If Your Brokerage Goes Broke

How solid is coverage for losses over $500,000? BY TODDI GUTNER

IN THE EVENT OF A CATASTROPHIC firm failure, can major brokerage companies really deliver on their promise to insure the cash and securities in their customers' accounts? That's a question for clients of the 14 firms that a year ago organized a captive insurer called Customer Asset Protection Co. CAPCO's mission is to provide virtually unlimited coverage above the $500,000 per account offered by Securities Investor Protection Corp. (SIPC).

According to CAPCO's Web site, "there is no specific dollar limit to the protection that CAPCO offers on customer accounts." But if you want to know what the financial backing is for that coverage, you won't get very far. "That's proprietary information," says CAPCO President Frank Lagerstedt. *BusinessWeek* tried to ferret out this information by analyzing more than 50 Securities & Exchange Commission (SEC) quarterly 10Q and annual 10K documents of CAPCO members. We did come up with an estimate of the insurer's initial capitalization. But that provides only a partial picture of CAPCO's resources at best.

Before CAPCO, brokerages used to buy unlimited excess coverage (also known as full-net-equity protection) from Travelers Property Casualty, Radian Asset Assurance, and American International Group. That insurance was intended to compensate customers for missing cash and securities as a result of firm failure—not investment losses—beyond the amount that SIPC covers. Then, despite racking up millions in premiums and never paying a claim, those insurers left the business in August, 2003, because, say industry experts, they couldn't quantify their potential liability from a brokerage firm failure.

To replace the excess coverage they had lost, 14 brokerages formed CAPCO. Others, including Charles Schwab, Merrill Lynch, and UBS Financial Services, declined to join the consortium. Spokespeople for Merrill and UBS say other options were better for their clients than CAPCO. Robert Meave, an insurance consultant to Schwab, says: "We weren't comfortable telling clients: 'You have unlimited insurance coverage—and by the way, we're founders of the insurance company.'"

Merrill and Schwab went to Lloyd's of London for excess SIPC coverage. Lloyd's insures $150 million per customer, but no more than a total of $600 million per broker-dealer. UBS turned to XL Insurance (Bermuda) Ltd., which also has a $600 million cap (table, page 178).

When companies say they have virtually unlimited insurance coverage, you'd expect them to provide proof that they can support the potential liability. In other words, "show me the money," says Robert Poyourow, a senior vice-president at AON, the insurance broker that structured the XL policy for UBS Financial Services.

LEGALLY TIGHT LID

LAGERSTEDT SAYS CAPCO doesn't need to divulge its capitalization and other financial information to the public. He says CAPCO provided that data to Standard & Poor's before S&P gave the insurer an A+ rating last December. "CAPCO's rating is considered strong because the likelihood of a material loss is very low," says Jason Jones, the S&P analyst who evaluated CAPCO. (S&P, like *BusinessWeek*, is owned by The McGraw-Hill Companies.)

Lagerstedt has legal backing for withholding the information, as *BusinessWeek* recently discovered after the New York State Insurance Dept. denied our Free-

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dom of Information Act (FOIA) request for CAPCO's financial information. Under New York Insurance Law, Section 7003(c) (3), the information filed by a captive insurer in its application for licensing is "given confidential treatment and shall not be subject to public inspection...except to the extent the superintendent finds release of information necessary to protect the public...."

After the FOIA request was denied, *BusinessWeek* was able to estimate that CAPCO had an initial capitalization of $75.6 million. We pieced this together by reviewing more than 50 financial documents of CAPCO member firms. One member reported in its 10Q that it invested $5.4 million. Since CAPCO has disclosed that each member owns equal shares, we multiplied $5.4 million by 14, for a total of $75.6 million.

Who's Insuring Whom?

The Securities Investors Protection Corp. (SIPC) insures retail brokerage accounts for up to $500,000 each in the event of a firm failure. To cover losses beyond that, brokers have arrangements with the following insurers:

CAPCO	A captive insurer of 14 brokerages that says it has no dollar limit on excess SIPC coverage
Member firms	Robert W. Baird, Bear Stearns, Credit Suisse First Boston, A.G. Edwards, Goldman Sachs, Edward Jones, Legg Mason Wood Walker, Lehman Brothers, J.P. Morgan Chase, Morgan Stanley, National Financial Services (Fidelity Investments), Pershing (Bank of New York), Raymond James Financial, and Wachovia Securities
LLOYD'S OF LONDON	Offers $150 million per customer but no more than a total of $600 million per broker-dealer for customer losses
Client firms	Ameritrade, E*Trade, Merrill Lynch, Charles Schwab, Smith Barney/Citigoup, T.D. Waterhouse
XL INSURANCE	Insures for up to $600 million in total customer losses
Client firm	UBS Financial Services

MARKETING GLOSS?

EVEN KNOWING THIS, it's impossible to assess CAPCO's complete financial picture. First, each member must pay a yearly premium for its CAPCO coverage. CAPCO, in turn, may buy reinsurance to cover a portion of its future liabilities. We don't know how much reinsurance CAPCO has or how much of the member premiums go to boosting the company's capital. CAPCO also won't say whether member firms are required to ante up additional capital if a large claim drains its resources.

Of course, as long as CAPCO doesn't have to pay a claim, the company's financial backing doesn't come into play. In fact, the need for excess SIPC coverage has been minimal in the past. Since 1970, SIPC has paid claims to 623,000 brokerage clients. Only 311 of those clients had losses beyond what SIPC provided. The total excess coverage was $40 million—and $10 million went to one client alone. "Most of those claims arose prior to 1980, when SIPC covered only $50,000, not the $500,000 limit it is today," says Stephen Harbeck, president of SIPC.

That history leads some in the industry to say that excess SIPC coverage is little more than a marketing tool for brokerages that say they offer it. "We buy insurance for the sleep-at-night factor, and excess SIPC has always been a nice enhancement for clients," says Schwab's consultant, Meave. "You had it because your competitors had it." Rather than consider the amount of excess SIPC coverage a firm carries, says Meave, an investor should place more emphasis on its financial strength.

Still, if brokerages are going to use unlimited excess SIPC coverage as a selling point, don't they owe their customers a better explanation of how they intend to provide it?

Benefits

Time to Empty That Piggybank

Use it or lose it. That's the mantra those with flexible spending accounts (FSAs) should be repeating to themselves as the year winds down. An FSA allows you to set aside up to $5,000 in pretax dollars to pay for medical expenses not covered by your company's regular health-insurance plan.

The catch is that once you agree to contribute a certain amount, you have to use it up by the end of the benefit year or forfeit the remaining funds to your employer. According to a recent study of 1,084 employees at major corporations by Richard Day Research on behalf of Fidelity Investments, 91% of FSA users spent the full amount in their accounts last year. Of those who didn't, a third reported leaving less than $100.

If you're still facing a big balance in your account, here are some ways you can eat up the surplus:

- **Remember your copays and deductibles.** The fixed amounts you have to pay for doctors' visits and prescriptions qualify as FSA expenses, as does what you spend out-of-pocket before your out-of-network coverage kicks in.
- **Stockpile over-the-counter medications.** As of this year, you can get reimbursement for everything from aspirin to cough syrup. Check with your plan administrator to see what's covered. Of course, don't forget to submit your prescription drug receipts as well.
- **Take care of your eyes.** In addition to an eye exam and prescription glasses, your FSA will cover vision-correction surgery and eye drops. You can also stock up on disposable contact lenses.
- **Visit your dentist.** Have an extra cleaning, get those braces you've been considering, or buy dental supplies, such as teeth-whitening cream.
- **Seek preventive care.** Get a flu shot (if you can find one) or have your cholesterol checked. *-Toddi Gutner*