reszel:

Yeah, I think communication is probably pretty key and important as well. I think that it's important that investors know that these compensation funds exist, what their role is, and that their assets will be moved to firms that are operating so that they can access them. And we keep learning over and over again, I guess, how frequently and how simply we need to communicate our message. And we try to do that in a number of ways, primarily through our website, but it's particularly relevant in times of an insolvency or an unsettled market.

Martin Daigneault:

Thank you. Moving onto our next topic. Are there any lessons learned by SIPC and CIPF from these past crises that are applicable to the situation we're faced with today?

Rozanne Reszel:

Well, my observation would be that every one is different, and it's all about being as ready as possible, whether you call it a to-do list, a playbook, whatever, having the contacts for appropriate professionals, legal and trustees, having staff ready. If you know you've brought on staff that haven't had the insolvency experience, running simulations become very important. I'd say also, from the board of directors, keeping the board ready and confident that they understand their role when there's an issue, and staying in touch with regulators who oversee us and give us our mandate so that they understand what we're doing and what we may need to come to them for.

Ken Caputo:

Rozanne has it exactly right. The "ready" is the key word that comes to mind for me. I mean, one of the lessons I've learned over the years is that the organization has to be ready to react, to take action as necessary, and sometimes without much warning. Rozanne will remember as well, and when we learned about MF Global failing, we received a call from the Securities and Exchange Commission in the wee hours... It was 5:30 in the morning. And so, we had to work very quickly to assemble our team and file our papers, and by 3:00 in the afternoon, we had done all that, traveled from Washington, DC to New York and obtained a court order commencing the liquidation proceeding. So, given all the uncertainties we talked about and the unknowns today, we stand ready to act, if called upon.

Martin Daigneault:

Excellent. Thank you both. Let's shift gears a bit to talk about member insolvencies. Can you both tell us about a member insolvency that's had a significant impact on shaping your organization? Any specific lessons learned from that, from those items that you'd like to discuss with us?

Rozanne Reszel:

I'd pick up again on the MF Global insolvency. I think, for me, there were a number of things that came from that insolvency. The first was the importance of the MOUs, or the memorandums of understanding, that we have with other compensation funds around the world. As Ken said, these things happen very quickly, you have to be able to pick up the phone if something's happening cross border and already have a relationship with people that you can talk to. You don't want to be introducing yourself or trying to figure out who those contacts are in the midst of a crisis. And then, as well, if you're going cross border, I think what we were all reminded of is the bankruptcy laws and legislation in our own country are different from those in another country. And again, it's important to understand what those might be and how they might impact the estates on both sides.

Rozanne Reszel:

In MF Global, what was particularly interesting on sort of day one of having a trustee in place was understanding the location of records. MF Global was an affiliate of the US company, and not unlike many businesses, used to its advantage, the opportunity to have the US affiliate run the books and records, particularly as the primary trading party for trades in the US. And so, when it came time for the trustee to go in and take control of the records, they weren't located in Canada. So, that led to rule changes at the regulatory level to ensure that there were always accessible copies of records available within the country.

Rozanne Reszel:

And then, the next thing that was relevant were the custodial relationships. So, again, for all sorts of good business reasons, member firms and their sort of corporate entities centralized a lot of things, including who has the legal relationship with the custodian, and it became quite relevant in this instance that Bank of New York Mellon had a relationship directly with Canada, as opposed to it coming through the US affiliate. And so, it's been something that we've kept top of mind as we've assessed what we would call location or custodial risk as the world becomes ever more global and people are investing in many different countries. So, I'd say we took away a lot of good lessons and sort of looking forward from the MF Global experience.

Ken Caputo:

There are two others, I think, that have to be mentioned when you talk about SIPCs program and of course I'm talking about Lehman Brothers and the Bernie Madoff case, both of which were in the same year, 2008. Lehman in September, Bernie Madoff case began in December, and as I said earlier, Lehman is the largest broker dealer failure ever. It involved more than 110,000 customers and hundreds of billions of dollars. I mean, this was a failure brought on by an economic crisis, and given all the customers that have been made whole, I believe what we learned from that foremost is that our program of investor protection works, even when dealing with what many believed to be an existential crisis.

Ken Caputo:

The Madoff case, it's entirely different. This is the biggest fraud, the biggest Ponzi scheme ever, and as you see in that case, just in a different way, how the program works. I mean, in Madoff, the trustee and his counsel started with very few assets, a ledger that involved years and years of fraudulent transactions. None of Madoff's activity was legitimate. And from there, the trustee and his team have worked to bring back money into the estate to pay the customers, who were Madoff's victims, and he's been really remarkably successful. I mean, the total value of claims in the Madoff case is somewhere around $19.4 billion. I mean, Martin, just think about that for a second. $19 billion is still a lot of money and the trustee has recovered, up to this point, more than $14 billion. They've recovered approximately 75%, and that is, frankly, truly remarkable, and they're still working today to bring in more. So, I would say both of these cases, which remain open and progressing, have been exceptional challenges for us, and yet, I have to say, the

SIPC team, really an extraordinary group of some very talented people, has responded so well. They've been just terrific.

Martin Daigneault:

Well, I totally agree with you, Ken. I think, in insolvencies, the issue is how fast you can go. In fraud, the issue is are you able to recover anything and how fast can you do it? And in most fraud cases, there's very few payments that are made, and there are a few exceptions to that and obviously the Madoff case really highlights how skills and expertise come into play into moving quickly. We'll move on to our next question. Although every insolvency is unique, have you seen any common themes among the different insolvencies you've faced over the years? There are some factors that are identical or similar in every case that your respective teams can use to deal with those matters.

Rozanne Reszel:

I think things have changed over the years. I mentioned event risk is one of those unexpected ones. I think that governance, the issue of whether an organization is vulnerable to owner/manager override would be one that would come to mind for some of the smaller firms. And then I think, as well, firms that set off on a different course, either because of a change of management or change of business line, possibly not necessarily with the strength or the underpinning that they require, but again, I would sort of reflect back on today's reality, which is a very strong and robust regulatory system such that, in theory, given that we look at these numbers with such frequency, no one should ever become insolvent. There are so many checks and balances and opportunities to close a firm down without an insolvency, or allow them to merge or find new capital. So, I think it's really watching carefully beyond the numbers into the business and the people running the business, and the business plan and orientation that they have, and the governance.

Ken Caputo:

I'd say that the most common theme among our cases is theft of customer property. That's the driver of most of our cases. They're not like Lehman, or MF Global, which are major failures driven by economic conditions, and that happens. Those crises do occur, but they're more like Madoff, but just smaller. I mean, even the MJK Clearing case, which I mentioned earlier, was driven by an offshore fraudulent scheme that deprived the broker dealer of necessary capital and caused the firm to fail. So, theft remains the main driver or cause of our cases, and what's curious is that, honestly Martin, to think about is why we haven't had more of them recently. If you think about it, there's been very few cases that have been commenced over the past few years, and I have to say, I think some of the credit has to go out to the regulators. Certainly at the SEC and at FINRA and others. I mean, they're clearly doing a good job of protecting investors.

Martin Daigneault:

That's great. All right, we're going to move on to our final question. Let's put an investor lens on the past crisis. What lessons do you believe investors have learned from the past crisis? We've looked at it on the regulator's side. Now let's look at the investor side. So, what do you think they've learned?

Rozanne Reszel:

I'm not entirely sure what they've learned, but I know the questions that we always ask them to think about when we get questions from investors. In the first instance, who are you dealing with? And by that, I mean the regulatory process has a number of different registrant categories, and there are also people out there who are offering investment opportunities without any sort of regulatory oversight at all. And so, if it sounds too good to be true, it probably is, is the classic situation, which takes you to sort of what have you invested in? Do you have a plan? There's nothing worse in times of market turmoil than not having sort of thought through what your plan is and what your risk appetite is. So, I think it's important for investors to be thoughtful, whether they're do-it-yourselfers or investors working with professional advisors to understand the importance of having a plan.

Rozanne Reszel:

And then, from a compensation fund perspective, it's where are the assets that you purchase located and how are they controlled? Do you have direct access to them? Or do you access them through an intermediary, such as a securities dealer? And if that's the case, then what happens if something goes wrong? Is there compensation fund coverage, as in the case of SIPC or CIPF? We're entering a world with new kinds of investments that will cause us all to have to reflect on things like coverage and location and safety. We're heading into a cyber crypto world, et cetera. We're in an environment right now where precious metals are rising. Are people buying precious metals? And if so, how and where are they residing? Et cetera. So, I think it's really trying to get investors to focus on being thoughtful. Not to react, but to have a plan and to ask themselves these questions.

Ken Caputo:

You're hitting it exactly on the head, Rozanne. So, I just sort of pile onto that thought stream. I mean, I think investors can take away two lessons, and one is, if you're investing in a US brokerage firm, make sure it's a SIPC member, and go to our website, SIPC.org, and check. Customers of our largest firm failures over the years have consistently been made whole, and that includes not just Lehman Brothers, but also, MF Global and MJK Clearing, and Adler Coleman Clearing. And I think the second lesson is check your account statements. Don't just ignore them or put them in a drawer. I mean, look to see what you believed you had, what transactions you intended, that they're actually recorded on your statement, and if something is wrong, don't just call the firm. Put it in writing. Document your situation. I mean, this is likely your nest egg. What you've worked so hard to grow and earn. Investors need to be diligent in examining their account activity.

Rozanne Reszel:

Yeah, no, I think that's so true, Ken. It's always tragic when the lens that we see things through is the failed end of a situation where investors are unhappy and feeling that they were not properly informed. And yet, as you say, I think every investor has a responsibility to inform themselves and to review those very key records, which they are relying on, really, for their savings.

Martin Daigneault:

This is all good stuff, and I think a lot of it is very sensible, but in day-to-day activities, we tend to forget about them and set them aside, and I think those are very wise words. Some of them are simple, but they're very wise and we tend to overlook some of that stuff from time-to-time. And so, on that note, I'd like to thank you, Ken and Rozanne, for joining us on this podcast and offering your insights to our listeners. I'd also like to thank our listeners for their time and I hope they found the discussion interesting. This is the first podcast in the CIPF Podcast Series. So, stay tuned for the next podcast to be posted on CIPF's website. Also, we welcome your feedback. Drop us a line at +1-866-243-6981 to let us know what you think, and if there's a topic you'd like to hear more about. I'm Martin Daigneault. Thank you again for joining us today.