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Not Money in the Bank: Why Investment Accounts Held by a Broker Are Not Insured Like Bank Deposits

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The SIPC was created to provide financial protection to the customers of insolvent broker-dealers. But as the SIPC itself candidly acknowledges[1], the SIPC should not be confused for the FDIC. When an FDIC member bank fails, FDIC coverage insures all depositors with that institution up to a certain dollar limit. SIPC coverage does not offer similar blanket coverage, and does not cover market losses. If an investor has been sold worthless securities, or if the value of the securities in a customer's account declines, SIPC coverage offers no protection. Coverage is only triggered when a SIPC-member broker-dealer becomes insolvent, or engages in authorized trading in a customer's account. This article summarizes the steps in the SIPC liquidation process, discusses the limitations of SIPC coverage, and offers some practical tips for investors.

The Liquidation Process

When money or securities are missing from investor accounts the SIPC does not investigate the broker or examine any customer accounts - that is the function of the Securities and Exchange Commission, state securities regulators, and the Financial Industry Regulatory Authority, a self-regulatory organization for the securities industry. Instead, the SIPC, once a regulatory action has been brought, has the authority to initiate an investor protection proceeding to return missing funds and securities (within certain limits that are discussed below).

SIPC proceedings are a specialized form of bankruptcy; once commenced, a trustee will be appointed to assist in the administration of the liquidation of the brokerage firm. The trustee will publish notice of the liquidation in various media describing the procedure for claims and the liquidation proceedings, and specifying a certain time period for investors to assert their claims. Upon court-approval of valid claims, the trustee typically distributes funds to investors within one to three months. In some cases, where records of the broker-dealer are accurate and client accounts are intact, the trustee may return funds in an expedited fashion, or transfer customer funds to another broker dealer. For example, in the dissolution of the broker dealer arm of Lehman Brothers, after a court approved the sale of brokerage assets to Barclays Bank, the trustee transferred customer assets to other solvent broker-dealers. According to the SIPC, in that case, brokerage customers of Lehman Brothers were able to "exercise control over their portfolios in a seamless way.[2]" In comparison, however, where the records of the liquidating broker dealer are inaccurate, the return of client assets or the distribution of SIPC funds (to the extent they still exist) can take more time. For example, in a recent proceeding involving the broker affiliated with Bernard Madoff, the president of the SIPC explained

to the Senate Banking Committee that it would take significantly more time than usual to assess investor claims because that firm's accounting records "bore little or no relation to reality[3]."

Limitations on Recovery

The SIPC has the statutory authority to restore client accounts of the broker dealer for up to $100,000 in claims of missing cash, and up to $500,000 per customer for claims of missing securities. In addition to the cap on recovery, investors should understand that certain investments are *not* covered, in any respect, by the SIPC. SIPC coverage does not apply to investment contracts, commodities futures contracts, investment contracts or limited partnerships. Hedge funds and funds managed by registered investment advisors are similarly outside the scope of coverage, unless those funds were held in a brokerage account of a broker-dealer that is a member of the SIPC at the time of loss. Further, broker-dealers who do not register with FINRA are not eligible to become members of the SIPC, and thus clients of unregistered broker-dealers will not be covered by the SIPC.

Practical Steps for Investors

Investors may take precautions at an early stage to ensure that their assets are subject to SIPC coverage, and to review the regulatory history of their brokers. SIPC maintains a public database of all member firms (http://www.sipc.org/). Additionally, FINRA provides a useful *BrokerCheck* service through which a brokers' employment and any disciplinary history may be reviewed (http://brokercheck.finra.org/), and offers safe investing tips to the public (http://www.finra.org/Investors/SmartInvesting).

This article is intended to serve as a summary of the issues outlined herein. While it may include some general guidance, it is not intended as, nor is it a substitute for, legal advice. Your receipt of Good Company or any of its individual articles does not create an attorney-client relationship between you and Sheehan Phinney Bass + Green or the Sheehan Phinney Capitol Group. The opinions expressed in Good Company are those of the authors of the specific articles.

[1] See introductory line of the SIPC brochure, *How SIPC Protects You*, which reads "SIPC is **not** the FDIC" (emphasis in original).
[2] Statement of Stephen P. Harbeck, President and CEO of the SIPC before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, January 27, 2009.
[3] Id.