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Investor Protection At U.S. Registered Brokerage Firms

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INVESTOR PROTECTION AT U.S. REGISTERED BROKERAGE FIRMS

Overview of Investor Protection at Brokerage Firms

In the United States, more than \$25 trillion in investment assets are held by individual and institutional investors at brokerage firms.¹ It is natural in economically turbulent times for clients to have some concerns about the security of these assets. This white paper helps explain the multiple levels of oversight around brokerage assets and provides a bird's-eye view of what happens in the rare instance that a brokerage firm does fail.

Investors are always at risk of changes in the market value of their securities. The protections discussed in this paper do not address protection against the risk of losses due to changes in market value of securities held in client accounts (see Exhibit 1, page 2).

A number of brokerage firms are part of a larger financial services corporation. However, a brokerage firm functions as its own legal entity, required to keep a separate

structure from its parent or affiliate companies. In the United States, brokerage firms function under strict regulatory oversight provided primarily by two bodies—the Securities and Exchange Commission (SEC) and the self-regulatory Financial Industry Regulatory Authority (FINRA). The SEC defines the brokerage industry's overall regulatory structure, sets in place rules for financial controls, and establishes capital requirements. FINRA conducts regular examinations to ensure brokerage firms are in compliance with regulations.

The cornerstone of protection of client assets in brokerage firms is the segregation of assets. SEC Rule 15c3-3, the Customer Protection Rule, requires that all fully paid² and excess margin³ client securities are to be held separately from the brokerage firm's own assets, and are not available for the firm's use.⁴ This rule ensures that if a brokerage firm were to experience losses, investor assets would not be affected.

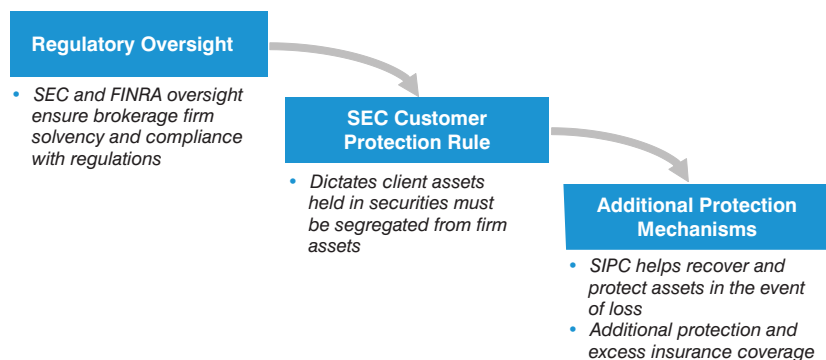
¹ Cerulli Associates, AM Survey, 2007.

² SEC Rule 15c3-3 defines "fully paid securities" as securities carried in any type of account for which the customer has made a full payment.

³ SEC Rule 15c3-3 defines "excess margin securities" as securities having a market value in excess of 140 percent of the amount the customer owes the broker-dealer and which the broker-dealer has designated as not constituting margin securities.

⁴ SEC Rule 15c3-3, Customer Protection Rule, www.sec.gov.

Exhibit 1
Layers of Investor Protection



Source: Booz & Company

In the rare event that a brokerage firm does fail, investors benefit from additional layers of protection. The Securities Investor Protection Corporation (SIPC) intervenes as soon as possible in the event of the failure of a member brokerage firm and appoints a trustee to take charge of the failed firm. SIPC's mandate is twofold: First, if the brokerage firm has correctly kept all of its records, SIPC ensures the orderly transfer of client assets to another firm. Second, in the event that there has been fraud, or records have not been properly kept, SIPC helps recover investor assets and provides protection against loss of up to \$500,000 in each separate capacity⁵ (i.e., each individual investor). SIPC is committed to protecting customers of member firms against the loss of their securities and replacing those securities, irrespective of changes in their market value. In addition,

many brokerage firms also obtain additional coverage against loss of assets, which covers assets in client accounts over the SIPC limits.

The U.S. regulatory structure described in this paper performs well, and failure of a brokerage firm requiring SIPC intervention is rare. In fact, in the last five years, SIPC has been required to intervene in only 14 instances. These instances involved less than 0.01 percent of total investment assets at brokerage firms. Since inception, SIPC has succeeded in recovering assets for approximately 99 percent of eligible⁶ investors who have filed claims.⁷

How Are Investor Assets Protected?

The protection afforded to investors at brokerage firms differs by the type of investment asset. The following section describes this in greater detail (see Exhibit 2).

Securities

Securities are investments regulated by the Securities Act of 1933 and the Investment Company Act of 1940, including stocks, bonds, exchange-traded funds, and mutual funds. At the cornerstone of investor protection of their securities in brokerage accounts is the SEC's Customer Protection Rule (SEC Rule 15c3-3), a "segregation" rule stating that all fully paid and excess margin securities are owned by the client and separated from the activities of the firm. In the rare event of a brokerage firm failure, this rule protects investors from loss of their securities.

Clients are entitled to recover all securities registered to their name or carried on their behalf in their brokerage firm's name. In the rare event of a brokerage firm failure, SIPC steps in to protect those client assets. SIPC transfers assets from the failed institution to another securities firm. If all client records have been accurately maintained and no securities are missing, this transfer of assets can be seamless and clients are not required to make specific claims.

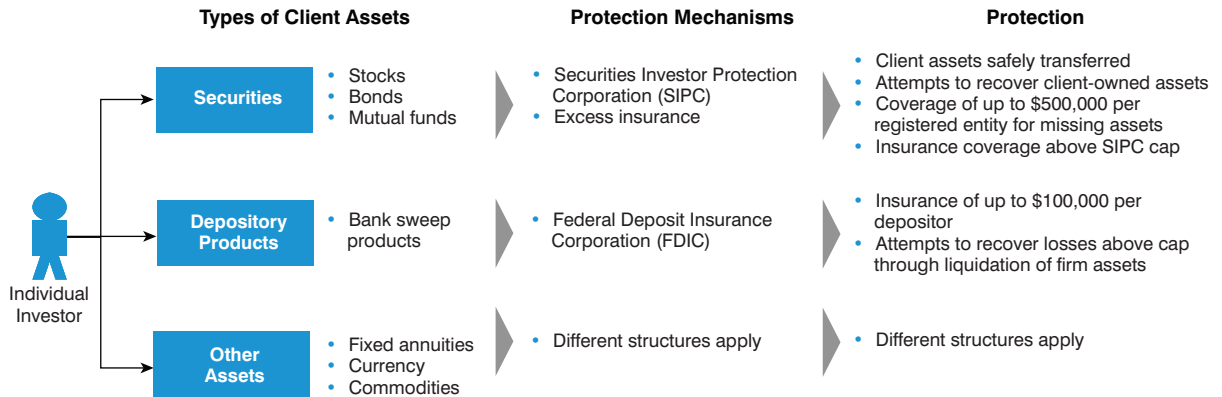
In the rare event of a failure, there may be missing securities because of fraud or poor controls. SIPC assists clients in recovering the missing securities and also provides insurance coverage. This coverage applies to securities and cash held in a brokerage account that is earmarked for securities purchases, for a total of up to \$500,000 of losses,

⁵ <http://www.sipc.org>

⁶ According to SIPC, most customers are eligible for SIPC funds, with the exception of: (1) general partners, officers, or directors of the firm; (2) beneficial owners of 5 percent or more of firm equity (except for nonconvertible preferred stock); (3) limited partners with more than 5 percent participation of assets and net firm profits; (4) those with power to exercise control over management of policies of the firm; and (5) a broker dealer or bank acting for itself rather than for its customers.

⁷ <http://www.sipc.org>

Exhibit 2
Protection Mechanisms by Asset Type



Source: Booz & Company

including \$100,000 in cash per account in each separate capacity.⁸ SIPC coverage only applies to missing securities, and does not offer clients protection against losses in market value of their securities.

To recover missing securities, clients must file a claim with SIPC. All securities owned by the brokerage firm’s clients are set aside in a fund of “customer property,” (i.e., separate from the brokerage firm’s property) used to satisfy all client claims for their assets. SIPC funds are then used as a reserve in cases in which customer property funds would be insufficient to satisfy all claims.

If a brokerage firm needs to be liquidated to meet client claims, it is done through the Securities Investor Protection Act of 1970 (SIPA) in a bankruptcy court. Under SIPA liquidation, delivering client securities

and meeting claims is the priority of the SIPC-appointed trustee.

When records have been kept accurately, delivery of customer assets can begin shortly after claims are filed.⁹ Problems may arise when records have not been properly kept by the firm, and recovering client investments may be delayed. Clients can facilitate the claim process by keeping electronic or paper copies of their account records and promptly resolving any inconsistencies in their account statements. It is also important to note that SIPC coverage only applies to member firms registered with the SEC. In the case of introducing firms using the services of another broker-dealer on behalf of their clients to custody their assets, known as a clearing provider,¹⁰ it is the clearing provider

who carries the responsibility for the end-client assets.

In addition to the coverage provided by SIPC, a number of brokerage firms offer additional protection through brokerage insurance for securities.

In 2003, a group of 14 broker dealers formed the Client Asset Protection Company (CAPCO) to provide excess SIPC coverage. “Excess SIPC” coverage refers to insurance beyond the level of coverage provided by SIPC for SIPC-protected securities. Today, CAPCO is funded by 15 member firms, including Goldman Sachs, Morgan Stanley and Wachovia Securities.¹¹

Outside the 15 members of CAPCO’s consortium, other firms such as Charles Schwab, Merrill Lynch, Smith Barney, and E*Trade have

⁸ <http://www.sipc.org/how/brochure.cfm>

⁹ <http://www.sipc.org/how/brochure.cfm>

¹⁰ A “clearing provider” is defined as a broker-dealer who specializes in servicing other, non-clearing broker dealers, by comparing and settling all their trades. Examples of clearing providers include: National Financial Services LLC, Pershing LLC, and First Clearing LLC.

¹¹ <http://www.capcoexcess.com>

chosen to receive additional coverage through other insurers, such as Lloyd's of London, which provides them with excess SIPC coverage.¹²

Depository Products

Assets held in deposit products, such as cash balances "swept" into bank accounts under brokerage bank sweep programs, qualify for Federal Deposit Insurance Corporation (FDIC) coverage. Those assets with a brokerage firm are housed in a depository institution (bank or thrift). These institutions are covered by the FDIC for up to \$100,000 per depositor.¹³ Deposits held in different ownership categories (i.e., individual or joint accounts) qualify for separate insurance.¹⁴ Deposits are not protected by SIPC, and therefore do not qualify for excess SIPC coverage.

Other Assets

There are other investment assets with different protection structures from those outlined above for securities and depository products.

Assets that have different protection structures than those covered in this paper include investments not registered with the SEC under the Securities Act of 1933, such as fixed annuity contracts; currency; interests in gold, silver, or other commodity-derivative contracts; and investment contracts (limited partnerships). In some cases, those assets are in funds held away from the brokerage firm, or held in a direct relationship between the individual and the fund manager and are not affected by the failure of the brokerage firm.¹⁵

Summary

Investors at brokerage firms benefit from regulation and other mechanisms to protect the security of their assets. Brokerage firms are regulated by multiple agencies designed to ensure solvency and the security of client assets. In the rare event of a brokerage firm failure, client assets at brokerage firms are protected through different mechanisms.

Securities are protected under the SEC Customer Protection Rule, which requires that customer assets are segregated from brokerage firm assets in order to ensure their security. In addition, in the event those securities do go missing, SIPC helps customers recover those assets and provides protection for up to a limit of \$500,000 for each separate capacity. Depository products are protected by the FDIC to a limit of \$100,000 per depositor. Most brokerage firms also offer additional brokerage insurance in excess of SIPC coverage.

The U.S. regulatory structure described in this paper performs well, and failure of a brokerage firm requiring SIPC intervention is rare. Since inception, SIPC has been successful at meeting claims for 99 percent of eligible investors.¹⁶

In conclusion, the combination of regulatory oversight around brokerage firm operations, asset segregation requirements, and additional protection mechanisms available to investors make brokerage firms a safe structure to custody investment assets.

¹² Todd Gutner, "If Your Brokerage Goes Broke," *Business Week*, November 22, 2004, http://www.businessweek.com/magazine/content/04_47/b3909156_mz070.htm; company Web sites.

¹³ <http://www.fdic.gov/consumers/consumer/information/fdiciorn.html>

¹⁴ <http://www.fdic.gov/about/learn/symbol/index.html>

¹⁵ Philip van Doorn, "What Happens When a Brokerage Fails," *TheStreet.com*, December 10, 2007, <http://www.thestreet.com/print/story/10393483.html>

¹⁶ <http://www.sipc.org/how/brochure.cfm>

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