Your Brokerage Account: Protection Beyond SIPC

By John E. Deysher

If a brokerage firm goes belly-up, how protected are customer accounts from creditors and other parties?

While brokerage busts have been rare in recent years, it's a question worth pondering.

The number of brokerage accounts (traditional, on-line, retirement, etc.) and the financial complexities of the brokerage business have mushroomed in recent years. Many believe our financial system has a few hand grenades rolling around on the floor without pins, and one of those grenades could be a major broker default triggered by a derivatives meltdown.

While you may not share those sentiments, it's important to know where you stand in the event of a problem.

If a broker/dealer becomes financially troubled, there are several layers of protection for the average retail customer:

- The broker/dealer's own capital or liquidation proceeds;
- SIPC (Securities Investor Protection Corp.) coverage;
- Excess SIPC coverage.

Broker/Dealer Capital

Like a bank or other financial institution, broker/dealers are required by regulatory authorities to maintain certain levels of capital to absorb potential losses. In this instance, we're talking about losses by various broker/dealer businesses, such as trading, brokerage, corporate finance and asset management. It is important to understand that customer portfolio losses due to poor decisions or market declines are never covered by the broker/dealer or any type of insurance.

Even if a major loss wipes out a broker/dealer's capital, most have fidelity bonds or relationships with corporate parents as additional protection.

In a liquidation, all customers share pro-ratably in any liquidation proceeds.

SIPC Coverage

After the above sources of capital are depleted, SIPC comes into play. [For more on the basics of SIPC coverage, see "SIPC: What Does It Cover?," part of the 2006 Discount Broker Guide in the February 2006 *AAII Journal*; available at AAII.com in the AAII Guides area.]

The SIPC is a quasi-governmental entity (non-taxpayer supported) overseen by the Securities and Exchange Commission (SEC). Generally, SIPC insures SEC-registered securities to a maximum of $500,000, including $100,000 cash, per account.

Excluded from coverage are: unregistered investments (i.e., limited partnerships), commodities, currencies and options. And remember, SIPC doesn't protect against investor mistakes.

If a broker/dealer goes bankrupt, customers who hold their securities in street name in a "cash account" should be able to retrieve their securities with minimal problem unless they're stolen (a rarity but still a possibility).

Usually, these type of accounts are transferred to a solvent broker/dealer, which then assumes the customer relationship.

The rub comes when a customer's securities are held in a "margin" account.

When you open a margin account, you agree that securities you place in the account as collateral may be loaned to other broker/dealers. Securities are usually loaned to other broker/dealers for delivery by their customer accounts to settle a short sale.

What is a short sale? When you sell a stock short, you're selling what you don't own at one price, with the hope of buying it back at a lower price and pocketing the difference. Your broker/dealer will borrow shares you've sold short from another broker/dealer's margin account and deliver those shares to the buyer. When you cover the short and buy the shares back, those shares are delivered to the original lending broker and placed back in the customer's margin account.

Broker/dealers like margin accounts and stock loans—they're highly profitable.

But it's when the stock leaves the broker/dealer's custody that trouble can arise for the margin account customer. That's because, if the lending broker/dealer fails, the borrowing broker/dealer may be unwilling to return the shares (even when the short is covered) until its own counter-claims against the failed broker/dealer are settled. Margin account customers whose shares have been lent out become unsecured creditors of the failed firm. If the margin account customer must sell those shares to meet a margin call, it can't be done—the securities aren't in the account.

The only way to avoid this scenario is to limit the number of securities in your margin account. If you maintain a margin account for occasional use (as I do), make sure your broker/dealer transfers any securities not required for collateral purposes into your cash account. Doing this makes those securities unavailable to the stock loan department. You can always transfer the securities back to the margin account if you need the collateral.

SIPC Resources

SIPC has done an excellent job at maintaining public confidence in our securities markets. Created in 1970 in response to the paperwork crisis of the late 1960s when many firms went out of business, SIPC now represents about 6,200 broker/dealers, each of which pays $150 per year for membership. The lion's share of SIPC's claims-paying ability comes from interest earned on its large U.S. government securities portfolio. SIPC has about $3.3 billion in resources to apply to losses, comprised of $1.3 billion of its own capital, $1 billion of borrowing capacity from the U.S. Treasury and $1 billion of borrowing availability from a group of U.S. banks. As you see, SIPC has fairly deep pockets.

Excess SIPC Coverage

But what about customer accounts that are in excess of the $500,000 SIPC coverage?

Until late 2003, three major insurers offered excess SIPC insurance to broker/dealers: AIG's National Union Fire, Travelers Property & Casualty and Radian Asset Assurance.

In late 2003, all three exited the business. Their reason—they had no idea what their exposure was. The policies were written with no cap on coverage, unlike SIPC's coverage which has a loss limit of $500,000 per account (including cash).

By late 2003 these insurers probably believed the risks were too great, since accounts in excess of $500,000 were commonplace and broker/dealer balance sheets and loss-absorbing capacity were becoming increasingly complex.

Brokerage firms responded to this vacuum of excess SIPC coverage in two ways.

First, a group of 14 broker/dealers (see Table 1) formed a captive insurer, Customer Asset Protection Co. (CAPCO), to provide excess SIPC coverage to this group only. CAPCO's Web site states there is no specific dollar limit (beyond the $500,000 SIPC deductible) to the protection CAPCO offers on customer accounts. However, as the saying goes, insurance is only as strong as the underlying carrier. In CAPCO's case, we don't know how strong the carrier actually is, since CAPCO is privately held and makes no disclosures of how much capital it has to absorb losses (they cite such important information as proprietary).

Table 1. CAPCO Clients

AG Edwards
Bear Stearns
CS First Boston
Edward Jones
Goldman Sachs
JP Morgan Chase
Lehman Brothers
Morgan Stanley
National Financial (Fidelity)
Pershing (Bank of NY)
Raymond James
Robert Baird & Co.
Wachovia

However, in a report dated March 17, 2005, S&P rates CAPCO A+ (strong) and cites as their strengths:

- Strong capitalization, sufficient to pay losses under various stress scenarios.
- Niche market position as a provider of excess SIPC insurance coverage.
- Very liquid & low risk investment portfolio.
- High underwriting standards with zero expected loss ratio.

But S&P also noted these weaknesses:

- Modest scope of operations with a single line of business concentration.
- Short operating history.
- Reliance on highly rated re-insurers for remotely possible extremely large losses.

What the weaknesses tell us is that, while CAPCO may be strong now, it's only a couple of years old and hasn't stood the test of time or the ravages of a major bear market that could put many of its insureds at risk. It also relies on re-insurance from unnamed re-insurers who absorb the highest levels of risk in return for a commensurate part of the premium.

For example, CAPCO may assume the risk of a $500,000 to $1 million loss while layering off any loss in excess of $1 million to a re-insurer. CAPCO declines to state who their re-insurers are, stating only that they're all rated AA or better.

As mentioned earlier, CAPCO was formed by a group of broker/dealers in response to a dearth of excess SIPC coverage. Another group of broker/dealers, (see Table 2) including Merrill Lynch and Charles Schwab, obtained excess SIPC coverage from Lloyd's of London, a well known insurer. Unlike CAPCO, Lloyd's caps losses at a specific amount per customer account and a specific amount per broker/dealer. For example, Merrill's coverage is capped at $150 million per customer and $600 million per firm—not a lot of coverage (0.00033%) for a firm with $1.8 trillion in customer assets in late 2005.

The question, of course, is: 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 2004, claims for cash and securities in excess of SIPC coverage ($500,000) amounted to $41.7 million across 341 brokerage accounts. One was for a $10 million single account leaving $31.7 million shared by 340 accounts or an average of $93,200 per account. These accounts received no further coverage beyond what SIPC provided. They're out in the cold because the underlying broker/dealers carried no excess SIPC coverage.

Has there ever been a call on excess SIPC coverage?

Again, the answer is yes—twice.

A small clearing firm failed generating $70,000 of excess SIPC claims that was covered jointly by liquidation proceeds and Lloyd's coverage. A larger claim of $800,000 by customers of another clearing firm remains to be settled. So far, the claims-paying ability of CAPCO and Lloyd's hasn't been seriously tested. But it will be.

Sources of Information

SIPC
SIPC 2004 Annual Report
www.sipc.org

Customer Asset Protection Co. (CAPCO)
www.capcoexcess.com

Lloyd's of London
Lloyd's of London 2004 Annual Report
www.lloyds.com

Table 2. Lloyd's of London Clients

Ameritrade
Charles Schwab
E* Trade
Merrill Lynch
Smith Barney (Citigroup)
TD Waterhouse
Wedbush

Summary

This article is not intended to be alarming. In fact, you should take comfort in knowing that your account has multiple layers of protection should your broker/dealer fail:

- Many Wall Street firms are well-capitalized, although some are not.
- SIPC has paid all claims within its $500,000 limit in full;
- Behind SIPC stand CAPCO and Lloyd's, ready to cover claims in excess of SIPC.
- Lloyd's caps its coverage, CAPCO doesn't.

Whether excess coverage will ever be called into use and whether it will be adequate, remains to be seen. What we do know is the brokerage business is cyclical and the next major downturn will produce some failures.

However, if you want further protection, you should take the following steps:

- Limit the securities in your margin account to the minimum collateral required.
- Only use broker/dealers who carry excess SIPC coverage—better to have than not.
- If you're worried about the ability of excess coverage insurers to meet their obligations, think about multiple brokerage accounts to limit your exposure to less than $500,000 per account.
- Consider taking these measures now, rather than later. When you're reading about brokerage failures in the newspaper, it'll be too late.

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