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How Safe is Your Brokerage Account?

The demise of Bear Stearns, rumors about insolvency at Lehman Brothers, and headlines about big losses at E*Trade have prompted questions from individuals about the safety of their investment assets and what might happen if their broker fails. This article is dedicated to addressing some of your concerns and questions about how to ensure that your assets remain safe at your custodial firm.

REGULATORY COMPLIANCE

The first line of defense comes from a myriad of regulatory laws and standards that have been developed over the years in response to past financial problems. Broker-dealers have come under strict requirements and constant scrutiny from a number of regulatory bodies, including the Securities & Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) at the national level, as well as state regulators. These are some of the protections that are already in place for investors under the current mandates:

- SEC registered brokers are required to maintain adequate net capital (i.e., assets must exceed liabilities) to provide financial resources so that, if the firm fails, customers get their cash and securities back.
- Registered brokers must segregate customer funds and securities from the broker's own proprietary holdings, thus protecting customers from trading losses of the firm. In the event a brokerage fails, customer claims for funds and securities are given preference over any other claims on the company.
- Broker-dealers registered with the SEC are required by law to be members of the Securities Investor Protection Corporation (SIPC), which, as we'll see in a minute, provides insurance for customer accounts.

Usually, troubled firms have adequate assets to cover everything that is owed to their customers. However, these tight regulatory standards do not prevent brokers from making poor business decisions or taking unwise credit risks. Nor do they fully eliminate the possibility of fraud or theft, which leads to the second line of defense.



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INSURANCE COVERAGE

Most investors are protected by the Securities Investor Protection Corporation (SIPC). Some brokerage firms also carry additional insurance coverage as added security. For instance, Charles Schwab & Co., which is one of Next Generation Wealth Management's custodians, carries an additional \$600 million in coverage with Lloyd's of London that would only be tapped if required funds exceed the SIPC limit. Here's some insight into SIPC insurance coverage.

WHAT IS THE SIPC?

The Securities Investor Protection Corporation was originally created in 1970 by Congress to protect investor interests. The SIPC is not a government agency or a regulator. Rather it is a nonprofit membership corporation that is funded by its member securities brokers.

WHAT DOES SIPC INSURANCE COVER?

SIPC is not an investor version of the FDIC, which automatically covers your bank account up to a certain dollar limit. If your broker fails, most, if not all, of your securities (stocks, bonds, mutual funds, etc.) will be returned to you. After the broker's customer assets have been distributed, SIPC steps in to replace only securities and cash that are missing from your account.

SIPC covers any missing assets up to a limit of \$500,000 per account type, of which \$100,000 may be claims for cash. In regard to money market funds, if your statement lists these assets as shares with a value of \$1, such as Schwab's Advisor Cash Reserves, they are viewed as mutual funds and qualify for the full \$500,000 coverage limit. If the money market assets are listed only in dollar figures or in a cash account, the limit of coverage is \$100,000.

Each account that is a separate legal entity is treated on an individual basis. For instance, the following would qualify as separate accounts, each subject to the \$500,000 limit: your individual account, your trust, your IRA, your spouse's individual account, trust and IRA, your joint account, as well as a custodial account for a child. Accounts with registrations that are substantially the same are combined for purposes of coverage. In other words, an IRA that is divided between two accounts would be viewed as a single account for insurance purposes.

There are, of course, some exceptions and caveats. Obviously, SIPC doesn't compensate investors for declines in the value of their investments, and that rule applies to money market funds that "break the buck." Nor does the company bail out investors who are sold worthless securities. If your broker fails, SIPC will return the shares of your missing securities whenever possible, regardless of the current market value.



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Also, coverage excludes commodity futures contracts, foreign currency, precious metals, investment contracts (limited partnerships) and fixed annuity contracts that are not registered with the SEC. Certain persons associated with the brokerage –partners, officers, directors, and some beneficial owners of the firm– are not covered.

WHAT HAPPENS IF YOUR BROKER FAILS?

In the case of a failed brokerage firm with accurate records, a court-appointed trustee and the SIPC will attempt to have customer accounts transferred to another member firm. You would be notified of the transfer and then have the option of moving your accounts elsewhere. If this isn't possible, the trustee arranges for liquidation of the firm and the distribution of assets.

Customer assets are distributed based on the company's record of your account positions. Any shortfall in assets is spread among affected accounts on a pro rata basis. After customer assets are allocated, SIPC steps in to cover any remaining, unsatisfied claims up to the specified limit for each account.

If your brokerage firm is put into liquidation, the trustee will notify you and send a claim form and instructions. You will need to act promptly as this form must be returned by the filing deadline set by the bankruptcy court, which is usually 30 to 60 days from the date the notice of proceeding is published. Federal law allows up to six months for filings, but late claims are subject to delayed processing and possibly limited payment.

SIPC'S TRACK RECORD

This double level of protection –broker regulatory requirements and SIPC insurance– has actually served investors extremely well. In its 37-year history, SIPC has helped liquidate 317 firms, making possible the recovery of approximately \$15.7 billion in assets for 625,000 investors. SIPC estimates that 99% of eligible persons have been made whole in the failed broker cases it has handled to date. What's truly remarkable is that the SIPC has only had to provide \$508 million of its own funds to achieve this level of protection. Only 349 claims have exceeded SIPC limits over this time frame – that means less than 0.05% of claims were not fully satisfied.



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Summary

Brokerage failures are rare and even when they do occur, today's tight regulatory rules help ensure that most or all of the client assets will be recovered. Still, there are important steps you should take to help protect your accounts and aid in recovery if problems occur:

1. Check that your broker is a member of SIPC (this should be displayed in the firm's offices or its website footnotes). Next Generation Wealth Management's current custodians, Charles Schwab & Co., Pershing LLC, and Grace Financial Group, all are all members of SIPC.
2. Check your monthly statements carefully. If an error or unauthorized purchase is not corrected promptly and remains on your statement, the SIPC will assume it is valid and that's what you'll get back in a recovery. If there's an error, always address it to the broker in writing and keep a copy for your records.
3. Maintain good records, which include a copy of your last statement, all trade confirmations, and cancelled checks. You'll need to produce these if you have to file a claim with the SIPC. The burden of proof is on you – authorities will assume a broker's records are correct.
4. Be cognizant of any signs of problems at your broker, including statements that are incorrect or missing assets, or failure to receive your monthly statement with no explanation from the company. If publicly traded, a dramatic loss in the stock price (greater than 70%) is a good indication that your brokerage company might be headed for trouble.

In the final analysis, the absolute best protection may lie in selecting a brokerage firm with a top-notch credit rating, strong balance sheet, and a reputation for limiting any investments in derivatives or the type of illiquid credit instruments that led to the inevitable downfall of Bear Stearns, or are now creating havoc at Lehman Brothers and E*Trade. Such risk-averse firms do exist. So choose your custodian wisely, and follow a few of these prudent steps to ensure your best possible SIPC coverage.