

Asset Protection with Broker-Dealers and Banks

As an independent investment advisor, you help your clients make important choices regarding the financial security of their assets. At Charles Schwab & Co., Inc. (Schwab), we understand that the safety and security of client funds is a key consideration in your decision about where to custody your clients' assets. Moreover, what makes any investor comfortable is an individual matter.

Introduction

The information presented here is intended to help you and your clients begin the discussion regarding bank or broker-dealer asset custody. Since this topic is complex, this material may not address all of your concerns. We encourage you to seek additional information from the Web sites listed at the end of this document, or to check other sources as you may deem necessary to make the most informed decision for your client.

Both broker-dealers and banks are highly regulated. Each is governed by multiple regulatory organizations whose primary goal is to protect clients' assets. Each has safeguards and risks. The following answers to some common questions explain a few of the differences.

How are broker-dealers regulated?

Broker-dealers are regulated by the U.S. Securities and Exchange Commission (SEC). This federal regulation is supplemented by the jurisdiction, rules and oversight of various self-regulatory organizations (SROs).

How are banks regulated?

Depending on their charter and status as members of the Federal Reserve System, banks are regulated by the Office of Thrift Supervision, the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC) and/or state banking regulators. This discussion focuses primarily on the OCC's supervision of national banks as representative of the regulatory system applicable to depository institutions.

Notwithstanding differences among federal and state banking regulators, the OCC has frequently been at the forefront of the supervision and regulation of the fiduciary activities of national banks, including their custodial activities. The OCC's practices are widely followed by other banking regulators.

Banks may provide custody and safekeeping services in a trustee or agent capacity. To act in a fiduciary capacity, a national bank must apply for and receive approval from the OCC to exercise fiduciary powers. National banks are required to keep the assets of fiduciary accounts separate from the assets of the bank. Assets held in custody by a bank trust department are considered to be fiduciary assets and are not regarded as bank assets.

What are some other differences in how banks and broker-dealers are regulated?

Although both banks and broker-dealers are subject to comprehensive regulation, there are differences in how they are regulated. For example, the twin goals of securities regulation generally are described as protecting investors and promoting the efficiency of the market, whereas banking regulators are concerned with the "safety and soundness" of banks. In addition, the system of self-regulation of broker-dealers has no equivalent under federal banking laws.

While both broker-dealers and banks are subject to regulatory capital requirements, the methodology for determining required capital differs. Broker-dealers are subject to the SEC's Net Capital Rule. It is generally defined as the broker-dealer's net worth (assets minus liabilities),

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plus certain subordinated liabilities, less certain assets that are not readily convertible into cash (e.g., fixed assets), less a percentage of certain other liquid assets (e.g., securities). The purpose of the Net Capital Rule is to protect customers and other market participants from broker-dealer failures, and to enable those firms that fall below the net capital minimum to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation (discussed below).

Bank regulatory capital is assessed using, among other factors, a risk-based standard and a leverage standard. The risk-based ratio is calculated by dividing capital by risk-weighted assets, and the leverage ratio is calculated by dividing capital by total assets. A bank's primary regulator assesses the bank's capital and assigns it a capital category. Banks must maintain certain minimum capital ratios to be categorized as "adequately capitalized" and higher minimum capital ratios to be categorized as "well capitalized." Among other things, a bank's capital category determines its ability to expand and conduct new operations.

Where are the securities held in custody by banks or broker-dealers kept?

Typically the overwhelming majority of securities held in custody by both banks and broker-dealers are held by a central securities depository, The Depository Trust Company (DTC).

Are there differences in how banks and broker-dealers hold their securities at DTC?

There is an important difference. Broker-dealers typically hold both customer securities and proprietary securities in the name of the broker-dealer (in so-called "street name"). Since banks are under a legal obligation to keep fiduciary assets separate from bank assets, a bank will use a nominee for holding securities in trust that is different from the nominee used for the bank's proprietary securities. Consequently, assets held by a bank in trust are usually not subject to the claims of creditors or depositors of the bank, even if the bank becomes insolvent.

In the event of failure by a broker-dealer, what coverage is available for client assets that were custodied with them?

Schwab adheres to industry standards for protecting its clients against the unlikely event of a firm's failure.

These include:

- Protection for securities and cash by the Securities Investor Protection Corporation (SIPC®)—Accounts of Charles Schwab & Co., Inc. (including those held by clients of Investment Advisors with Schwab Institutional®) are insured by SIPC for securities and cash in the event of broker-dealer failure.
- SIPC provides up to \$500,000 of protection for accounts your clients hold in each separate capacity (e.g., joint tenant or sole owner), with a limit of \$100,000 for claims of uninvested cash balances.
- More information about SIPC coverage is available at www.sipc.org.

In the event of failure by a bank, what coverage is available for client assets that were custodied with the bank?

The Federal Deposit Insurance Corporation (FDIC) provides deposit insurance coverage for up to \$100,000 based on account ownership type. Deposit accounts include passbook savings, CDs and money market deposit accounts. Deposit accounts held through an IRA, section 457 plan, and certain self-directed plans are insured by FDIC for up to \$250,000. It should be noted, however, that FDIC deposit insurance does not apply to securities held by a bank's trust department in a custodial capacity, such as stocks, bonds and mutual funds. The custodial assets remain the property of the customer and are not considered to be assets or deposits of the bank.

How can one protect oneself against fraud or embezzlement at the firm holding his or her securities?

Investors should understand the risks of any investment product they are purchasing. They should establish that a broker-dealer or bank addresses their concerns regarding asset custody.

Also, investors should demand and retain trade confirmations and monthly or quarterly account statements from the broker-dealer or bank. A broker-dealer or bank's failure to provide timely account statements may indicate that the entity is experiencing difficulty or is no longer in business.

Investors who fail to receive a broker-dealer statement when due and cannot get a satisfactory explanation should contact the nearest SEC office promptly. Investors who fail to receive a bank statement should contact the bank's primary regulator as soon as possible.

Your Next Step

To learn if a bank is FDIC-insured:

- **Visit www.fdic.gov**

To learn if a broker-dealer is registered with the SEC:

- **Visit www.finra.org**

To learn more about asset protection:

- **Visit the Web sites listed below**

SECURITIES INDUSTRY ASSOCIATION

www.sia.com

SECURITIES INVESTOR PROTECTION CORPORATION

www.sipc.org

FINANCIAL INDUSTRY SERVICES REGULATORY AUTHORITY

www.finra.org

SECURITIES AND EXCHANGE COMMISSION

www.sec.gov

FEDERAL DEPOSIT INSURANCE CORPORATION

www.fdic.gov

OFFICE OF THRIFT SUPERVISION

www.ots.treas.gov

OFFICE OF THE COMPTROLLER OF THE CURRENCY

www.occ.treas.gov

FEDERAL RESERVE SYSTEM

www.federalreserve.gov

DEPOSITORY TRUST & CLEARING CORPORATION

www.dtcc.com

DEPOSITORY TRUST COMPANY

www.dtc.org

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