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If a Brokerage Firm Closes Its Doors

Given the turbulence affecting the financial services industry these days, you may be wondering what would happen to your securities account if your brokerage firm closed its doors.

In virtually all cases, when a brokerage firm ceases to operate, customer assets are safe and typically are transferred in an orderly fashion to another registered brokerage firm. Multiple layers of protection safeguard investor assets. For example, registered brokerage firms must keep their customers' securities and cash segregated from their own so that, even if a firm fails, its customers' assets will be safe. Brokerage firms are also required to meet minimum net capital requirements to reduce the likelihood of insolvency, and to be members of the Securities Investor Protection Corp (SIPC), which insures customer securities accounts up to \$500,000. SIPC insurance comes into play in those rare cases of firm failure where customer assets are missing because of theft or fraud. In other words, SIPC insurance is used as a last course of action in the unlikely event that the other customer protections have failed.

This publication explains the role regulators—including FINRA—play when a firm goes out of business unexpectedly, and what you should know and do in the event that your brokerage firm ceases to operate. While the customer safeguards are extensive and the track record of making investors whole in the aftermath of a financial crisis is strong, not all investor assets may be covered, and there are steps and precautions investors can take to help protect their assets—not to mention their peace of mind.

Updated Information for Former Customers of Lehman Brothers, Inc.

On December 2, 2008, SIPC announced that an estimated 925,000 claims forms were mailed to customers and creditors of Lehman Brothers Inc. (LBI). View [more information](#).

Regulatory Safety Net

Brokerage firms are required to follow certain rules that are designed to minimize the chances of financial failure and, more importantly, to protect customer assets if they do fail. For example, the SEC's Rule 15c3-1—the "Net Capital Rule"—requires brokerage firms to maintain certain levels of their own liquid assets. The minimum net capital a firm must have on hand depends on its size and business.

In addition, the SEC's Rule 15c3-3—the "Customer Protection Rule"—requires brokerage firms that have custody of customer assets to keep those assets separate from their own accounts. In other words, customers' cash must be placed in a special, separate "reserve" account; and fully paid customer securities must be kept separate from firm and customer margin securities.

Carrying and Introducing Firms

To understand how these rules work, it is helpful to understand the difference between "clearing and carrying" firms (or "carrying" firms for short) and "introducing" firms. When you open an account with a brokerage firm that is a carrying firm, the firm not only handles your orders to buy and sell securities, but it also maintains custody of your securities and other assets (like any cash in your account). With an introducing firm, the brokerage firm accepts your orders—but it will have an arrangement with a carrying firm to maintain custody of your securities account. Because they have custody of customer assets, carrying firms must maintain higher levels of net capital than introducing firms—and they are responsible for segregating the customer funds and securities in their custody.

Additional rules require firms that do business with public customers to have their financial statements audited by an independent accounting firm annually. All brokerage firms must file financial statements (on Form X-17A-5) with the SEC—and those that are publicly traded must file quarterly, annual and other periodic reports with the SEC (which

investors can view using the SEC's [EDGAR database](#) of company filings). We describe how an investor can obtain a firm's financial statements in our [Investor Checklist](#).

What Happens to My Account?

Historically, brokerage firms that have faced financial insolvency—meaning they cannot meet their financial obligations as they come due—have handled the crisis in different ways. Some have been able to find a buyer to stave off insolvency. Bear Stearns, for example, was bought by J.P. Morgan in 2008.

Other firms self-liquidate, as did Drexel Burnham Lambert in 1990. When a brokerage firm self-liquidates, securities regulators, including the SEC and FINRA, work with the firm to make sure that customer accounts are protected and that customer assets are transferred in an orderly fashion to one or more SIPC-insured brokerage firms.

If My Firm Fails, What Do I Do?

The failure of a brokerage firm will understandably cause some anxiety for the firm's customers. The first thing you should do is avoid panic. If you hear your firm is in financial trouble, contact the firm to see what procedures you should follow. For example, there may be a window of time when you cannot trade or transfer your account.

What Happens if SIPC Protection Is Invoked

SIPC is a non-profit organization created in 1970 under the Securities Investor Protection Act (SIPA) that provides limited insurance to investors on their brokerage accounts if their brokerage firm becomes insolvent. All brokerage firms that do business with the investing public are required to be members of SIPC. SIPC protection is limited. It covers the replacement of missing stocks and other securities up to \$500,000, including \$100,000 in cash claims. However, it does so only when a firm shuts down due to financial circumstances in which customer assets are missing—because of theft, conversion, or unauthorized trading—or are otherwise at risk because of the firm's failure.

SIPC does **not** cover the following:

- Ordinary market loss;
- Investments in commodity futures, fixed annuities, currency, hedge funds or investment contracts (such as limited partnerships) that are not registered with the SEC; and
- Accounts of partners, directors, officers or anyone with a significant beneficial ownership in the failed firm.

SIPC coverage of \$500,000 is extended to each "legal customer." For instance, if you have three accounts at a firm—and one is an individually held account in your name only, another is a joint account with your spouse, and a third is an IRA account in your name—each account is considered a separate "legal customer" and each will be eligible for full SIPC coverage.

SIPC Liquidation: Step-by-Step

In almost four decades of operation, SIPC has advanced approximately \$508 million to facilitate the return of more than \$15.7 billion in cash and securities to an estimated 625,000 customers.

If a SIPC liquidation takes place, you will be notified by letter that your brokerage firm has closed and that SIPC has begun a "Direct Payment Procedure" or a liquidation proceeding in court. If you receive such a letter, SIPC advises in its [Investor's Guide to Brokerage Firm Liquidations](#) that you promptly:

- Gather key information together, including brokerage account records, monthly or quarterly statements and trade confirmations;
- Locate cancelled checks and correspondence with your brokerage firm;
- Check your account statements for accuracy and verify that the statements reflect all cash deposits you sent to

the brokerage firm. Determine if there are any transactions that you did NOT authorize.

- Verify your correct address. If you hear about a liquidation that involves your firm and have not received a letter, go to the [SIPC Web site](#) for contact information.
- Follow SIPC instructions in filling out necessary forms; and
- Pay strict attention to time limits set forth in the notice and claim form. Under federal law, no one—not the trustee, SIPC or the court—has the authority to satisfy claims that are filed late.

Once liquidation is initiated, most customers can expect to receive their assets in one to three months. The speed at which customer funds and securities are returned depends on a number of factors, including the accuracy of brokerage firm records.

Investors should be aware that they may be unable to transfer accounts or execute trades during the liquidation process. Furthermore, if a clearing firm is in financial trouble or in liquidation, this may affect customers of introducing firms that clear through the troubled firm, including their ability to trade, liquidate their securities positions and/or transfer holdings to another firm.

Some firms carry additional insurance over the protection limits currently provided by SIPC. Protections are generally triggered only in the event of the financial failure and liquidation of a participating securities affiliate and if the customers' securities are not returned by the firm or through SIPC. Two prominent names in the excess insurance business are a consortium of brokerage firms that formed the [Customer Asset Protection Co \(CAPCO\)](#) and Lloyds of London. As with all insurance, the ability to pay claims depends on the financial strength of the carrier. In addition, some policies may have caps or other limits on the amount of protection provided to individual customers or to the firm's customers as a group.

SIPC vs. FDIC

While SIPC insures customer assets in brokerage accounts, FDIC insures assets in bank accounts. The chart below outlines the major differences in coverage:

	FDIC	SIPC
What's insured	Bank deposits, money market deposit accounts (which differ from money market mutual funds) and certain retirement accounts	Securities and cash held in a brokerage account at a SIPC member firm
Protection limits	\$250,000 per depositor in each bank or thrift (this limit might change at the end of 2009); \$250,000 per insured retirement account	Up to \$500,000, including \$100,000 in cash
What's not insured	<ul style="list-style-type: none"> ▪ Investments in mutual funds (stock, bond or money market mutual funds), whether purchased from a bank, brokerage or dealer ▪ Annuities (underwritten by insurance companies, but sold at some banks) ▪ Stocks, bonds, Treasury securities or other investment products, whether purchased through a bank or a broker-dealer 	<ul style="list-style-type: none"> ▪ Losses due to market fluctuation, poor investment decisions or lost investment opportunities; ▪ Investments in commodity futures, fixed annuities, currency, hedge funds or investment contracts (such as limited partnerships) that are not registered with the SEC; and ▪ Accounts of partners, directors, officers or anyone with a significant beneficial ownership in the failed firm.

Investor Checklist

There are steps investors can take in advance to minimize the chances of being involved with a brokerage firm that ends up in financial distress. For a checklist that can help you steer clear of firms that pose financial and fraud risk to investors [click here](#).

FINRA's Role

FINRA monitors firms for compliance with the Customer Protection Rule, the Net Capital Rule and other financial responsibility rules through its surveillance and examinations programs:

- **Surveillance**—FINRA conducts ongoing surveillance of the financial condition of brokerage firms. This involves monitoring a firm's capital position and material changes in its business—such as a merger, acquisition, divestiture, any change in clearing relationships, or any change in operating systems and changes to its business model. We also review the financial reports that firms must file with both FINRA and the SEC, and we conduct an assessment of all carrying firms to identify potential regulatory risks and the extent to which exposure to those risks could impact a firm's financial stability. Separately, FINRA monitors the customer complaints firms receive concerning both sales practice and operational issues. We also keep a close eye on how firms handle the transfer of customer accounts, including the timeliness of transfers of customer assets from one firm to another.
- **Examinations**—FINRA regularly examines regulated brokerage firms for compliance with a host of SEC and FINRA rules, including financial responsibility and customer protection rules. This involves reviewing financial statements and verifying that carrying firms properly calculate cash reserves, make timely and accurate deposits of customer funds, and follow the rules concerning custody of customer securities. Our examiners review firms' books and records to verify that they are current and accurate and maintained in compliance with SEC and FINRA regulatory requirements. They also look at supervisory systems and controls to assess whether a firm has adequate written policies, procedures, and a practical framework to capture and monitor relevant risks related to its business activity.

If we uncover financial problems at a brokerage firm, we promptly report issues to the SEC and, if it appears that theft or fraud has occurred, to SIPC. These matters are also referred to FINRA's Enforcement Division for further action.

If a failing firm is in compliance with the Customer Protection Rule, the Net Capital Rule, and other financial responsibility rules, it will be able to "self-liquidate"—meaning that it should be in a position to return all customer securities and other assets in an orderly and timely fashion. In the rare circumstance where customer assets appear to be missing—as, for example, in the case of fraud or theft—a SIPC liquidation may be necessary.

Additional Resources

- SIPC Press Release, [December 2, 2008](#)
- SIPC Press Release, [September 18, 2008](#)
- SIPC Brochure, [The Investor's Guide to Brokerage Firm Liquidations: What You Need to Know...And Do](#)
- SIPC, [How SIPC Protects Investors](#)
- [FINRA BrokerCheck](#)
- FDIC, [Are My Deposits Insured](#)

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