

WHITE PAPER

ASSET PROTECTION FOR BANK AND BROKERAGE FIRM ACCOUNTS

October, 2009

ASSET PROTECTION

The Lipson Group

The Lipson Group provides affluent, multi-generational families with a comprehensive approach to tax management and wealth protection, growth and sustainability. As part of our effort to provide up-to-date guidance to our clients, we have prepared this White Paper to address one of today's most pressing issues – asset protection.

INTRODUCTION

A short time ago, we all thought we understood the protections that existed in the financial system. We all thought we knew when our assets were at risk and when they were protected. We all thought there were some safe, if unexciting, investment opportunities.

Everything we thought was wrong!

What we have learned is that many of the organizations and institutions we trusted for asset protection no longer can be counted on to work as we anticipated.

At the beginning of 2008, concerned with the safety of client assets, I undertook a comprehensive review of asset protection protocols then in place. I found that many brokerage firms, banks, trust companies and money managers had sent letters to their clients to reassure them concerning asset safety. However, much of the information was confusing, incomplete or simply incomprehensible. I tried to clear up the confusion in a White Paper distributed by my office in April 2008.

That might have been the last word. But the financial world continued to implode. Financial institutions continued to fail, huge frauds were uncovered and, as a result, the insurance protections that existed less than two years ago were strained – some nearly to the breaking point – therefore, I felt it necessary to reevaluate the protection provided by the programs and protocols that remain.

This revised White Paper, completed October 2009, reviews common safeguards such as FDIC deposit insurance for banks, SIPC insurance for brokerage firms and the electronic record keeping systems of the Deposit Trust Company (DTC) and National Book Entry System (NBES). This knowledge should help you assess the extent to which your assets may be at risk.

The easiest way to approach this subject is to align the protection protocols with the types of accounts they serve, such as banks that carry FDIC insurance for deposit accounts; bank trust and custody accounts and brokerage firms that use the electronic record keeping systems of the Deposit Trust Company and National Book Entry System that services the security industry; and brokerage firm SIPC insurance.

BANK ACCOUNTS

FDIC Insurance

The asset protection most people are familiar with is the FDIC insurance coverage carried by banks. The Federal Deposit Insurance Corporation (FDIC) is an independent agency of the United States government that protects funds that depositors place in FDIC-insured institutions. FDIC deposit insurance is backed by the full faith and credit of the United States government. Since the FDIC was established in 1933, no depositor has ever lost a penny of FDIC-insured funds.

There is no need for depositors to apply for FDIC insurance or even to request it; coverage is automatic. FDIC insurance covers funds in deposit accounts, including checking and savings accounts, money market deposit accounts and certificates of deposit. FDIC insurance does **NOT** cover other financial products that insured banks may offer, such as money market mutual funds, stocks, bonds, mutual fund shares, life insurance policies, annuities or municipal securities.

The amount insured by the FDIC, per account holder, has historically been \$100,000. As of October 3, 2008, the amount was increased to \$250,000. Pursuant to legislation passed on May 20, 2009, the \$250,000 of coverage was extended to December 31, 2013, except for IRAs and certain other retirement accounts. The limit on those accounts will remain at \$250,000 per depositor.

How FDIC insurance is determined

FDIC insurance is based on all deposits held by a customer at a covered bank. All accounts owned by the same person or entity at the same insured bank are added together and the total is insured up to \$250,000. In some cases, the FDIC provides additional coverage for multiple deposit accounts of the same customer if the accounts are held in different ownership categories such as single accounts, joint accounts, trust accounts and retirement accounts. By carefully controlling the ownership of accounts within one FDIC insured bank you can dramatically increase the amount insured.

The following chart, taken from the FDIC web site explains the coverage limits per account.

Ownership Categories

(Table below is from the FDIC website www.fdic.gov)

FDIC Deposit Insurance Coverage Limits (Through December 31, 2013)	
Single Accounts (owned by one person)	\$250,000 per owner
Joint Accounts (two or more persons)	\$250,000 per co-owner
IRAs and other Certain Retirement Accounts (1)	\$250,000 per owner
Revocable Trust Accounts	\$250,000 per owner per beneficiary up to 5 beneficiaries (more coverage is available with 6 or more beneficiaries subject to specific limitations and requirements)
Irrevocable Trust Accounts	\$250,000 for the non-contingent, ascertainable interest of each beneficiary
Corporation, Partnership and Unincorporated Association Accounts	\$250,000 per corporation, partnership or unincorporated association
Employee Benefit Plan Accounts	\$250,000 for the non-contingent, ascertainable interest of each plan participant
Government Accounts	\$250,000 per official custodian

(1) All deposits that an individual has in any of the types of retirement plans at the same bank are added together, and the total is insured up to \$250,000. Naming beneficiaries on a retirement account does not increase deposit insurance.

The FDIC web site also has an online calculator called EDIE that can be used to create a report indicating whether an owner's deposits are within or exceed coverage limits at each FDIC insured bank.

<https://www.fdic.gov/edie/index.html>.

Timing and priority of payments

Should a bank fail, the law requires that insured depositors are paid first. Uninsured depositors are paid next, followed by general creditors and then stockholders. Payments of uninsured funds depend on the net proceeds recovered from the liquidation of the bank's assets and the payment of bank liabilities according to federal statute. While fully insured deposits are paid promptly, the disbursements of uninsured funds may take several years based on the timing in the liquidation of the failed bank's assets.

Customers who have deposits in excess of the insured amount (\$250,000 for now) may recover a portion of their uninsured deposits when the bank liquidation is complete, but there is no guarantee.

Deposits in the name of a trust at a failed bank

In determining the insurance coverage for a deposit account opened in the name of a formal trust agreement, either revocable (commonly called a "living" or "family" trust) or an irrevocable trust, the FDIC may request that the owner or trustee of the trust agreement provide the FDIC with a current copy of the trust document which the FDIC would review to confirm the applicable amount of deposit insurance coverage. The owner or trustee of either a formal revocable trust or an informal trust may be required to complete a declaration of testamentary trust statement attesting to the relationships of the beneficiaries to the trust owner.

The FDIC insures the interest of each beneficiary up to \$250,000 for each owner if all of the following requirements are met:

- The beneficiary is the owner or spouse, child, grandchild, parent, or sibling of the owner. Adopted and stepchildren also qualify. In-laws, grandparents, great-grandchildren, cousins, nieces, nephews, friends, organizations (including charities), and trusts do not qualify.
- The account title must indicate the existence of the trust relationship by including a term such as "payable on death," "in trust for," "trust," "living trust," "family trust" or an acronym such as POD (payable on death) or ITF (in trust for).
- For POD accounts, each beneficiary must be identified by name in the bank's account records.

POD accounts – also known as testamentary or Totten Trust accounts are the most common form of revocable trust deposits. These informal revocable trusts are created when an account owner signs an agreement (usually part of the bank's signature card) stating that the deposits will be payable to one or named beneficiaries upon the owner's death.

It is a common mistake to assume that the FDIC insures POD and living trust accounts separately. The FDIC combines an owner's POD accounts with the living trust accounts that name the same beneficiaries at the same bank.

Maintaining protection

The best protection for bank assets is to maintain less than \$250,000 in checking, savings accounts and CDs at any one bank and spread any amounts in excess of the maximum insurance into accounts at various unaffiliated banks.

An individual who wants to make large deposits in FDIC insured CDs without the inconvenience of dealing with multiple banks and multiple accounts may find Certificate of Deposit Account Registry Service (CDARS) beneficial. With CDARS, everything is handled through one member bank. The large deposit is broken into smaller amounts and placed with other banks that are members of the CDARS network. Then, those member banks issue CDs in amounts under

the standard FDIC insurance maximum, so that the entire investment is eligible for FDIC insurance.

Another way to maintain protection is to transfer amounts in excess of the maximum insurance held in a bank into a segregated trust or custody account in your name. Most banks have a trust department that can establish trust or custodial accounts for their customers. Assets held in trust or custodial accounts in the trust department of a bank do not become assets of the bank and must be segregated from the bank's own funds and also from the funds of other customers. More importantly, account ownership in the assets held in the trust or custodial accounts remains vested in the individual or entity for whose benefit the bank is acting as trustee or custodian and are not subject to claims of the bank's creditors.

Sweep options

Most banks have a sweep option in which the cash in a checking account is swept into a savings instrument at the end of each day so that it earns interest on idle cash. When a check is written, funds are automatically swept from the interest bearing account back into the checking account to cover the check.

There are different kinds of sweep options with different types and levels of protection. Some are subject to the FDIC \$250,000 limit. In others, the money is transferred to a money market mutual fund that does not have FDIC protection and funds may be subject to other risks as well. It is important to understand what type of sweep option a specific bank is using for a specific account. See www.fdic.gov for additional information.

Payroll accounts and other non-interest bearing transaction accounts

Recently, the FDIC took steps to temporarily provide greater protection for payroll accounts and other non-interest bearing accounts. On October 14, 2008, FDIC announced the Transaction Account Guarantee Program (TAGP), which provides full coverage for non-interest bearing transaction deposit accounts at FDIC-insured institutions that agree to participate in the program. The transaction account guarantee applies to personal and business checking deposit accounts that do not earn interest at participating institutions. This unlimited insurance coverage is scheduled to expire December 31, 2009.

The FDIC recognizes Negotiable Order of Withdrawal (NOW) Accounts with low interest rates up to a maximum interest rate of .50% or less as a type of non-interest bearing transaction account for the purpose of TAGP. A NOW account is a deposit account, on which checks may be written, that pays interest. NOW accounts are structured to comply with Regulation Q (A U.S. Government Banking Regulation), which prohibits interest on checking accounts.

Strains on the FDIC system

As a result of the large number of recent bank failures, the FDIC has increased assessments on its member banks. For example, Key Bank incurred a \$68 million fee increase and a \$44 million special assessment. PNC had \$133

million of additional fees. U.S. Bank paid \$123 million in a one time assessment and \$27 million in fees in the first quarter of 2009.

THE ELECTRONIC RECORD KEEPING SYSTEM

The days of paper stock certificates have nearly disappeared. In fact, municipal bonds, federal paper and government sponsored entities do not issue paper bonds or notes at all. The financial system has developed an electronic method for keeping track of stock and bonds that are held in accounts at either bank trust departments or brokerage firms.

THE CUSTOMER

- Purchases or deposits securities that are recorded in the account of the customer at the broker/dealer or financial institution
- Receives a statement from the broker/dealer or financial institution

*Mr. Smith
Owns 100 shares of Coca Cola, Inc.
Owns \$100,000 T Bill*

BROKER/DEALERS & FINANCIAL INSTITUTIONS

- Maintain book-entry accounts for each individual customer, corporation and other entity
- When a Customer purchases securities, the securities are held on the book-entry system of that firm

*Holds 1,000 shares of Coca Cola, Inc. on behalf of Mr. Smith and nine other customers.

Holds \$1,000,000 of T Bills on behalf of Mr. Smith and seven other customers*

Equities/Corporate & Municipal Bonds

U.S. Treasuries/Certain Agency Bonds

DEPOSITORY TRUST CLEARING CORP (DTCC)
DEPOSITORY TRUST CORPORATION (DTC)

- Maintains an aggregate book-entry account for each broker/dealer and financial institution
- DTCC is owned by members of the financial industry

The \$1,000 shares of Coca Cola, Inc. are held for Jones & Co. in an account with a DTC Participant.

The DTC Participant holds millions of shares of Coca Cola, Inc. on its books on behalf of hundreds of brokers similar to Jones & Co.

NATIONAL BOOK-ENTRY SYSTEM (NBES)

- Maintains an aggregate book-entry account for each broker/dealer, financial institution, the U.S. Treasury, foreign central banks, and most government sponsored enterprises
- Operated by the Federal Reserve Bank in their capacity as the fiscal agent of the U.S. Treasury

The \$1,000,000 in T Bills are held for Jones & Co. in an account with NBES.

NBES holds millions of dollars in Treasuries on its books on behalf of hundreds of brokers similar to Jones & Co.

It is important to understand electronic safekeeping systems and the protections, or so-called protections it includes. The electronic process is run by the Depository Trust & Clearing Corporation (DTCC), a limited purpose trust company under New York Banking Law, a member of the Federal Reserve System, and a registered clearing agency with the Securities and Exchange Commission. DTCC is a non-profit cooperative owned by approximately 30 large Wall Street firms that typically act as brokers or dealers in securities. These firms are called Deposit Trust Company (DTC) participants.

DTCC is the world's largest depository, holding nearly \$20 trillion in assets for its participants and their customers. It is a national clearinghouse for the settlement of trades in corporate, municipal and mortgage-backed securities and performs asset services for its participating banks and broker/dealers. See www.dtcc.com for additional information.

Acting through its subsidiary, the DTC, DTCC administers the electronic system using a "book entry" accounting method. No certificates actually change hands.

Here is an example of how the process works. Mr. Smith owns 100 shares of Coca Cola, Inc. in his brokerage account at local broker Jones & Co. and a \$100,000 T-Bill. In turn, Jones & Co. holds 1,000 shares of Coca Cola on behalf of Mr. Smith and nine other customers in a single commingled fungible mass at an account with a DTC participant. In turn, the DTC participant holds millions of Coca Cola shares on its books on behalf of hundreds of brokers similar to Jones & Co. Jones & Co. holds \$1,000,000 of T-Bills for Mr. Smith and seven other customers in its NBES account. The NBES holds billions of dollars of T Bills on its books on behalf of hundreds of brokers similar to Jones & Co.

The agency bonds held at the NBES include the following government sponsored entity (GSE) bonds:

- Federal National Mortgage Association (Fannie Mae)
- Federal Home Loan Mortgage Corporation (Freddie Mac)
- Federal Agricultural Mortgage Corporation (Farmer Mac)
- Federal Home Loan Bank System
- Farm Credit System

The first three are investor owned and the last two are owned by the borrowers.

Securities maintained through DTC and NBES remain the property of the customer. They do not become property of the bank trust department or the broker/dealer and are not subject to claims of creditors of those firms.

While the securities held for a customer in his/her account are safe from the creditors of the broker or financial institution and the creditors of DTC, an issue may arise as to the accuracy of the record keeping of the broker/dealer, the bank trust department or DTC. The task of keeping records as to which trust

department or the brokerage firm. In the absence of paper shares, the only written evidence that an individual customer has of his or her holdings are statements or trade confirmation slips.

Banks and brokers are required to reconcile the shares they hold in every account daily, and to account for or otherwise verify every security owned by a client or due from brokers, or owned by the broker at least once every calendar quarter.

Bank trust companies, brokerage firms and DTC carry Fidelity Bonds to protect their customers from errors.

DTCC holds nearly \$20 trillion in assets. Its network links more than 11,000 broker/dealers, custodian banks, and institutional investors, as well as transfer agents and exchange and redemption agents for securities issuers. In 2005, DTCC processed over 263 million book-entry deliveries valued at more than \$148 trillion. Yet DTCC carries less than one billion dollars of insurance for any errors it might make.

DTCC's coverage provides:

- **\$250 million** – Fidelity Bond all risk on premise coverage.
- **\$250 million** – Fidelity Bond all risk in-transit coverage
- **\$700 million** – in-transit coverage provided by the insurer of the armored car carrier service. All-risk policies provide secondary coverage for securities lost while in the custody of an armored carrier.
- **\$25 million** – Mail Policy for non-negotiable securities shipped via registered mail, express mail, or express courier.
- **\$1 million** – Mail Policy for non-negotiable securities shipped via first class mail.

In relation to the securities deposited and book entry deliveries the insurance coverage for errors is quite limited.

Mutual Funds

Among brokerages and mutual fund companies, a large amount of mutual fund share transactions take place among intermediaries as opposed to shares being sold and redeemed directly with the transfer agent of the fund. Most of these intermediaries such as brokerage firms clear the shares electronically through the National Securities Clearing Corp. (NSCC), a subsidiary of DTCC.

TRUST OR CUSTODY ACCOUNTS

While both bank trust departments and brokerage firms are required to maintain DTC accounts, there are some important differences.

Securities held in either type of account are deposited into the firm's single aggregate omnibus DTC account in a vault or in a box position that includes the securities and cash of all clients of the bank trust department or brokerage firm. However, customers of a bank trust department cannot have a margin account and the bank cannot use the shares held in trust or custody for any purpose. In contrast, the customers of a broker may establish a margin account. Brokers are supposed to segregate margin from non-margin accounts at the brokerage level, a process that is more complicated and susceptible to error than a bank trust account.

The bank or trust company maintains the records segregating the securities in the name of each customer's account and reconciles the accounts daily. All bank and trust companies carry Fidelity Bonds to protect their customers from errors. The bank or trust company is the insured.

BROKERAGE ACCOUNTS

Securities held in a brokerage account are deposited into the broker's single aggregate omnibus DTC account in a vault or in a box position (a location within the stock record system) that includes all the securities and cash of the customers of the broker. The securities remain the property of each customer. As such the securities are not subject to the claims of the broker's creditors.

Federal rules require that customer securities that are fully paid for (not purchased on margin) be kept separate from firm capital and securities. The broker maintains the records segregating the securities in the name of each customer's account and reconciles accounts daily.

All brokers carry Fidelity Bonds to protect their customers from errors. The broker is the insured.

Margin accounts-The fine print in brokerage account agreements

The typical brokerage customer margin account agreement allows the brokerage to hypothecate or lend the customer's securities without notice or benefit to the customer, up to 140 percent of the amount borrowed as a margin loan. It is the broker that earns interest on the loan, and not the shareholder, and this fact is acknowledged in the account agreement. When a broker lends the stock of its customers, it does so out of the general pool of marginable fungible securities held by the firm. It may not keep records documenting the ownership of the securities that have been lent. It cannot tell its customers when their stock has been lent (or returned) because the shares are included in the fungible pool of stock that serves as the source of the loan. In fact, this pool of stock is simply an electronic entry at DTC and the broker. It has no identifying characteristics linking it to particular customers.

This means the broker can lend customers' stock (and collect fees) to short sellers, hedge funds, corporate raiders and buyout funds and possibly even give them voting rights and control for key periods, without your knowledge and without maintaining offsetting collateral.

A margin account contains language such as or similar to the following:

“All securities, commodities and other property held, carried or maintained by you in your possession in any of my accounts may be pledged and repledged by you from time to time, without notice to me, either separately or in common with other such securities, commodities and other property for any amount due in my accounts or for any greater amount, and you may do so without retaining in your possession or control for delivery a like amount of similar securities, commodities and/or other property.” (Arvest Securities Account Agreement)

The DTC account of a brokerage firm holds the shares of the firm’s customers, some of whom may have margin accounts as well as those who do not. As discussed above, the brokerage firm may use the shares in the margin accounts to hypothecate or lend the customers' securities without notice or benefit to the customer. This makes the process of dividing the assets in the DTC account of a broker more complicated than that of a bank or trust company with more chance of potential error.

This is a major difference between accounts at a bank trust or custody department and accounts at a brokerage firm. The DTC account of a bank trust department does not provide margin accounts and the bank cannot use the shares held in trust or custody for any purpose.

We recommend that our clients tell their asset managers to custody their accounts at a bank, trust company or in a brokerage account without margin provisions. We also advise against margin accounts where possible.

Brokerage account insurance

Should a broker-dealer become financially distressed, its assets are liquidated either under Chapter 7 of the Bankruptcy Code or, if the broker-dealer is a member of the Securities Investor Protection Corporation (SIPC), under a liquidation proceeding commenced by SIPC.

SIPC is a non-profit organization created in 1970 under the Securities Investor Protection Act (SIPA) that provides limited insurance to investors on their brokerage accounts. All brokerage firms that do business with the investing public are required to be members of SIPC.

SIPIC is the first line of defense in the event a brokerage firm fails with customer cash and securities missing from customer accounts. SIPC either acts as the trustee or works with the independent court-appointed trustee in a brokerage insolvency case to recover funds.

SIPC funds are available to make up for shortfalls in customer assets that the broker was required to maintain up to a maximum of:

- **\$500,000** per account for securities, and including up to
- **\$100,000** per account for cash.

For a SIPC claim to occur, all of the following must happen:

- a broker/dealer must be deemed insolvent;
- client assets must be found to be missing, lost or stolen;
- customer property, SIPC advances, fidelity bond proceeds, if any, and distributions from the general estate of the failed brokerage house, if any, must be insufficient to satisfy customer account obligations.

The customer is the insured under SIPC coverage. It takes longer to process SIPC claims than FDIC claims.

All assets are not covered by SIPC

Brokers are covered by SIPC, while bank trust departments are not. Neither SIPC nor excess SIPC (see below) cover a decline in the market value of investments. Some investments such as commodity futures contracts, investment contracts (such as limited partnerships) and fixed annuity contracts that are not registered with the U.S. Securities and Exchange Commission under the Securities Act of 1933 are ineligible for SIPC protection.

If a customer has more than one account at a broker-dealer the accounts are aggregated for purposes of the \$500,000 SIPC limit. However, accounts held by a customer in separate capacities are deemed accounts of separate customers. For example, someone with an individual account, a joint account with a spouse, an individual retirement account, and a trust account will be protected up to \$500,000 on each account.

See www.sipc.org for further information.

How a failed broker-dealer's assets are distributed

When a broker-dealer fails, its assets are generally divided into 3 categories:

- "Customer name securities," which are paper stock certificates and bond certificates registered in a customer's name, are either returned to the applicable customer or transferred on behalf of such a customer to another firm. With the decline of paper stock certificates this has limited applicability;
- Cash and other securities held for customers (including stocks and bonds that are, for example, held in "street name," and securities held in margin accounts) is referred to as "customer property" and is divided on a pro rata basis with all customers sharing in proportion to the size of their net equity claims. Shortfalls in the pool of customer property might occur, for example from a broker's use of securities pledged by customers to secure margin loans. Because customer property is distributed pro rata, all customers share in any shortfall, even if it is generated by activities relating to the accounts of others. Customers net equity claims are satisfied by advances from SIPC, which insures losses for missing securities or cash up to \$500,000 per customer (with a sub-limit of \$100,000 for any cash held with the broker). To the extent

possible, net equity claims are settle with the identical securities owned by that customer as of the day the liquidation case was commenced; and

- Non-customer property owned by a broker-dealer, which consists of any remaining general assets of the broker-dealer after expenses of the liquidation and reimbursement of SIPC advances, is used to pay any remaining customers' claims as well as the claims of other general unsecured creditors of the broker-dealer. If the aggregate pool of customer property is insufficient to repay the full net equity claims of all customers, the customers share from the pool of non-customer property of the broker on a pro rata basis (based on the amount of the customer's deficiency) with holders of general unsecured claims.

A SIPC liquidation

If a SIPC liquidation takes place, account holders are notified by letter that the brokerage firm has closed and that SIPC has begun a "Direct Payment Procedure" or a liquidation proceeding in court. If you receive such a letter, SIPC advises that you promptly:

- Gather key information, including brokerage account records, monthly or quarterly statements and trade confirmations;
- Locate cancelled checks and correspondence with the brokerage firm;
- Check account statements for accuracy and verify that the statements reflect all cash deposits sent to the brokerage firm. Determine if there are any unauthorized transactions;
- Verify your correct address.
- Follow SIPC instructions in filling out necessary forms. Pay strict attention to time limits set forth in the notice and claim form.

If you hear about a liquidation that involves a firm you use, and have not received a letter, go to the SIPC web site for contact information.

The Strain on SIPC

From the time Congress created SIPC in 1970 through December 2008, SIPC advanced \$520 million to approximately 761,000 account holders.

The SIPC fund had \$1.6 billion in assets in January, 2009 before exposure to Bernard L. Madoff Investment Securities LLC (Madoff Securities) claims. As a brokerage firm, Madoff Securities provided SIPC insurance for its customers. As of July 2009, 543 customers of Madoff Securities filed claims:

	<u>Total</u>	<u>Per Account</u>
Customer claims	\$2.972 billion	\$5,473,297
SIPC advance	<u>231 million</u>	<u>425,414</u>
Unpaid claims	<u>\$ 2.741 billion</u>	<u>\$ 5,047,882</u>

The Madoff case is unusual in that securities never were deposited into customer accounts. The account statements customers received were complete fabrications. SIPC was never intended to handle this type of situation. It was never anticipated that SIPC would be liable for the entire accounts of all the customers of a brokerage firm.

The Madoff Securities bankruptcy trustee is taking action to recover Madoff Securities property to cover the claims of its customers. As of January 2009, the Madoff Securities trustee appeared to have located \$860 million in assets that should be available to reduce SIPC exposure. In addition, SIPC has assessed member firms ¼ of 1% of their net operating revenue.

Excess SIPC Insurance

Most firms carry additional insurance, over the protection limits currently provided by SIPC. Typical excess SIPC is issued by an insurance company such as Lloyds of London for \$600 million maximum for an entire firm, limited to \$150 million per customer. The customer is the insured under the excess SIPC insurance. The aggregate maximum is a small percentage of the assets of a typical brokerage firm.

As with all insurance, the ability to pay claims depends on the financial strength of the carrier. In addition, the \$600 million cap or other limits on the amount of protection provided to individual customers or to the firm's customers as a group, represents a small amount of total customer securities for many firms.

Protection is generally triggered only when a participating securities affiliate fails, is liquidated AND customers' securities are not returned by the firm or through SIPC.

Excess SPIC doesn't always work.

The Customer Asset Protection Company (CAPCO) was formed in 2003 by Lehman Brothers and 13 other brokerage firms to cover its members' customers' losses in excess of the SIPC limits.

The following broker/dealers previously carried CAPCO's Excess SIPC protection:

- Bear Stearns Securities Corp.
- Credit Suisse Securities (USA) LLC
- JP Morgan Clearing Corp.
- Edward D. Jones & Co. L.P.

- National Financial Services LLC (Fidelity)
- Goldman Sachs & Co.
- Lehman Brothers Inc. (Neuberger Berman)
- Morgan Stanley & Co., Inc.
- Raymond James and Associates
- Ridge Clearing & Outsourcing Solutions, Inc.
- Robert W. Baird & Co.
- Pershing LLC
- First Clearing, LLC (Wachovia and NatCity Investments, Inc.)

When Lehman Brother failed, CAPCO was exposed to potential claims of \$11 billion. Unfortunately, CAPCO had only \$150 million of capital to meet the claims.

CAPCO discontinued writing policies as of February 16, 2009. Most of CAPCO's owners have purchased excess SIPC insurance from private insurance companies. Many of the new policies provide coverage up to \$150 million of insurance per account and a maximum of \$600 million for the entire firm. Based on what has happened in the last couple of years, we don't think the \$600 million of coverage assures customers that their assets are protected.

Non-SIPC firms

Another coverage problem may occur when investors place their cash or securities in the hands of a firm that is not a member of SIPC. This sometimes happens when the firm doesn't actually execute buy and sell orders but instead uses another firm — known as a "clearing firm" — to process its trades.

We urge clients to make sure that their brokerage firms and the clearing firms they deal with are members of SIPC. Firms are required by law to tell you if they are not. You can also search SIPC's Membership Database or call the SIPC Membership Department at (202) 371-8300.

Clients can also protect themselves by making payments only to firms that are members of SIPC. Checks should not be made out to a sales representative and should never be sent to an address different from the business address of the brokerage firm or a designated address listed in the prospectus. In addition, it is important to review your statements for accuracy.

Broker/dealer Fidelity Bonds

In addition to SIPC and excess SIPC insurance all broker/dealers are required by law to carry Fidelity Bond insurance to protect their customers from errors. The broker is the insured.

Such a bond might have a \$100 million aggregate maximum, with a \$5 million deductible, and cover employee dishonesty, robbery, theft, and mysterious disappearance.

MUTUAL FUND AND MONEY MARKET FUND SHARES

Mutual funds and money market funds (MMF) are Registered Investment Companies organized under the Rules and Regulations of the Investment Company Act of 1940. Mutual funds and MMFs are operated by investment companies, not banks or brokerage firms, and are made up of many shareholders who buy individual shares. The assets of mutual funds are not available to creditors of the sponsoring investment companies. Mutual fund shares, including MMF shares, are considered securities of the customer for purposes of SIPC.

It is important not to confuse a bank-issued deposit money market account (that may be FDIC insured) with a money market mutual fund that is not FDIC insured. While the yield may be higher with a MMF, it is an investment product and has the risks associated with investing.

The purpose of a MMF is to provide a place to keep cash for the short term with easy in and out access. MMF's can invest in different types of paper such as:

- bank CDs (CDs are not protected from the claims of the bank creditors)
- federal paper
- municipal bonds (subject to the financial health of the municipality)
- collateralized debt obligations
- mortgage-backed securities or other structured investment vehicles
- variable rate obligations

SEC Proposed Rule Amendments

Every investment, including a MMF, has risk. Historically MMFs have an excellent safety record, primarily because they invest in short-term securities of the government, large institutions and corporations. Investors should regularly review the prospectus and annual report of any MMF they own in order to monitor the type of investments made by the MMF and to evaluate the safety and liquidity of the assets in the fund.

However, in September 2008, the Reserve Primary Fund, which was the first money market mutual fund created back in 1970 by Bruce Bent, told its investors their shares were worth less than a dollar. The fund had invested in Lehman Brothers' debt and when Lehman Brothers filed for bankruptcy the assets of the fund were worth less than \$1. This situation, "breaking the buck" happened only once before in the nearly 40-year history of money market mutual funds. Fourteen years ago, investors in a small institutional money market fund called Community Bankers lost about four cents on the dollar.

On June 24, 2009 the Securities and Exchange Commission voted unanimously to propose rule amendments designed to significantly strengthen the regulatory framework for MMFs, to increase their resilience to economic stresses and reduce the risks of runs on the funds.

The proposals would require MMFs to maintain a portion of their portfolios in highly liquid investments, reduce their exposure to long-term debt, and limit their investments to only the highest quality portfolio securities. The proposals also would require the monthly reporting of portfolio holdings, and allow the suspension of redemptions if a fund "breaks the buck" to allow for the orderly liquidation of fund assets. As of this writing, the proposal has not become law.

THE U.S. GOVERNMENT GUARANTY OF FEDERAL SECURITIES

Only securities issued by government agencies which are divisions of the federal government, carry the full faith and credit guarantee of the U.S. government.

The Government National Mortgage Association (GNMA or Ginnie Mae) a government-owned corporation within the U. S. Department of Housing and Urban Development that guarantees mortgage-backed securities backed by federally insured or guaranteed loans. Ginnie Mae does not purchase mortgages from lenders, nor does it buy, sell or issue securities. Ginnie Mae securities are guaranteed by the federal government.

In contrast, Government Sponsored Entities (GSEs) are shareholder-owned companies created by Congress to serve a public purpose. While they are sponsored by the federal government their securities are NOT guaranteed by the federal government. These entities include:

- Federal National Mortgage Association (FNMA or Fannie Mae),
- Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac),
- Federal Agricultural Mortgage Corporation (Farmer Mac)
- Federal Home Loan Banks (FHLB) and
- Federal Farm Credit System,

Fannie Mae and Freddie Mac have now been taken over by the federal government. As part of the take over, the government has provided various arrangements to ensure Fannie Mae and Freddie Mac's positive net worth in order to protect holders of Fannie Mae and Freddie Mac debt and mortgaged-backed securities. The arrangements include a new liquidity facility, a new GSE mortgage backed securities purchase program, and a senior preferred stock purchase program under which Treasury can purchase senior preferred stock of Fannie Mae and Freddie Mac up to \$100 billion each.

Treasury Securities

Treasury securities include Treasury bills (T-bills), notes and bonds. T-bills are commonly purchased through a financial institution. Banks purchase T-bills via book entry, meaning that there is an accounting entry maintained electronically

on the records of the Treasury Department; no engraved certificates are issued. Treasury securities belong to the customer, the bank is merely acting as custodian.

Customers who hold Treasury securities purchased through a bank that later fails can request a document from the acquiring bank (or from the FDIC if there is no acquirer) showing proof of ownership and redeem the security at a Federal Reserve Bank. Or, customers can wait for the security to reach its maturity date and receive a check from the acquiring institution, which may automatically become the new custodian of the failed bank's T-bill customer list (or from the FDIC acting as receiver for the failed bank when there is no acquirer).

With TreasuryDirect (a web site run by the United States Treasury) individuals can purchase T-Bills online and have funds withdrawn from and deposited directly to their personal bank accounts. Investors receive a Treasury Direct Statement of Account when the securities are issued, reinvested or if any changes are made to the account. The payments, including principle and interest, are made electronically via direct deposit into an account at a financial institution. Transactions are documented by a Confirmation of Sale (COS) or Confirmation of Purchase (COP)

CONCLUSION

The area of asset protection has become much more complex. But some of the old investment rules still apply:

- Beware of “Too-good-to-be-true” promises. Any legitimate investment involves risk. Guarantees of unrealistically high or unreasonably consistent returns are suspect.
- Diversify. Diversify not only your assets but also your money managers, accounts, and financial institutions. Diversifying limits exposure to the financial problems at any one institution.
- Understand the investment. Don't rely on reputation or word of mouth. Con artists are experts at building networks of trust. If investments and the investment strategy are not explained in detail, walk away.
- Check the auditor, or ask your financial adviser to check the auditor. Auditors sign and certify financial statements of companies and investment funds and are liable for inaccuracies. A legitimate investment company, managing billions of dollars of assets should use a reputable, well known auditing firm.

In today's financial environment, asset protection has become a primary concern for investors. We hope the information presented here provides a better understanding of the complicated situations that may put accounts at risk and of the actions that can be taken to better protect assets.

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October, 2009

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NOTE: This paper is intended to provide readers with insight on asset protection and is not intended to address the needs of any particular investor. It is not intended to promote any broker/dealer or financial institution or advertise their services. All opinions expressed are those of The Lipson Group, Inc.

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