ORRICK Investment Risks Client Alert

INVESTMENTS HELD IN DISTRESSED FINANCIAL INSTITUTIONS AND STOCKBROKERS: A USER'S GUIDE

The current economic crisis raises critical questions for individuals, companies and other entities regarding the safety and liquidity of their cash and investment accounts at troubled banks and other financial institutions. The following is a brief summary of the current landscape, along with a few practical tips. Note that the situation is fluid as new regulations are being promulgated to promote greater confidence in the safety and soundness of our banking institutions. Lawyers in Orrick's Creditors' Rights and Bankruptcy Group would welcome the opportunity to speak with you about recent developments and address any specific questions that you may have.

October 29, 2008

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Topics included in this alert:

BANK DEPOSITS AT DISTRESSED FINANCIAL INSTITUTIONS

What is FDIC insurance?

When a bank fails, the FDIC insures depositors at that institution against loss up to $100,000 **(increased to $250,000 through December 31, 2009)** for deposit accounts held at that institution. FDIC insurance is not determined on a per-account basis, but based on all deposits held by a customer at that institution—in other words, all single accounts owned by the same person or entity at the same insured bank are added together and the total is insured up to $250,000 (there are, however, special rules that apply with respect to deposit insurance for joint accounts held by individuals and trust accounts, such that amounts held in those accounts would not be aggregated for purposes of the $250,000 limit). The FDIC will either transfer the insured portion of a deposit to another FDIC insured institution or provide deposit insurance payment checks to the customer as soon as possible. Customers who have deposits in excess of the insured amount ($250,000 for now) may recover a portion of their uninsured deposits, but there is no guarantee; if there is money remaining from the liquidation of the bank's assets, then customers with uninsured deposits will receive periodic distributions from the liquidation proceeds on a pro rata basis with other general unsecured creditors of the bank.

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What is covered and not covered by the FDIC?

Covered
- Savings accounts
- Checking accounts
- NOW Accounts
- Time deposits (including CDs)
- Money-market deposit accounts established with banks and savings and loans

Not Covered
- Stocks
- Bonds
- Municipal Bonds
- Mutual Funds (including money market mutual funds or mutual funds that invest in stocks, bonds or other securities)
- Annuities or other insurance products, even if purchased from an FDIC-insured bank
- U.S. Treasury bills, bonds or notes (but these are subject to the full faith and credit of the U.S. government)
- Other Securities

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What about payroll accounts and other non-interest bearing deposit transaction accounts?

The FDIC has taken recent steps to provide temporarily greater protection for payroll accounts and other non-interest bearing accounts. These accounts generally would only be insured up to the FDIC insurance limit ($250,000 through December 31, 2009; generally $100,000). However, on October 14, 2008, the FDIC announced that participating depository institutions will be able to provide full deposit insurance coverage for non-interest bearing deposit transaction accounts, such as payroll accounts, regardless of dollar amount. This insurance is automatic for the next 30 days, and will continue unless the bank expressly opts out of participating. This guarantee is temporary and expires **December 31, 2009**.

Tip: Consider transferring excess cash (any amounts in excess of the maximum insurance) held in a bank into a segregated trust or custody account in your name. Most banks have a custodial or trust department who can establish trust accounts for their customers.

The account must be segregated from the bank's own funds and also from the funds of other customers. Assets held in custodial accounts in the trust department of a bank do not become assets of the bank and are segregated from the bank's assets. More importantly, account ownership in the assets held in the custodial account remains vested in the individuals or entities for whose benefit the bank is acting as custodian and the assets are not subject to the claims of the bank's creditors.

Less practical, but also effective: spread the excess cash into accounts at various unaffiliated banks.

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What happens if I had deposits at two banks that merged?

If you have deposits in two separate banks that merge, deposits at both banks will continue to be insured separately for approximately **6 months** after the date of the merger. Certificates of deposit from the non-surviving bank in a bank merger will be separately insured until the earliest maturity date after the end of the 6 month grace period.

Tip: Monitor bank merger activity by creating a Google News Alert on any bank in which you hold deposits and inventory all CDs on where they are held and their respective maturity dates.

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How secure are money-market mutual funds, since they are not covered by the FDIC?

Every investment, including money market funds, has some degree of risk. Money market funds have an excellent safety record, primarily because they invest in short-term securities of the government, large institutions, and corporations. Money market mutual funds typically buy bankers acceptances (generally with maturities of less than 180 days), certificates of deposit with limited maturity, commercial paper, government-agency obligations, and repurchase agreements (usually Treasury bills, notes and bonds, but the repo may include many types of securities, including mortgaged-backed securities, government securities and corporate bonds).

Tip: The safest money-market mutual funds are those that invest in Treasury bills. Treasury bills are obligations of the U.S. government.

The Treasury Department has established a temporary guaranty program for publicly-offered money market funds. For a fee, the Treasury Department will insure the holdings of any eligible publicly offered retail or institutional money market mutual fund for the next year. To participate, the money market fund itself must pay the up-front fee; investors cannot sign up for the program individually. The guaranty only applies to balances that existed as of the close of business on September 19, 2008, or the balance when the guaranty is triggered, whichever is less. The Treasury guarantee will exist for a three-month term, subject to renewal and extension by the Secretary of the Treasury, up to the close of business on September 18, 2009.

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Does the U.S. Government guaranty all federal securities?

No—only securities issued by government agencies such as Government National Mortgage Association (Ginnie Mae), which are divisions of the federal government, carry the full faith and credit guarantee of the U.S. government.

Government Sponsored Entities (GSEs) are sponsored by the federal government but their securities are NOT guaranteed by the federal government. The Primary GSE issuers are: Federal Farm Credit System, Fannie Mae, Freddie Mac, Sallie Mae, Federal Home Loan Banks (FHLB) and Federal Farm Credit Banks (FFCB).

Fannie Mae and Freddie Mac have now been taken over by the federal government; the federal government has provided various forms of arrangements to ensure Fannie and Freddie's positive net worth and to protect holders of Fannie Mae and Freddie Mac debt and mortgaged-backed securities. The arrangements include a new liquidity facility, a new GSE mortgage backed securities purchase program and a senior preferred stock purchase program under which Treasury can purchase senior preferred stock of Fannie Mae and Freddie Mac up to $100 billion each.

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SECURITIES ACCOUNTS AT DISTRESSED BROKER-DEALERS

What happens when a broker-dealer (like Lehman Brothers, Inc.) fails?

When a broker-dealer becomes financially distressed, its assets will be liquidated either under Chapter 7 of the Bankruptcy Code or, if the broker-dealer is a member of the Securities Investor Protection Corporation (SIPC), under a liquidation proceeding commenced by the SIPC. A trustee will be appointed by the court to marshal, liquidate and distribute the assets of the failed broker to customers and to general creditors.

SIPC aids customers of failed brokerage firms when assets are missing from customer accounts. If sufficient funds are not available in the firm's customer accounts to satisfy claims, SIPC may make advances to the trustee to supplement distribution to customers, up to a ceiling of $500,000 per customer, including a maximum of $100,000 for cash claims. How are the failed broker-dealer's assets distributed?

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How are the failed broker-dealer's assets distributed?

When a broker-dealer fails, its assets are generally divided into 3 categories:

- "Customer name securities," which are securities (including stocks and bonds) registered in the name of customers, are either returned to the applicable customer or transferred on behalf of such customer to another firm;
- After the customer name securities are distributed, the remaining cash and other securities held for customers (including stocks and bonds that are, for example, held in "street name," and securities held in a margin account) is referred to as "customer property" and is divided on a pro rata basis with all customers sharing in proportion to the size of claims; and
- The non-customer property owned by a broker-dealer, which consists of any remaining general assets of the broker-dealer after expenses of the liquidation and reimbursement of SIPC for advances made by it to customers (up to the $500,000 limit per customer) are used to pay any remaining customers' claims as well as the claims of other general unsecured creditors of the broker-dealer.

Tip: The safest (but somewhat impractical) investment is securities held by a broker-dealer in a customer's name ("customer name securities"). Customer name securities are largely without risk arising from the insolvency of the broker-dealer.

Only non-negotiable securities that are registered in the name of the customer constitute "customer name securities." Customers of a failed broker-dealer are generally entitled to reclaim all of the securities that are registered in their name or are in the process of being registered (so called, customer name securities).

Securities registered in the name of a customer are usually transferred to another firm in the event of a broker-dealer failure. This process is generally completed in days or weeks following the commencement of the liquidation proceeding (rather than months/years in the case of determining customer net equity claims).

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My account has cash and securities in street name, but I thought I heard that brokers had to segregate customer funds—so aren't I protected?

Note that while brokers are required to segregate customer funds, this only means the funds are physically segregated from the broker's operations to avoid commingling with the broker's property, ***but are not necessarily segregated for customer protection***. The segregation is more like a "pool" of customer funds. Any customer funds that are "customer property" (as opposed to customer name securities) are subject to the pro rata distribution described above.

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How is the amount that I am owed by a failed broker-dealer ("net equity claim") determined?

Distribution of property other than customer name securities is based on a customer's "net equity claim." A customer's net equity claim equals the dollar amount of all cash in the customer's account at the broker dealer plus the value of securities held in the customer's account as of the date of the commencement of the liquidation proceeding minus any amount owed by the customer to the broker-dealer (for example, on account of margin loans).

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How is a net equity claim paid out?

Net equity claims are satisfied first by a pro rata distribution of "customer property," which consists principally of the pool of "street name" securities and cash held by the broker for all customers. Shortfalls in the pool of customer property might occur, for example, from a broker's use of securities pledged by customers to secure margin loans. Because customer property is distributed pro rata in a liquidation, all customers share in any shortfall, even if it is generated by activities relating to the accounts of others.

Second, customer's net equity claims are satisfied by an advance from SIPC, which insures losses for missing securities or cash up to $500,000 per customer (with a sub-limit of $100,000 for any cash held with the broker). The trustee will pay this net equity claim, to the extent possible, with the identical securities owned by that customer as of the day the liquidation case was commenced. Some SIPC members have purchased so-called "excess SIPC coverage" from third-party insurers such as the Customer Asset Protection Company that would cover claims exceeding the SIPC.

If the aggregate pool of customer property is insufficient to repay the full net equity claims of all customers, the customers will then share from the pool of non-customer property of the broker on a pro rata basis (based on the amount of the customer's deficiency) with holders of general unsecured claims.

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How does SIPC coverage work?

SIPC coverage does not function the same as FDIC insurance — payment will not be made days after a broker-dealer fails. Note that this is not a guarantee against losses on investments. SIPC will replace missing stocks and other securities and cash where it is possible to do so, such as notes, stocks, bonds, mutual funds (including money market mutual funds) and other investment company shares, and other registered securities. It does not protect investors when the value of their stocks, bonds and other investments falls for any reason.

Customers who have more than one account at the same broker-dealer will have their accounts aggregated for purposes of the $500,000 SIPC coverage limit. However, accounts held by a customer in separate capacities will be deemed accounts of separate customers. For example, someone with an individual account, a joint account with a spouse, an individual retirement account, and a trust account will be protected up to $500,000 on each account.

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What assets are not covered by SIPC?

SIPC does not cover (and will not replace) instruments such as unregistered investment contracts, unregistered limited partnership interests, fixed annuity contracts, currency, and interests in gold, silver or other commodity futures contracts or commodity options.

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If securities are deposited in a custodial account at a bank, the bank must properly and clearly label the securities for the benefit of the customer. Under normal circumstances (absent fraud or operational error), securities properly identified in a custodial account at a bank should be returned to the customers in the event of a failure of the bank.

Tip: Consider having excess cash/assets held in broker accounts transferred to a custodial account, preferably with a non-affiliated custodian. Operationally, this would require keeping some minimal amount of cash at the broker-dealer to satisfy expected market-to-mark settlements, and moving the majority to custodial accounts.

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