CUSTODY RISK: WHAT DOES IT MEAN IF MY BROKER GOES BANKRUPT?

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In A Brief History of Time (Bantam Books, 1988), Stephen Hawking tells the story of an elderly woman who confronted Bertrand Russell at the end of a lecture on orbital mechanics, claiming she had a theory superior to his. "We don't live on a ball revolving around the Sun," she said, "we live on a crust of earth on the back of a giant turtle." Wishing to humor the woman Russell asked, "And what does this turtle stand on?" "On the back of a second, still larger turtle," was her confident answer. "But what holds up the second turtle?" he persisted, now in a slightly exasperated tone. "It's no use, young man," the old woman replied, "it's turtles all the way down."

What the client of a typical investment bank does not appreciate and the broker (they call them investment consultants today) will not highlight is that the average Wall Street offering is expensive, mediocre in quality, and fraught with a risk that you probably never thought of. The risk that is never mentioned? Everything that you own or think you own is called into question if your broker/dealer becomes insolvent right down to the value of your wealth and when/if you can access it. It is the proverbial turtle on top of a turtle on top of another turtle. What happens when the bottom turtle collapses? With the demise of Bear Stearns such a topic of conversation has become relevant. The implosion of a major Wall Street firm should lead their clients to suddenly and unpleasantly realize how many parts of their investment portfolio are suddenly at risk:

- Client service (the broker quits or gets fired),
- Money managers (internal managers quit or get fired),
- Access to cash and securities (Custodial risk),
- Hedges or value of derivative securities (Counterparty risk),
- Limited Partnership investments (the General Partner is bankrupt)
- The value of structured notes (Debt of the issuer)
- Permanent loss of value on securities (Custodial risk).

While typically we focus our quarterly editorial on capital markets related insights, this quarter we delve into the little known, but critically important, world of custody.

**Custody & Safekeeping**

When was the last time you were at a party and heard someone brag about their amazing custody operations? It is always more interesting to discuss mergers, the Yen/Euro/Yuan, hedge fund successes (and failures), takeovers, and takeouts. Yet every fund, portfolio and limited partnership needs a place to hold its securities and cash. There are basically two options: (1) a broker/dealer or (2) a trust bank. Here, we briefly compare and contrast each.

Broker/dealers ("B/D") include both full service investment banks like Merrill Lynch, Goldman Sachs, Morgan Stanley, and UBS and niche firms like Charles Schwab, Fidelity, and eTrade. Their services, typically provided to their retail client base (retail brokerage) and hedge funds (prime brokerage), include lending, cash-management, reporting, and securities settlement. B/Ds make their money by
charging interest on leverage, fees on the cash vehicles, and interest on stock shorts. They also might charge transaction fees for each trade or asset-based fees on the value of the account. Although not required, most hedge funds will transact with their prime broker for derivative securities as well. It is important to know that securities and cash held at the B/D are registered in “street name” - the name of the broker/dealer - and not under the name of the fund or customer. In fact, it is impossible for a broker/dealer to register securities at a central depository (DTC) in the name of the client. All securities including T-bills, CDs, stocks, bonds, and mutual funds held at a B/D are registered in the name of that B/D. This is done so that it is easier for the broker/dealer to settle trades, collect dividends/interest, vote proxies, and other mundane, but critical, back office functions. An obvious indication of this is how B/D clients receive proxy statements and annual reports from the B/D rather than the issuing company.

Trust banks such as State Street, Northern Trust, Bank of New York, or JPMorgan Chase offer a fundamentally different process of asset custody. Institutional organizations including pension plans, endowments, foundations, and SEC-registered mutual funds utilize trust banks due to ERISA and other government regulations governing the heightened fiduciary requirements to keep their assets protected from theft, fraud and insolvency of the custodian. While trust banks offer all of the same basic custody services as a broker/dealer, there is a crucial difference between the two: Trust banks, unlike brokerage firms, do not commingle clients’ assets. Client assets are held in “nominee name” rather than “street name”, meaning that securities are registered in the name of the beneficial owner rather than in the name of the bank. Trust banks typically will charge asset-based fees as well as transaction charges. Because trust banks do not offer traditional margin loans, derivative transactions, and other high fee services, the custody fees are generally greater than the custody fees charged by broker/dealers. So what? Why should I care where I custody my assets?

In “normal” markets, there is practically no difference in safety, service and execution between the two custody providers. As investors are starting to realize recently, we are not in a “normal” market environment. Given all of the possibilities that could occur, we highlight the risks associated with the different custody solutions.

Trust banks: This is easy to quantify. If a trust bank were to go into bankruptcy, outside of fraud, there would be no disruption of service to custody accounts and no possibility of loss of assets as a result of the bankruptcy. Why? As we explained above, assets held at a custodian are registered in the client’s name and not in the name of the bank or other clients. Therefore, in a bankruptcy proceeding, client assets are 100% segregated from both the bank’s assets and other customers so there is never a question as to who owns the securities. As long as the account is not set up for securities lending (generally available only to very large institutions) money managers can still trade on the account, cash can be wired out, and securities can be bought or sold.

Broker/Dealers: This is where things get a bit more complicated. There is a lot of myth, hyperbole,
speculation, and misinformation with the risks associated with the bankruptcy of a broker/dealer. We endeavor to dispel the rumors and illuminate the truth.

- Myth #1: While brokerage customers have their securities registered in street name (the name of the B/D), if that B/D went bankrupt the customer is not considered a general creditor but is a preferred creditor. Customers get their assets ahead of general creditors (everyone else).

- Myth #2: There are two types of accounts that one can open at a B/D: (1) Cash and (2) Margin. While only securities in margin accounts can be lent out to hedge funds (they pay fees to the brokerage house), if the borrower of the lent securities defaulted and the collateral (usually 102-104% of the value of the securities borrowed) did not cover the loss while the B/D is bankrupt, then all customers holding cash or margin accounts, share in the loss on a pro rata basis. This occurs because all securities are held in the name of the B/D and not in the name of the client.

The Securities Investor Protection Corporation (SIPC) is the governing authority that is responsible for a B/D in the case of its insolvency. SIPC provides insurance per brokerage client up to $500k ($400k in securities and $100k in cash) only in the event of a loss of the securities or cash. SIPC is the FDIC equivalent for the B/D community. Both organizations were created by Congress and both are funded by industry, i.e. banks and trust companies fund FDIC and B/D’s fund SIPC. Contrary to popular belief, these organizations do not receive appropriations from the Federal government though, like Fannie Mae and Freddie Mac, there is the expectation that the Federal government would make good on its pledges. In addition, 15 broker/dealers also participate with CAPCO, an industry organization that offers insurance in excess of SIPC protection. However, as CAPCO is self-insured by the participating B/Ds, it is highly debatable whether CAPCO could cover losses in the event of a major financial problem that affected all participants. Some B/Ds do not participate in CAPCO but instead carry an insurance policy with Lloyd’s of London (Schwab has an aggregate policy of up to $600m).

What can we learn from past situations? Since 1970, SIPC has returned money to 625,000 customers of 318 failed brokers. CAPCO was formed in 2003 and has never been tested. The two most recent broker/dealers failures were MJK and Refco. MJK went bankrupt in September 2001, at the time the largest liquidation in SIPC history. The broker/dealer suffered from problems in its securities lending operations by not matching assets and collateral appropriately. Refco, at the time a leading market maker in the futures market, collapsed in 2005 as a result of the CEO fraudulently hiding losses from a separate hedge fund on to the books of Refco. Refco subsidiaries covered by SIPC received their money almost immediately and MJK customers received their assets within a few weeks. Many people ask about high profile broker, Drexel Burnham, who filed for bankruptcy in 1987. However, Drexel made all of its customers whole before it declared bankruptcy and never became a SIPC case.
The obvious and most tangible case study is the existing situation with Bear Stearns. As with everything on Wall Street, it is not a straightforward situation. First we must differentiate between hedge funds that use Bear Stearns as a prime broker and high net worth customers who use Bear Stearns for custody. The risks are different for each constituent.

1. Bear Stearns Prime Brokerage ("PB"): Hedge fund managers will hire this group to act as their custodian, clearing agent, lender, and other operational support. The PB is owned by The Bear Stearns Companies Inc. and if Bear Stearns were to go insolvent, there could be a temporary freeze on trading. As described earlier, there could be a problem in the mismatch of assets and collateral held at the PB so some hedge funds could lose assets or cash collateral and certainly trading would be frozen for some period of time while everything was sorted. For a hedge fund manager that needs access to funds in order to make trades, modify hedging positions, or meet redemptions, not being able to access assets could put them out of the business. It was for this reason that on March 21 there was a mass exodus of hedge fund managers who pulled their accounts from Bear Stearns. (FYI- none of our hedge fund managers had but a minor amount of assets or exposure to Bear Stearns as of March 21).

2. Bear Stearns Securities Corp ("BSSC"): In July 1991, in order to attract non-institutional, non-hedge fund assets, Bear Stearns set up a separately capitalized, broker-dealer subsidiary “for the express purpose of having all customer accounts and transactions held and processed in an entity which would not conduct any proprietary trading or market making activities”. Bear Stearns, to the best of our knowledge is the only major broker/dealer that set up a new company in order to offer segregated custody from the firm’s prime brokerage operations. While BSSC still has the same risks as any broker/dealer (already discussed), there is an extra layer of protection in the sense that assets held in this group is not commingled with those of the firm’s PB or proprietary trading.

So you may be asking yourself, “Self, what is my worst case scenario”? Let’s examine the possibilities. It almost goes without saying that assets held directly at a trust bank are almost free of custody risk. This leaves clients that use a broker/dealer as custodian (Charles Schwab, Bear Stearns, Goldman Sachs, etc.). First off, the full service brokerage firms like Bear Stearns, Goldman Sachs, Lehman Brothers, Morgan Stanley and the like (in contrast with Charles Schwab et al.) are perhaps most at-risk for insolvency mainly because they are tremendously levered and this leverage is very short term in nature. In essence, they are subject to a crisis in confidence more than a situation of liabilities exceeding assets. As we have seen with Bear Stearns recently, their client base is less loyal and can quickly change providers at the first hint of a problem. This “run on the bank” scenario is exactly why the Federal Reserve recently made available loans directly to investment banks, something it had never done before. The B/Ds also engage in proprietary trading, bringing about the 100% non-quantifiable “rogue trader” risk. Recall that the actions of one or two individuals resulted in Societe Generale losing $8bn this year (Jerome Kerviel), Barings Bank becoming insolvent and worth only £1 after 200+ years in
operation (Nick Leeson), and resulted in the government suit against Drexel Burnham that put them out of business (Michael Milken).

Broker/dealers not in the proprietary trading business are also subject to insolvency. MJK, for example, had internal problems matching collateral on their securities lending program compounded by the September 11, 2001 event resulted in a violation of their regulatory capital requirements. Many broker/dealers including heavyweights Charles Schwab and Fidelity routinely use the margin account as the default setup when customers open brokerage accounts (note: Presidio defaults to the cash account set up for all of our clients). This allows them the flexibility to lend securities to hedge funds that need them (the B/D keeps the profits and does not share it with the owner of the security). Electronic trading firm E-Trade came close to bankruptcy last year when it wrote down major mortgage security losses from its bank subsidiary. Refco was a case of outright fraud when the CEO hid losses from a separate hedge fund vehicle that he owned on Refco’s balance sheet. Ironically, Refco declared bankruptcy only months after their IPO – a process that put the firm under the most stringent scrutiny by auditors, bankers, and regulators. All B/Ds have risks that almost certainly cannot be observed by an outsider or customer ex-ante.

How likely is it that a Schwab/Fidelity/Vanguard could get into such a bad situation? After all, they do not have proprietary trading, underwrite loans to private equity funds, or structure sub-prime mortgages. Perhaps a “perfect storm” of adverse and seemingly unconnected events could occur across their various business lines. Their biggest potential liability is the fact that they are asset managers, a role that attracts lawsuits when markets do poorly. Schwab, for example, is currently attracting plenty of unwanted attention after one of its enhanced money market funds fell almost 20% in 2008. Such liability on top of sloppy securities lending practices and/or poor treasury management and/or a slowdown in their core business could theoretically lead to insolvency. Could such a series of events happen? Not likely but certainly not impossible. Even if Schwab did go bankrupt and there was a loss of on their securities lending program the loss would be evenly spread throughout their over $1.0 trillion in assets under custody.

While we are not trying to scare anyone needlessly, it is important to understand that all broker/dealers have limited physical assets (buildings, real estate, cash) and comprise mostly of human capital and the confidence their customers have in the firm. If you take away the confidence for whatever the reason, a “run on the bank” scenario is a possibility that would force the firm into bankruptcy regardless of the capital adequacy of the broker/dealer. Since we are dealing with human emotion and confidence, no one can state with certainty the likelihood of such an event occurring.

We believe the real risk is not losing one’s assets but the nervousness that comes with the inability to access one’s liquid wealth that would occur while SIPC locates a new clearing firm. Historically this has
taken days or weeks to accomplish. Southwest Securities took over MJK and Man Financial took Refco’s accounts. For there to be a substantial and permanent loss, a host of events must occur including: (1) The B/D must go insolvent, (2) A significant sum of assets were lent out, (3) There was not enough collateral posted despite the daily mark to market netting, (4) The loss was greater than SIPC coverage, (5) The loss was greater than CAPCO or insurance coverage, (6) The loss was large when spread across all of the B/Ds asset base, and (7) The magnitude of the loss did not cause the Federal government to step in (we presume that in a major loss the government would do so to prevent a major panic). Since there is no way to put a probability on such a series of events we will not attempt such an exercise. Why would you not use a Trust bank for custody?

The history of trust banks offering custody is an interesting study on financial Darwinism. A couple of decades ago there were dozens of custodians offering their services. However, the combination of low fees, commodity services, and high fixed costs primarily on IT resulted in a massive wave of consolidation. Today, there are only four major global custodians (Northern Trust, BoNY, State Street, JPMorgan Chase) and a handful of smaller, niche firms (e.g. Pictet, Brown Brothers, Union Bank of California). The key players custody trillions of dollars each as they house the world’s institutional assets.

The global custodians have made only small in-roads to the high net worth marketplace and only with the largest family offices. Even with very large family offices the custody fees are generally higher than what they might be charged at a broker/dealer assuming the custodian even wants the business. While broker/dealers engage in several high margin businesses that help offset the people intensive clearing and custody businesses, trust banks have historically concentrated on custody first and perhaps low margin passive asset management and money market funds as an adjunct. Fair warning: This is beginning to change. JPMorganChase is growing their broker/dealer business (acquisition of Bear Stearns), Northern Trust and State Street both have a good size active asset management divisions, and Bank of New York acquired a number of asset managers recently including large hedge fund-of-funds shop, Ivy Asset Management. Nevertheless, as it relates to their custody business trust banks tend to be technology heavy and light on human capital. A $20bn institution may have no more client servicing demands than a $10m high net worth client. It is no mystery why the custodian has sought the former and shunned the latter even as high net worth clients have traditionally not valued the additional level of security and disdained the higher level of fees.

What are your options?

Like voting in communist Soviet Union, individuals that use full service broker/dealers for their wealth management solution have a single option: custody at that B/D. If you have a relationship with Goldman Sachs or Morgan Stanley you absolutely must hold your assets at that firm and in Street Name.
In such a scenario you take your chances. To you hardy souls, “Caveat Emptor”. An intermediate step would be to custody with a broker/dealer like Charles Schwab or Fidelity who does hold client assets in their name but most likely has far less risk than a more levered B/D. Such an arrangement requires the investor to then either “go it alone” or utilize an independent financial advisor. Finally, trust banks offer the ultimate in security but generally require very large asset bases, fees can be significant, and you generally need to utilize the services of an independent advisor. Note that most independent wealth advisors employ a broker/dealer of some sort for their custody services because their size is not attractive enough for a trust bank relationship.

Again, so what?

At the risk of over using the turtle analogy referenced in the introduction, we believe that the best investment programs are not built with one turtle standing on the back of the next. Such architecture is subject to the weakest turtle with the outcome eventually resulting in a dramatic tumble. The preferred schematic for our “bale of turtles” is a line with each marching to the same beat.

Okay, enough with the analogies. Presidio Wealth Management has always adopted the philosophy that each and every service provider must stand alone and on its individual merits. Do not be beholden to the total “wrap solution”. Such product offerings are the equivalent of a roach motel: easy to enter but impossible to check out. With any of the major broker/dealers you are limited to their custody solution, their in-house products, their execution, their lending facilities, their counterparty risk, and their salesperson. It is an “all or nothing” situation with no ability to find the best money managers, best execution, best lending terms, the safest counterparty, and the safest custodial solution. In a crisis situation, all of these providers are interconnected to the parent firm and might collectively suffer to create the perfect storm.

While Presidio has always recognized the risks in employing a broker/dealer as a custodian, it has historically been difficult convincing high net worth families to pay extra fees for the additional security of assets. The dramatic fall from grace by Bear Stearns has made this risk tangible. Also, until recently, trust banks were not interested in non-institutional clients; this has begun to change. As one of the largest independent investment advisors in the country, Presidio Wealth Management can and does use its size to negotiate the best terms with the top service providers. In fact, we have received quotes from each of the top global custodians and believe that we may be able to finalize an arrangement with one of them such that the cost differential may be negligible for many clients. We look forward to reviewing our findings with you shortly.