THE SAFETY OF CUSTOMER ASSETS HELD AT NATIONAL FINANCIAL SERVICES LLC

National Financial Services LLC (NFS) serves as the clearing firm for Commonwealth Financial Network® (Commonwealth).[1] As such, NFS provides trade execution, clearing, custody, and other related services for Commonwealth's customers' brokerage accounts. As registered broker/dealers, both Commonwealth and NFS are subject to the rules and regulations of the SEC, FINRA, and any other exchanges either firm is a member of, as well as of the Municipal Securities Rulemaking Board. Each of these regulatory organizations has certain rules and regulations regarding the safeguarding of customer assets, including, but not limited to, keeping accurate books and records, net capital requirements, and the Customer Protection Rule.

The Customer Protection Rule (Rule 15c3-3 of the Securities Exchange Act of 1934) generally requires a broker/dealer to (1) take physical possession or control of all fully paid securities and excess margin securities on its books and records; and (2) maintain with a bank a special reserve account for the exclusive benefit of its customers containing the net funds it owes its customers. Under the Customer Protection Rule, NFS is prohibited from pledging or borrowing a customer's fully paid (non-margin account) securities in its proprietary business. The rule also limits the amount of customers' securities NFS can pledge to third-party lenders to support customer margin debt owed to NFS.

SIPC—PROTECTING CUSTOMERS FROM BROKER/DEALER FAILURE

Both Commonwealth and NFS are members of the Securities Investor Protection Corporation (SIPC). SIPC was created in 1970 as a nonprofit, nongovernment membership corporation funded by member broker/dealers. Its primary role is to return funds and securities to investors if the broker/dealer holding their assets fails financially. SIPC does not reimburse customers for market loss, investment fraud, or worthless securities; instead, it steps in to help individuals whose money, stocks, and other securities are at risk when a broker/dealer files bankruptcy or becomes insolvent. The SIPC fund currently stands at $1.5 billion; it has a $1 billion line of credit with a bank consortium and borrowing power of up to $1 billion more from the U.S. Treasury through the SEC.[2]

It should be noted that, from the time SIPC came into existence through December 2007, SIPC has advanced $508 million in order to make possible the recovery of $15.7 billion in assets for an estimated 625,000 investors. Although not every investor is protected by SIPC, SIPC estimates that no fewer than 99 percent of those persons who were eligible have been made whole in the failed brokerage firm cases that it has handled to date.[3] As discussed below, NFS has arranged for additional protection beyond SIPC for its customers' cash and securities.

SIPC steps in when a firm has either failed and filed bankruptcy or is in danger of doing so. Upon either of these two events, SIPC would request a federal court to issue a protective decree and appointment of a trustee to liquidate the firm's assets.

For purposes of a liquidation under SIPC, a firm's assets are divided into three categories: (1) securities (including stocks and bonds) registered in the customer's name, which are either returned directly to the customer or transferred on behalf of the customer to another brokerage firm; (2) cash and other securities held for customers

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(including stocks, bonds, and money market funds that are invested in securities) in "street name," which are divided prorata among all customers; and (3) general assets of the firm, which are used to pay any remaining unsecured claims of customers (after SIPC payments discussed below) and expenses of the liquidation.

If the securities and funds in (1) and (2) above are insufficient to cover customers' claims, SIPC will cover the remaining shortfall owed to customers up to $500,000 (including a maximum of $100,000, which a customer may have at the time held in cash with the firm). If there is any shortfall remaining after the SIPC payment, customers become unsecured creditors of the firm.

To reiterate, if a broker/dealer fails and is subsequently liquidated under SIPC, any securities registered in a customer's name would be transferred to another firm. Cash and securities held in street name would be paid out to customers in a prorata portion of the aggregate amount of the cash and securities actually held by the broker/dealer. Any remaining shortfall would be covered by SIPC, up to a maximum of $500,000, only $100,000 of which may be the recovery of cash held at the broker/dealer.

A customer may increase his or her SIPC coverage by having different account registrations. For example, a customer with an individual account, a joint account, an IRA, and a 401(k) plan account would be eligible for $500,000 coverage in each account, for a total of $2 million.

While most customers are eligible for SIPC assistance, SIPC's funds may not be used to pay claims of any failed brokerage firm customer who is also:

- A general partner, officer, or director of the firm;
- The beneficial owner of 5 percent or more of any class of equity security of the firm (other than certain nonconvertible preferred stocks);
- A limited partner with a participation of 5 percent or more in the net assets or net profits of the firm;
- Someone with the power to exercise a controlling influence over the management or policies of the firm; or
- A broker or dealer or bank acting for itself rather than for its own customer or customers.

In addition, it should be noted that not all investments are protected by SIPC. In general, SIPC covers notes, stocks, bonds, money market funds invested in securities, mutual fund and other investment company shares, and other registered securities. It does not cover instruments such as unregistered investment contracts; unregistered limited partnerships; fixed annuity contracts; currency; and interest in gold, silver, or other commodity futures contracts or commodity options.

If a customer buys mutual funds through a brokerage account, those funds are protected by SIPC. If a customer buys mutual funds directly from the fund company, however, he or she is not protected by SIPC, because no protection is necessary. Every mutual fund is set up as a separate entity, apart from the investment advisor that manages the fund. The employees at a mutual fund company do not have direct access to customers' assets. Mutual fund assets by law are not held at the mutual fund, but rather are held in a trust account at a custodian bank. The trust account is not considered part of the bank's assets. While banks can and do fail, the mutual fund trust accounts are not involved in that failure.

After SIPC steps in, most customers can expect to receive their property in one to three months.

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ADDITIONAL CUSTOMER PROTECTION

In an effort to supplement its SIPC coverage, NFS has arranged for additional protection for customers' cash and covered securities. In 2003, NFS, along with 14 other firms, organized a captive insurance company called Customer Asset Protection Company (CAPCO).[4] CAPCO is a Vermont-licensed insurance company that has received an A+ financial strength rating from Standard & Poor's.

CAPCO provides the participating securities broker/dealers with "Excess SIPC" net equity protection for institutional and individual clients' securities accounts. This excess protection is in addition to the protection provided by SIPC and covers both securities and cash. There is no specific dollar limit to the protection CAPCO provides. CAPCO's coverage is designed to cover the difference between a customer's net equity and the total of all funds and securities distributed to the customer by other sources. Accounts and investments that are excluded by SIPC are also excluded by CAPCO.[5]

In addition to the above insurance coverage, NFS has other safeguards in place that are designed to protect its customers' assets. For example, NFS is required by the SEC to file monthly and quarterly financial and operation reports (FOCUS reports) within 14 business days of the month's end. These quarterly reports contain financial statements, including:

- Statement of financial condition
- Income statement and statement of changes in the stockholder's equity
- Regulatory schedules, including a computation of net capital, a reserve formula computation, and other key financial and operational data

Moreover, as stated above, NFS cannot use fully paid (non-margin account) customer securities for its own business. These securities must be held for the customer's exclusive benefit and are subject to the instructions Commonwealth, as the introducing broker/dealer, provides to NFS.

1. The conclusions stated in this memo equally apply to Commonwealth's relationship with Pershing LLC, which provides clearing services on a minimal number of customer accounts.
2. SIPC Annual Report, 2007
3. SIPC Track Record, ***http://www.sipc.org/who/sipctrackrecord.cfm***, 2008
4. Including Pershing LLC
5. CAPCO, ***http://www.capcoexcess.com/USA/index.html***

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HYPOTHETICAL SITUATIONS

Example #1. If NFS was supposed to have $1 billion in customer assets on the date it failed, of which $1 million was yours, but it only had $900 million due to bad loans, you would get back 90 percent of your $1 million, or $900,000, worth of securities from the common pool ($900 million ÷ $1 billion x $1 million). This payment would leave you with a $100,000 deficit. As a result, SIPC would dip into its funds, up to your individual $500,000 limit. In this case, you would get $100,000 from SIPC and therefore be made whole.

Example #2. If NFS was supposed to have $1 billion in customer assets on the date it failed, of which $5 million was yours, but it only had $900 million due to bad loans, you would get back 90 percent of your $5 million, or $4.5 million, worth of securities from the common pool ($900 million ÷ $1 billion x $5 million). This payment would leave you with a $500,000 deficit. As a result, SIPC would dip into its funds, up to your individual $500,000 limit. In this case, you would get the SIPC maximum of $500,000 and therefore be made whole.

Example #3. If NFS was supposed to have $1 billion in customer assets on the date it failed, of which $4 million was yours in securities and $1 million was yours in a cash account for a total of $5 million, but it only had $900 million due to bad loans, you would get back 90 percent of your $5 million, or $4,500,000, from the common pool, consisting of $3.6 million worth of securities ($900 million ÷ $1 billion x $4 million) and $900,000 in cash ($900 million ÷ $1 billion x $1 million). This payment would leave you with a $500,000 deficit consisting of $400,000 of securities and $100,000 of cash. As a result, SIPC would dip into its funds, up to your individual $500,000 limit ($400,000 for securities and $100,000 for cash). In this case, you would get the SIPC maximum of $500,000 and therefore be made whole.

Example #4. If NFS was supposed to have $1 billion in customer assets on the date it failed, of which $50 million was yours, but it only had $900 million due to bad loans, you would get back 90 percent of your $50 million, or $45 million, worth of securities from the common pool ($900 million ÷ $1 billion x $50 million). This payment would leave you with a $5 million deficit. As a result, SIPC would dip into its funds and pay you the maximum amount allowed: $500,000. In this case, you would still be $4.5 million short. CAPCO would then step in and pay you the remaining $4.5 million and, again, you would be made whole.

FREQUENTLY ASKED QUESTIONS

Q: In the event Commonwealth fails, are my funds at risk?

A: No. As a fully introducing broker/dealer to NFS, Commonwealth does not have custody of client funds or securities.

Q: In the event NFS fails, do general creditors share in the distribution of cash and securities of all client assets on hand?

A: No. Clients receive a preferential distribution of cash and securities equal in value to their prorata share of all client assets on hand, in which general creditors do not share.

Q: What is the limit of SIPC coverage?

A: SIPC coverage is limited to $500,000 per customer, including $100,000 for cash.

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Q: Is the $500,000 SIPC coverage for each account a customer has at NFS or for all the customer's accounts?

A: The limit is $500,000 per person, per account type. For example, if an individual customer had two individual accounts in his name, those accounts would be combined for SIPC purposes and his total SIPC coverage would be $500,000. If a customer and his spouse each had individual accounts, individual IRAs, 401(k) plan accounts, and a joint account, however, each account would be eligible for $500,000 of SIPC coverage.

Q: Are margin accounts treated differently from other accounts?

A: No. You will receive your prorata share of the net equity value of your account.

Q: Are money market funds treated as securities or cash?

A: Money market funds are treated as securities and fall within the $500,000 securities maximum.

Q: If I am not fully reimbursed from my prorata share and my SIPC payment, is there any other source to make me whole?

A: Yes. To cover this exact possibility, NFS, along with 14 other firms, created a captive insurance company called Customer Asset Protection Company (CAPCO). CAPCO provides NFS with "Excess SIPC" net equity protection for institutional and individual clients' securities accounts. This excess protection is in addition to the protection provided by SIPC and covers both securities and cash.

Q: Is there any limit to the amount CAPCO will pay me, like there is with SIPC?

A: No. There is no specific dollar limit to the protection CAPCO provides. CAPCO's coverage is designed to cover the difference between a customer's net equity and the total of all funds and securities distributed to the customer by other sources. Payment, as with all insurance companies, is subject to CAPCO's financial strength and claims-paying ability. CAPCO has received an A+ financial strength rating from Standard & Poor's.

Q: Is there any exclusion to what SIPC covers?

A: Yes. SIPC does not cover commodity futures contracts, fixed annuity contracts, and currency, nor does it cover investment contracts such as limited partnerships.

Q: If NFS goes under, how quickly will I get my investments back?

A: Historically, customers have received their property and payments within one to three months.