Throughout most of its U.S. history, operation of the securities market has been directed by private associations with very little government regulation or interference.

This situation changed after the Crash of 1929, when an estimated $50 billion stock market loss triggered the Great Depression and ended the government's hands-off attitude.

Since the Depression, Congress has enacted a number of measures, including the Securities Act of 1933 and the Securities Exchange Act of 1934, that have been designed to stabilize the stock market and to protect investors.

Continuing in this tradition, Congress in 1970 passed the Securities Investor Protection Act (SIPA), and established the Securities Investor Protection Corporation (SIPC) as an industry-funded, nonprofit, membership corporation that offers limited protection to investors.

As of year-end 1986, SIPC had 11,305 members, including all firms registered as broker-dealers with the Securities and Exchange Commission (SEC) and all members of the national securities exchanges.

In this Economic Commentary, we shall outline briefly the events that led to the establishment of SIPC, placing an emphasis on the mechanics of securities trading in 1970. We shall then proceed to an analysis of the rationale for such an insurance mechanism by discussing the role that SIPC might be expected to play in response to disruptions in the securities industry. Finally, a comparison with other financial insurance programs leads to an assessment of SIPC's exposure to loss.

**Background**

In the wake of the Great Depression, the securities industry settled into a new, highly regulated environment. The public's indifference towards private financial instruments helped to slow growth in the industry. Despite the rapid increase in the amount of U.S. Treasury obligations associated with the financing of the Second World War, the dominance of the Federal Reserve and commercial banks over the securities market served to limit opportunities for broker-dealers to expand.

The only noteworthy attention received by the securities industry in the postwar years resulted from charges of price-fixing against a few powerful underwriters. For nearly 30 years thereafter, there were no significant disruptions in the industry.

Interest in the securities markets, as measured by equity trading on the New York Stock Exchange (NYSE), resumed at a slow pace in the period following the Second World War. Average daily volume on the Big Board stood at 1,422,000 shares in 1945, at 1,980,000 shares in 1950, at 2,578,000 shares in 1955, and at 3,042,000 shares in 1960.

The increased trade in securities was accompanied by several isolated failures of small dealers and brokers. The first post-Depression failure, in 1960, was allegedly the result of a "partner's illegalities." In 1963, a second failure, a by-product of the "Great Salad Oil Scandal," found the New York Stock Exchange paying $9.5 million in reimbursements to the failed firm's customers.

To maintain confidence in the financial markets, the New York Stock Exchange subsequently established a fund, with initial assets of $10 million and a $15 million line of credit, to compensate customers of failed firms for losses that resulted from theft or fraud. The other exchanges followed the NYSE's lead and also established customer protection funds. The exchanges, however, were under no legal obligation to settle any claims.

By 1965, the average daily volume on the New York Stock Exchange rose to 6,176,000 shares; by 1968, it reached 12,971,000 shares. The dramatic growth in trading volume over this period led to what was referred to as the "paperwork crunch." At that time, securities transactions were processed by hand. Brokerage firms maintained a "cage" in which cash and certificates were physically stored and exchanged, sometimes leading to settlement mismatches as trading volume grew. The level of so-called "fails-to-deliver" incidents, in which a firm fails to deliver securities within five business days (then a rather common occurrence), exceeded $4 billion at the end of 1968.

Responding to the turmoil caused by the increased trading volume and lack of automation, the major exchanges initiated "trading holidays" on Wednesdays throughout the second half of


2. Firms in New York (and the Federal Reserve Bank of New York) still have cages—certificates of deposit (CDs) and banker's acceptances (B/As) are traded for physical delivery.
1968. The New York Stock Exchange also established the Central Certificate Service, the forerunner of the Depository Trust Company of New York today. The Central Certificate Service was a sort of clearinghouse that had responsibility for the processing and actual delivery of securities. The Central Certificate Service was an intermediate stage of the evolution from the physical transference of securities to electronic bookkeeping, which rendered the cages obsolete.

A few small-firm failures in 1969 were covered adequately by the assets of the NYSE's trust fund. Several larger fail- ures and amalgamations throughout 1970, however, made it clear that the NYSE need to replenish the customer protection fund from its general fund, calling into question the ability of the NYSE's general trust fund to withstand further failures by its members. Many of the failures that era involved violations of the exchange's net capital requirements; members were required to maintain capital in excess of 5 percent of their liabilities.

In June 1970, Congressional hearings were initiated to investigate the history and adequacy of the NYSE's and the other exchanges' funds. Supported by representatives of the financial exchange's trade associations, the Congressional subcommittees found that to the financial strains arising from the uncertainty in the existing broker-dealer network were large enough to warrant public-sector involvement. Thus, in December 1970, the Securities Investor Protection Act became law, establishing SIPC, an industry-wide replacement for the troubled funds previously created by the NYSE.
erors of the Federal Reserve System and from the Department of the Treas-

ure. The three individuals associated with different aspects of the securities indus-
ty, and two individuals (one of whom serves as the chairman) not associated with the securities industry. The latter five individuals are appointed by the President of the United States and con-

firmed by the U.S. Senate.

SIPC was created to promote investor confidence in the securities industry by insuring customers of failed broker-dealers against losses due to missing cash and securities. Currently, the pro-
tection limit for a customer against loss totals $500,000. This limit includes $100,000 of protection against claims for cash. Of course, securities on hand that are identifiable as fully paid for property of customers need no protection and are returned to customers.

The term “customer” is intended to refer to individuals or firms with claims on the broker-dealer arising out of ordinary business dealings. Such dealings include purchases or sales of securities or the safekeeping of securities and any cash balances maintained for purchases or sales. Providers of cap-

ital, noncustomer creditors, or persons with interests subordinate to those of the

firm’s general creditors are not considered customers. The failed firm’s general partners, officers, directors, and participants in at least 5 percent of the firm’s equity, and participants in at least 10 percent of the firm’s assets are excluded from customer protection.

A “failed firm” is defined as one that is declared bankrupt, that is placed in liquidation or receivership by any agency of the United States, or any state, or in violation of the Securities Ex-
terchange Act or the rules of the firm’s self-regulatory agency, or that is unable to establish its compliance with applicable laws and rules. Faulty record keeping, often accompanied by fraud, appears to be one of the most prominent factors leading to the demise of members of SIPC. Poor record keep-
ing is often caused by the fluctuation in the settlement of customers’ claims. By

er year 1986, 55 of the 197 procedures ever initiated under SIPC

remained unsettled because of so-called problem claims and/or litigation. Crim-
inual action has been taken in 20 of these years.

A failed firm is brought to SIPC’s attention by the SEC or the relevant self-regu-

latory agency (such as the NYSE, the American Stock Exchange [AMEX], or the National Association of Securities Dealers [NASD]). In most cases, unless the failed firm is merged into an ongoing firm that agrees to assume the losses of customers, the failed firm simply is liquidated. Most liquidations are not performed directly by SIPC, but rather under the direction of a SIPC-appointed or court-appointed trustee. The difference on the filing date between the market value of the securities or cash claims of customers (less cash or security owed by cus-
tomers) and the value of the failed firm’s holdings is satisfied out of the SIPC fund.

This procedure differs from an ordi-
nary bankruptcy proceeding because SIPC is prepared to ready customers to pay customers in full at once, in bankruptcy proceedings, claimants of failed firms must stand in line for a pro rata distribution as trustee-
ship or receivership proceeds. Although SIPC protection covers most types of securities (including stocks, bonds, notes, and CDAs), commodity contracts and commodity options are not covered. 4. The SIPC Act specifies that the resources of the

SIPC fund shall be maintained at a minimum of $150 million, an amount re-

ceived in 1977, bylaws passed in 1985 raise the minimum to $250 million. SIPC

authorized to assess premiums on its members. These premiums are tra-

ditionally calculated as an adjust-

ment for the firm’s experience, based on the historical cost of physical investment and to increase overall economic efficiency. If

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any single large member, let alone the liabilities from more than one large member, would constitute at least prima facie evidence that premium collections have been too small or that protection limits have been too great. It is to the securities industry’s advantage, after all, to minimize disruptions associated with a loss of public confidence, which could be potentially manifested as “runs” on securities dealers.

Government involvement might be justified if one could show that disruptions would inevitably lead to a severe bear market instead of simply being limited to certificate withdrawals. Though causation is difficult to determine, past experience suggests that broker-dealer failures may actually be associated with bear markets.5

Drawing the argument to a conclusion, opponents of public assistance to SIPC might say that the maintenance of investor confidence is best accomplished by establishing strict rules of conduct and by extensive self-policing. Industry-funded insurance schemes, such as SIPC, would be expected to operate with a minimum of public-sector involvement or support. Thus, government assistance to SIPC might be desirable and convenient, at least from the perspective of the member firms, but it is not always necessary from the perspective of the broad public interest.

The position in favor of extensive self-regulation partly reflects the spirit of the Securities Exchange Act of 1934. Specifically, the SEA stresses self-regulation on the part of the securities industry. Because the exchanges and NASD already had sufficient supervisory capability, the SEC was created to provide regulatory oversight. Beyond reducing redundancy, this system also served to protect the Treasury’s exposure to loss in the industry.

Among the dangers associated with an investor protection plan is that uninformed investors might mistakenly think that coverage extends to the market value of their securities, thereby encouraging insufficient investor scrutiny of broker-dealers and reckless behavior on the part of the firms. This is a variant of the moral hazard argument used against insurance protection in general, and against deposit insurance protection in particular. Moreover, this type of protection may allow inefficient firms to survive longer than would be the case with unfettered markets.

SIPC and Federal Deposit Insurance
The insurance provided by SIPC differs in many respects from that provided to commercial bank or savings and loan (S&L) depositors either by the Federal Deposit Insurance Corporation (FDIC) or by the Federal Savings and Loan Insurance Corporation (FSLIC).

First, the FDIC and FSLIC either have regulatory powers themselves or have affiliated authorities, such as the Federal Home Loan Bank Board, that have such powers and that maintain close supervision of their members. SIPC, on the other hand, must rely on the SEC or its members’ self-regulatory organizations for supervision and regulatory control.

Second, when a bank or thrift institution fails, the federal deposit insurer typically acts as the receiver, supervising the liquidation or, possibly, the merger of the failed firm with a healthy one, often with financial assistance from the insurance fund. Such failures usually occur, for instance, when an institution’s loan portfolio has an excess of problem loans, when it faces severe liquidity problems, or through management fraud or neglect.

More importantly, federal deposit insurance funds guarantee (currently up to a stated maximum coverage of $100,000 per account) the full value of insured deposits in the event of a covered institution’s insolvency. The determination of the insurer’s residual liability usually is straightforward because banks and S&Ls carry deposit liabilities, and most assets on their books, at par value. The protection afforded by SIPC, on the other hand, is offered simply against missing securities owed to the customers of a failed broker-dealer. The value of a customer’s claim, however, is determined by current market prices, which change as often as market conditions change. SIPC coverage does not protect customers from changes in the market value of their securities after a member firm’s failure.

Furthermore, the deposit insurance premium charged to an insured institution is computed as a percentage of its total deposit base, unlike the revenue-based (or flat-rate) premium charged to SIPC members. The FDIC, for instance, charges members a rebatable one-twelfth of one percent of total deposits. Finally, the federal deposit insurance funds claim to be backed by the full faith and credit of the federal government. SIPC has to avoid making this particular claim.6

Fund Exposure
One of the difficulties encountered in comparing SIPC-type coverage and deposit insurance is in determining the insurer’s exposure to risk. The value of total insured deposits approximates the level of a federal deposit insurance fund’s exposure. In practice, however, many general creditors of depository institutions have been granted de facto 100 percent insurance in recent years, so that the true exposure of the deposit insurance funds is somewhat greater than the total of insured deposits. SIPC, on the other hand, rarely extends its coverage to noncustomers, as determined either by itself or by a court.

The total exposure of a financial insurance mechanism, however, is only one determinant of the adequacy of its resources. On an actuarial basis, it is necessary for the present value of future premiums to at least equal the present value of expected future claims. The role of the insurance fund is to allow for deviations from expected payouts. An insurance system faced with a claims stream with a high variance will need a larger fund than a system facing a less volatile payout stream.

Ideally, the insurer’s revenues rise when the industry experiences strong growth—and is therefore most able to finance the fund’s needs—and fall during difficult periods. This pro-cyclical premium strategy minimizes the overall burden of the insurance mechanism. The revenue-based premium of SIPC members, though perhaps unrelated to the risk involved, has fallen precipitously just as the industry is experiencing enormous growth and increased risk.

Furthermore, not all financial insurance mechanisms are designed to protect against the same type of risk. A bank depositor may depend on the backing of an insurance mechanism because the use of deposited funds is completely relinquished. In the absence of insurance, the depositor would be subject to the underlying risk of the institution’s assets.

5. SIPC’s 1985 annual report cites its origin in the difficult years of 1968-70, when “the paper work crunch, brought on by unexpectedly high volume, was followed by a very severe decline in stock prices.”

6. We should note, however, that Congress has not yet made a legally binding commitment to provide the necessary funds to fully guarantee the ailing FSLIC.
On the other hand, a broker-dealer fully complying with existing securities regulations does not subject the custo-
mer to the type of risk SIPC insures. The qualitative differences between risks limit the insight provided by
direct comparisons with FIDC insurance. For illustrative purposes only, however, we provide here a comparison
between SIPC’s potential exposure and that of the FDIC.

Since 1950, the FDIC’s fund balance has ranged between 1.15 and 1.50 per-
cent of total insured deposits. An analog-
ous figure for SIPC is not readily available, since there are no published estimates of the aggregate value of
securities holdings for customers by all SIPC members. A proxy for this figure that may serve as an upper bound to
the insurance fund’s exposure can be constructed from data maintained by the Depository Trust Company (DTC) and the Federal Reserve System.

The Depository Trust Company is a participant-owned corporation that
serves as a securities depository for a major portion of the financial industry.
DTC is regulated by the SEC, the New York State Banking Department, and
the Federal Reserve. DTC holds actual securities and issues its own book-
tapes and records. Changes in DTC’s records facilitate the change of
ownership of securities. DTC also provides information about owners, or
ownership information, to publicly traded
firms and to others. DTC traditionally has accepted only corporate bonds and
securities held for their primary dealers’ own trading accounts.

Estimates of nonbroking broker-dealer positions in government securities
are not available. Several recent failures of previously unregu-
lated government securities dealers led Congress to enact the Government
Securities Act of 1986, covering participi-
ants in this market.7 As a result, a large number of government securities
dealers will be required to register with the SEC. At present, however, there is no way of knowing just how many firms will choose the registration
option that automatically would make them members of SIPC, and that would
automatically increase the risk-level of its insurance fund.

The aim is to provide a clue about
the potential increase in risk. The data at
our disposal indicate an almost eighteen-fold increase in the potential exposure of SIPC over an 11-year
period during which the SIPC insurance
fund balance only quadrupled. It should be noted that this period par-

tially covered the planned buildup of the SIPC fund to its old statutory min-
um of $150 million. On the basis of
our estimates and assumptions, the level of the SIPC fund at year-end 1986
represents only 0.06 percent of its poten-
tial exposure.

Of special importance to this analysis
is the implication of last year’s ruling on
the status of counterparties with
SIPC. SIPC had considered such
agreements on a case-by-case basis. In
a typical repurchase agreement, the broker-
dealer sells selected securities to a
counterparty with an obligation to buy
them at a later date at a specified (higher) price. In essence, the
counterparty obtains a loan from the
broker-dealer. Although these securities were
"customers" entitled to SIPC protection.

SIPC may appeal this ruling, estimates of its current level of exposure should be adjusted for the
level of repurchase and reverse repur-
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Weekly averages of the level of repur-
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The annual average levels of the two

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Commentary, Federal Reserve Bank of Cleveland,
April 15, 1987.

1981 through 1986 in Figure 4. In terms of
year-end levels, this six-year period
witnessed a quadrupling of the com-

bined outstanding volume of these con-
tracts to more than $460 billion, raising
SIPC’s potential exposure to over $1 trillion. Of course, these figures would be somewhat greater if we included the remaining SIPC members. Combining the estimates and assumptions associated with these securities agreements with the estimates and assumptions previously advanced, it then appears that SIPC’s fund currently represents coverage for only 0.03 percent of
its total potential exposure.

The implications of the repurchase
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increase in exposure to the higher risks associated with these financial con-
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lated government securities firms in the past. Congress responded to these
conditions by imposing tighter regula-
tions on all government securities
firms, though several provisions of the
Government Securities Act of 1986
have not yet taken effect.

The recent emergence of a whole
new generation of financial instruments
may have broadened the scope of SIPC’s liabilities. Many of these
instruments are of the so-called asset-
backed variety, and cover such issues as
automobile receivables and credit card
payment obligations as well as "stripped" securities, often applied to
mortgages and other debt instruments.

In most cases, these instruments are
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lack the full backing of the underlying
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quacy and risks.

Conclusion

Several issues connected with SIPC are worth considering. First, the nominal
level of its members’ annual assessment may result in the slow depletion of its insurance fund—especially in view of the corporation’s payout experience.

Second, considering the current size of the securities industry and the
nature of some of SIPC’s new expo-
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timum level of its insurance fund probably is too low.

Third, in the event of severe losses in the securities industry, it is quite possible that SIPC would be unable to meet its insurance obligations. In that
event, the federal government most likely would step in to assist investors, even possibly at the insistence of the financial burden to taxpayers.

The urgency of addressing these problems, however, rests on certain
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8. See E.J. Stevens, op.cit. lists all of them.

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DTC maintains records of the value of securities on deposit for its nonbank broker-dealer participants. Similar records are kept for banks (DTC’s largest participant group) and for clearing agencies. Presented in figure 3 are the year-end balances (at market value) of all corporate and municipal securities held at DTC for nonbank broker-dealers. Because this aggregation does not distinguish between securities held for a broker-dealer’s own account and securities held for its customers, or between the portion of customers’ securities that are insured and those that exceed insurance limits, the aggregation may overestimate SIPC’s exposure by an unknown amount. Also shown in figure 3 are the year-
end positions in U.S. Treasury securi-
ties and Federal Agency obligations (most notably, mortgage-related securities) for the nonbank, nonbroker-dealers designated as primary dealers by the Federal Reserve Bank of New York. Although there were only 21 firms with this particular designation (as of June 1986), they are among the largest securities dealers. Primary dealers facilitate the implementation of mone-
tary policy through open-market opera-
tions in government securities and help to underwrite the huge borrowing needs of the federal government. Just as with DTC’s data, we cannot distin-
guish between holdings for customers and positions taken for the primary dealers’ own trading accounts.

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The purpose of this article is to provide a clue about the potential increase in risk. The data at our disposal indicate an almost eighteen-fold increase in the potential exposure of SIPC over an 11-year period during which the SIPC insur-
ance fund balance only quadrupled. It should be noted that this period par-
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um of $150 million. On the basis of our estimates and assumptions, the level of the SIPC fund at year-end 1986 represents only 0.06 percent of its potential exposure.

Of special importance to this analysis is the implication of last year’s ruling on the status of counterparties with whom member firms have engaged in repurchase and reverse repurchase agreements. SIPC had considered such transactions to be the equivalent of repurchase and reverse repurchase agreements often are used by broker-dealers as financing vehicles for their securities inventories. In a typical repurchase agreement, the broker-dealer sells selected securities to a counterparty with an obligation to buy (or repurchase) them at a later date at a specified higher price. In essence, the firm obtains a loan from the counter-
party. The typical reverse repurchase agreement for the broker-dealer pur-
chase selected securities, hold them for a short period, and then resell them to the counterparty. This practice can be interpreted as a short-term loan by the firm to the counterparty.

Last year, however, a U.S. District court in New Jersey held that these agreements constitute contracts for the sale and resale of securities. This means that repurchase and reverse repurchase agreement counterparties are “customers” entitled to SIPC pro-
tection. Although SIPC may appeal this ruling, estimates of its current level of exposure should be adjusted for the level of repurchase and reverse repurchase activity of its members.

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The recent emergence of a whole new generation of financial instruments may have even further complicated the scope of SIPC’s liabilities. Many of these new instruments are of the so-called asset-backed variety, and cover such items as automobile receivables and credit card payment obligations as well as "stripped" securities, often applied to mortgages and other debt instruments.

In most cases, these instruments are obligations of the institution perform-
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Second, considering the current size of the securities industry and the nature of some of SIPC’s new expo-
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