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COVID-19 UPDATE

Understanding and Minimizing the Risks of Financial Institution and Broker-Dealer Insolvency

The current volatility of the markets has raised investors' concerns about the safety of their bank accounts and securities accounts. In addition, some people may be transitioning more of their assets to cash, which raises certain questions. Now, more than ever, it is important to have a basic understanding of the rights of a customer with respect to their bank and securities accounts.

I. Protection of Your Bank Accounts

Every bank commercial ends with a voice that says something about being "FDIC insured." What does this mean in practice, and what are the limitations to this insurance?

The Federal Government established the Federal Deposit Insurance Corporation ("FDIC") to protect you against the loss of your insured deposits when there is a bank failure. The FDIC acts in two capacities following a bank failure. First, the FDIC serves as an insurer of the bank's deposits and will pay depositors up to the insurance limits. Second, the FDIC will become the receiver of the failed bank and will assume the task of selling/collecting the assets of the failed bank and settling its debts, including claims for deposits in excess of the insured limit.

In summary, the FDIC insurance coverage is up to $250,000 per deposit account in each account ownership category for each distinct bank. What does this mean? You can open accounts at different banks, or in different ownership categories at a single bank, to increase and maximize your insurance coverage. There are however a number of questions to consider.

What accounts are covered?

The FDIC insurance covers:

- Checking accounts;
- Savings accounts;
- Money market deposit accounts; and
- Certificates of Deposit.

The FDIC insurance does not cover:

- Stock Investments;
- Bond Investments;
- Mutual Funds;
- Life Insurance Policies;
- Annuities;
- Municipal Securities;
- Safety Deposit Boxes; and
- Treasury Bills, Bonds, or Notes.

How do you maximize your insurance eligibility?

There are a number of ways to maximize your coverage:

- You can have accounts at different banks (not just branches of the same bank). You can have one account with up to $250,000 in one bank and another account with $250,000 at a second (third, fourth…) bank. The FDIC will insure each of these accounts;
- Accounts at the same bank in different ownership categories each qualify for $250,000. These ownership categories are:
    - Single accounts;
    - Certain retirement accounts;
    - Joint accounts;
    - Revocable Trust accounts;
    - Employee benefit accounts; and
    - Corporation, partnership, or unincorporated association accounts.

Therefore, with thoughtful advance planning, an individual can deploy techniques to qualify for significantly more than $250,000 in FDIC account insurance.

II. Broker-Dealer Insolvencies

While your bank account balances may be insured by the FDIC as discussed above, assets in your brokerage accounts are also protected, but by a different entity – the Securities Investors Protection Corporation ("SIPC"). In fact, if you scroll to the bottom of nearly any page on a brokerage firm's site, you will see the SIPC membership disclosure.

The analysis of the availability and limits of insurance coverage is more complicated than the FDIC bank account insurance and may vary based not only on the value of the account but also the specific contents of your account. As discussed below, in order to determine the extent of your available insurance, you have to review the type of security you are holding and whether there is also cash in the account.

<u>SIPC Insurance for Securities and Cash</u>

SIPC generally insures losses up to $500,000 per customer with a sub-limit of $250,000 for any cash held with the brokerage firms. Some firms may carry excess insurance to cover claims over the $500,000 SIPC limit. The insurance is paid in the form of identical replacement securities (or cash, in the case of missing cash). SIPC insurance covers only registered securities; it does not provide protection for commodities, foreign exchange or other investments. SIPC will neither insure investments for investment losses nor claims for bad investment advice.

Just like under the FDIC rules, you may qualify for an increased amount of insurance through accounts at different institutions or in a different ownership capacity for accounts at one particular firm.

<u>Treatment of a Customer's Securities</u>

How your securities are titled impacts what happens if the value of your securities exceeds the amount of insurance coverage.

<u>Customer Name Securities</u>

A "customer name security" is a security registered in the customer's name and ordinarily takes the form of a physical certificate. In a liquidation, physical securities registered in the customer's name are returned to the customer and are not pooled with the other assets to satisfy the claims of general creditors or other customers.

The following distinctions may be relevant if the value of your securities exceed the amount of available insurance coverage.

Street Name Securities

Most widely held securities are registered in "street name" (i.e., held indirectly through a clearing corporation). Each customer has a "net equity claim" against the broker for its street name securities, which is the dollar amount in the account(s) of the customer, calculated as if the entire portfolio of the customer's securities had been liquidated on the filing date, net of any claims of the broker against the customer (for example, on account of margin loans). Net equity claims are satisfied first by a pro rata distribution of "customer property," which consists principally of the pool of "street name" securities and cash held by the broker for all customers. Aside from cases of fraud or malfeasance, 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 in a liquidation, all customers share in any shortfall, even if it is generated by activities relating to the accounts of others.

Cash

Similar to FDIC coverage, the SIPC insurance covers $250,000 of cash in your account. You may generally deploy the techniques discussed above to obtain increased coverage (e.g. distinct institutions and types of account ownership).

Managing the Risks of Broker-Dealer Insolvency

As discussed above, care should be given to the value of each account, the number of accounts at a particular institution and the specific ownership of each account. Customers should also assess the financial condition of their brokers. Broker-dealers are required to file Focus Reports with the SEC which provides a look at the firm's financial and operational health. These reports are available on the Commission's Web site (sec.gov). In addition, customers may wish to review the quarterly and annual financial reports of publicly traded banks and brokerages, which are generally available on the Internet, including on the Commission's Web site.

Customers that currently hold all their accounts with a single broker may wish to establish additional brokerage accounts at other firms, which would diversify their risk and also expedite the transfer of assets out of a troubled brokerage. Alternatively, to the extent cash or securities are not otherwise needed in brokerage accounts (for example, to satisfy margin requirements), customers may want to consider moving these assets to bank custodial accounts.

Summary

This information illustrates the limits on insurance and the degree of potential exposure in the event of a bank or brokerage firm failure. Some assets and accounts will be entitled to greater protection, in terms of account insurance and distribution priorities.

Steps should be taken now to review your accounts, and each account relationship must be evaluated separately to determine where it lies on that continuum. We hope you found this information helpful. Please reach out if you have any questions.

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