FINANCIAL PLANNING

Are You Protected If Your Broker Goes Bankrupt?

For most investors, there are several layers of protection to keep your assets from disappearing in the event of a broker liquidation.

BY JOHN DEYSHER, CFA

In the wake of the coronavirus pandemic we're starting to see more bankruptcies like JCPenney, Hertz, Brooks Brothers and others. While no major brokerage firms have made the list, it's worth asking what happens to your securities if your broker goes bust. Recall that Lehman Brothers and Madoff Securities failed in 2008, and left thousands of clients worried over their portfolios. Both are in the final stages of recovery with billions distributed to clients, but this took years to resolve.

While brokerage busts have been rare in recent years, the types of brokerage accounts (traditional, online, retirement, etc.) and financial complexity of the brokerage industry have grown significantly. Some brokerage firms are highly leveraged, with a sliver of equity supporting a mountain of assets. This spins gold when times are good but can be a road to ruin when the music stops. Once losses impact a firm's ability to continue as a going concern, the result is often a downward spiral.

Some brokerage firms are highly leveraged, with a sliver of equity supporting a mountain of assets.

Remember that securities and cash held in your brokerage account are your property and must be segregated from the assets and liabilities of the brokerage firm. If a broker becomes troubled, there are several layers of protection for most investors:

1. Broker-dealer is recapitalized/reorganized as a going concern;
2. Broker-dealer liquidation and Securities Investor Protection Corp. (SIPC) coverage;
3. Excess SIPC coverage.

***John Deysher**, CFA, is president and portfolio manager of the Pinnacle Value Fund, a diversified, SEC-registered mutual fund specializing in the securities of small and micro-cap firms. He has managed equity portfolios for over 30 years. Find out more at www.aaii.com/authors/john-deysher.*

Broker-Dealer Capital and Other Resources

Like banks and other financial institutions, broker-dealers are required by regulators to maintain certain capital levels to absorb potential losses. Broker-dealer losses might occur because of bad bets on a proprietary trading desk, bad loans to customers (including margin debt) or soured private equity deals.

Once a loss impairs capital, there may be several remedies. The broker may raise additional debt or equity capital and remain independent. It might be absorbed by a stronger firm, whereby client accounts are transferred to the new firm. Recall that during the 2008 financial crisis, Merrill Lynch was absorbed by Bank of America and Bear Stearns was absorbed by JPMorgan Chase & Co. The failing firm may file Chapter 11 reorganization and continue as a going concern with new owners or it may go into liquidation, at which point the SIPC would step in to help oversee the process.

SIPC Coverage

The SIPC is a federally mandated, non-profit, member-funded U.S. corporation created under the Securities Investor Protection Act (SIPA) of 1970. While created by federal legislation and overseen by the U.S. Securities and Exchange Commission (SEC), it is neither a government agency nor a regulator of broker-dealers. Its purpose is to expedite the recovery of missing securities and cash during the liquidation of a failed broker-dealer.

The SIPC was created by Congress during of the "paperwork crunch" of 1968 to 1970 that forced over 100 broker-dealers into liquidation and left many customers stranded. The SIPC has deep pockets: In addition to unrestricted net assets of $2.9 billion as of December 2019, it maintains a credit line of $2.5 billion with the U.S. Treasury.

When a broker-dealer fails and client assets are missing, the SIPC gets involved and, with certain limits, works to reconstitute the cash and securities held at the firm. Although not every investor is protected by the SIPC, over the years, 99% of eligible investor assets have been retrieved or replaced at failed firms. The SIPC says that it has advanced over $3 billion since 1970 to make possible the recovery of

SIPC Protection for Multiple Accounts

For individual and joint accounts, SIPC protection is determined by "separate capacity." The $500,000 ($250,000 for cash only) limits apply to all accounts held in the same capacity. Each account with separate capacity is eligible for the $500,000 ($250,000) protection.

Here's an example of how the rules apply to a hypothetical married couple, Bill and Kathy. All of their accounts are held at the same brokerage firm.

» Kathy holds $475,000 of investments in a brokerage account held in her name. The account is fully covered by the SIPC.

» Bill has two brokerage accounts held in his name. Each account holds $300,000. The accounts are combined and are only eligible for a total of $500,000 SIPC protection. (He could get around the cap by moving one of the two accounts to a different brokerage firm.)

» Bill and Kathy hold a fourth joint account. This account is eligible for up to $500,000 of protection because it is held in a separate capacity from the other accounts.

» Bill holds a traditional IRA and Kathy holds a Roth IRA. Both of these accounts are also considered to be held in a separate capacity and therefore are each eligible for SIPC protection.

The SIPC lists the following types of accounts as examples of separate capacities:

» individual account,
» joint account,
» an account for a corporation,
» an account for a trust created under state law,
» an individual retirement account (IRA),
» a Roth individual retirement account (IRA),
» an account held by an executor for an estate and
» an account held by a guardian for a ward or minor.

$141.5 billion in securities or cash for 773,000 customer accounts. Of that amount, $140.5 billion came from debtor estates and $1 billion from the SIPC. Overall, the SIPC has done an excellent job of maintaining public confidence in the securities markets.

In the vast majority of cases where a broker fails, there are no missing securities or cash and the SIPC's primary role is to oversee the transfer from failed firm to solvent firm. If there are missing securities or cash, the SIPC will help oversee the reconstitution of client accounts.

However, it's important to know what the SIPC covers and what it doesn't. If a broker fails and is liquidated, the SIPC protects each account for up to $500,000 including $250,000 cash. Securities covered include stocks, bonds, money market funds, mutual funds, exchange-traded funds (ETFs), options and most other SEC-registered securities.

The SIPC does not cover:

1. Market losses due to poor investment decisions;
2. Commodities futures, except in certain circumstances (commodity ETFs are covered);
3. Non-SEC registered investments, including "private" limited partnerships and annuities; and
4. Securities held by non-SIPC member firms.

This last point is important since the SIPC only protects customers of brokers that are SIPC members. At year-end 2019, the SIPC had 3,524 member firms that are assessed a small percentage of net operating revenues for SIPC protection. Once a broker is no longer an SIPC member, coverage ceases. Always make sure your broker designates itself as a "Member SIPC." (See www.sipc.org/list-of-members for a list of member firms.)

Another important point is that protection of a customer with multiple accounts at the same broker is determined by "separate capacity." Each account held by a customer in a separate capacity is protected up to $500,000 including $250,000 cash. Accounts held in the same capacity at the same brokerage firm are combined for SIPC protection limits.

Separate capacities include individual account, joint account, corporate account, trust/estate account and IRA account. For example, an individual holding accounts worth $1 million at a single brokerage will only be covered up to $500,000. A couple holding a joint account worth $2 million will only be covered up to $500,000.

What to Expect in a Broker Closure or Liquidation

When an SIPC-member broker fails and goes into liquidation, the first question is whether any client securities or cash are missing. If no securities or cash are missing, client accounts are normally transferred to a new broker. If securities or cash are missing, a trustee is often appointed to try to retrieve the missing securities or liquidate the remaining firm assets, with proceeds to replace missing securities and cash. Because liquidations are often complex and take time, the SIPC may advance funds to the trustee to reconstitute customer positions up to applicable SIPC limits. This speeds the recovery process, and the SIPC is repaid with proceeds from the debtor's estate ultimately retrieved by the trustee.

If your broker fails and securities or cash are missing, you must file a claim with the trustee within applicable time limits to be protected by the SIPC. Typically, the trustee will contact you by mail, but the claim form should also be available at www.sipc.org or by calling 202-371-8300. When completing the form, you'll need to list the securities and cash owned by you. The trustee will then compare your claim with the records of the broker-dealer. You should also enclose any written correspondence, trade confirmations and statements to support your claim. How quickly a claim is settled depends on the liquidation complexity and the condition of the broker records.

If your broker fails and securities or cash are missing, you must file a claim with the trustee within applicable time limits to be protected by the SIPC.

Sometimes, after the liquidation process has started, you may receive a notice that your account is being transferred to a new firm. Should you still complete the claims form? Absolutely. Complete the form and return it to the trustee overseeing the liquidation. The account transfer may not proceed as planned and the claims form, with supporting documents, supports your right to receive your assets.

Remember that the SIPC protects you only for the value of your securities and cash at the time of the failure date. It does not make whole preexisting losses.

Types of Investments Protected by the SIPC

The SIPC protects against the loss of cash and securities, such as stocks and bonds, held by a customer at a financially troubled SIPC brokerage firm. The limit of SIPC protection is $500,000, which includes a $250,000 limit for cash.

The SIPC seeks to restore securities and cash that are in investors' accounts when a brokerage firm liquidation begins. It does not protect against the decline in value of investments.

Cash: The SIPC protects cash in a brokerage firm account from the sale of or for the purchase of securities. Cash held in connection with a commodities trade is not protected. Money market mutual funds, often thought of as cash, are protected as securities by SIPC. Cash held by the broker for customers in connection with the customers' purchase or sale of securities—whether the cash is in U.S. dollars or denominated in non-U.S. dollar currency—is protected.

Securities: The SIPC protects stocks, bonds, Treasury securities, certificates of deposit, mutual funds, money market mutual funds and certain other investments as securities. It generally does not protect commodity futures contracts, or foreign exchange trades, or investment contracts (such as limited partnerships) and fixed annuity contracts that are not registered with the U.S. Securities and Exchange Commission (SEC) under the Securities Act of 1933.

See www.sipc.org/for-investors/what-sipc-protects for a broader list of securities covered and more details.

Source: "What SIPC Protects," SIPC.org

Accounts in Excess of SIPC Coverage Limits

What about customer accounts in excess of the $500,000 SIPC coverage? Nowadays, many brokers carry excess SIPC coverage. For example, Vanguard provides excess SIPC coverage with an aggregate limit of $250 million for all claims, with a per-client limit of $49.5 million for securities and $1.9 million cash, underwritten by Lloyd's of London Syndicates. Schwab provides excess SIPC coverage with an aggregate limit of $600 million for all claims, with a per-client limit of $150 million for securities and $1.2 million cash, also underwritten by Lloyd's of London Syndicates.

Check your broker's website or call them to determine the amount of excess SIPC coverage they may provide. For some reason, this disclosure is not always available on a firm's website so you may have to contact them directly. Additional information on Lloyd's of London may be found at www.lloyds.com.

Has there ever been a claim in excess of the $500,000 SIPC coverage? The answer is yes. From its founding in 1970 through December 2019, claims for securities and cash in excess of SIPC coverage amounted to $49.7 million for 355 accounts. Typically, the SIPC or the trustee will pursue excess SIPC coverage to remedy any shortfall.

Ways to Minimize Risk

» 1. Only do business with SIPC-member firms—check with the firm directly.

» 2. Pick the right type of broker-dealer. Generally national or regional firms are safer than smaller local firms. They have compliance policies and procedures in place that provide a framework to oversee the welfare of client accounts. If the firm is public, check out the financials on the SEC's EDGAR database (www.sec.gov/edgar/searchedgar/companysearch.html)—paying particular attention to balance sheet strength. All brokers (public and private) registered with the SEC must file annually Form X-17A-5, an audited financial report that provides a balance sheet and affiliated notes. Visit https://brokercheck.finra.org for additional information.

» 3. Know the difference between an executing broker and a clearing broker. Most large brokers will both execute the trade (buy or sell) and clear the trade (exchange cash for securities, settle accounts, etc.). However, many executing brokers rely on clearing brokers to settle the trades. Well-known clearing firms include Pershing (owned by BNY Mellon), National Financial Services (Fidelity) and Broadcort (owned by Bank of America Merrill Lynch). If your executing broker uses a clearing firm, you should put the clearing firm though the same financial scrutiny as the executing firm outlined above.

» 4. Avoid non-SEC-registered securities, which may be excluded from coverage. These include "private" real estate and oil & gas limited partnerships and annuities.

» 5. Keep good records. You may be required to present copies in the event of a claim. Review all trade confirmations and account statements promptly and report anything unusual (unauthorized trades) to the branch manager or compliance officer promptly.

» 6. Spread your accounts around if you have a sizeable portfolio and are in excess of SIPC coverage. Consider splitting accounts across multiple brokers to diversify risk. In our example, a couple with a $2 million joint account at a single broker might establish three more joint accounts at three different brokers for a total of four accounts at $500,000 each.

» 7. Watch margin accounts carefully. If you have a margin account, any securities held there as collateral may be loaned by your broker to another broker for a fee of which you see none. Usually this is done to facilitate a short sale by the other broker's customer. If the borrowing broker becomes insolvent, it may be difficult and time consuming to retrieve your securities. Better to keep as many securities as possible in a cash account to prevent them from being loaned out to other brokers. Said another way, keep as few securities in your margin account as possible for collateral. It's very easy to have your broker journal securities between cash and margin as required.

Conclusion

While brokerage firms rarely go bust, it does happen, typically in the midst of a sustained market downturn. Fortunately for most investors there are several layers of protection to keep your assets from disappearing in the event of a liquidation. These include both SIPC protection and excess SIPC protection. The SIPC has deep pockets to help investors retrieve or replace missing securities and cash and thus maintain the integrity of the nation's securities markets. However, there is no substitute for doing your homework and taking preemptive steps to avoid becoming involved with a potentially troubled broker.

SIPC documents available at www.sipc.org include:

1. How the SIPC Protects You;
2. Investors Guide to Brokerage Firm Liquidation; and
3. SIPC Annual Report.

JOIN THE CONVERSATION ONLINE
Visit AAII.com/journal to comment on this article.

MORE AT AAII.COM/JOURNAL
Comparing the Discount Brokers and Investment Apps by AAII Staff, January 2021
Resources for Checking Out an Adviser or Broker by Ryan Reeh, April 2020
How Schwab Invests, and His Views on the Broker Industry by Charles R. Schwab, March 2020