

Is My Money Safe at Schwab?

For the past few years, financial scandals have erupted one after another. At the forefront of the media, every headline reads, "CEO Indicted on Fraud Charges" or "Financial Scandals Alive and Well in 2003." Look at giants like Enron and powerful financiers like Richard S. Strong of Strong funds. It's no wonder wealthy people are wary of investing their money anywhere these days! The aforementioned examples beg the following questions... Could Charles Schwab be a future financial scandal? Could they abscond with their customer's wealth? What would happen if Charles Schwab filed bankruptcy? In summary... **IS MY MONEY SAFE?**

First, let's clarify the question. There are two categories of risk investors face – **Investment risk** and **Custodial risk**.

Investment risk is the risk that investments may fail to produce the expected return due to market or security factors.* The stock market drop of the early 2000's was an investment risk. Losses associated with Enron, WorldCom and Tyco were also investment risks. These risks are managed through diversification and portfolio strategies.

Custodial risk is the risk that the holder or custodian (i.e., Schwab) of wealth may cause wealth to be lost. Bank failures, fraud and theft are examples of custodial risk. In this article, we will address custodial risk. Investors accept the investment risk inherent in the portfolio strategy they have adopted. However, investors rely on their custodian to ensure that their money is not stolen, lost or misplaced.

Is custodial risk significant? Should investors take steps to protect themselves from custodial risk? If so, what steps are appropriate? The first step is being informed. Good news... you're half way there!

To investigate all of these questions, we must start by asking; who are the custodians of client wealth invested by Resource Consulting Group (RCG)? Following is a table summarizing the role of the various participants in the management of RCG client wealth:

<u>Participant</u>	<u>Investment Risk</u>	<u>Custodial Risk</u>
Client	Yes	Yes
Resource Consulting Group	Yes	No
Charles Schwab & Co	No	Yes
Dimensional Fund Advisors	Yes	No
Vanguard Funds	Yes	Sometimes
PNC Bank (DFA custodian)	No	Yes
Wachovia Bank (Vanguard custodian)	No	Yes
Depository Trust & Clearing Company	No	Yes

*If you have further questions about investment risks, please contact our office for clarification.

Each of these institutions adds both a layer of custodial risk and a layer of protection. For example, an employee of Charles Schwab could forge documents in an attempt to steal the wealth of a Charles Schwab customer. Doing so with a RCG account would require selling mutual funds. When RCG does their daily download of updated client information, they would instantly see that an unauthorized trade had been done and start investigating immediately. All of these institutions have information that could allow them to steal client wealth and systems to reduce the chance that will happen. Moreover, these safety systems reduce the chance of theft within other institutions in the process. RCG helps protect the client against Charles Schwab and vice versa.

Charles Schwab & Co.

Charles Schwab is the custodian at the first level, and they hold shares in mutual funds purchased on behalf of clients by RCG. Following are the answers to some commonly asked question about the security of your wealth at Charles Schwab.

What would happen if Charles Schwab developed financial trouble?

Of course we do not expect Charles Schwab to develop financial trouble, but hypothetically speaking, it could happen. The SEC has stringent rules in place for all broker-dealers including the Net Capital Rule (15c3-1), which ensures that broker-dealers (Schwab) maintain sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers. So let's look at Schwab's current financial picture. They hold over \$1 billion in cash, have long-term debt of less than 15% of total capital, have assets totaling \$877 billion (\$31 billion in new assets in 2003) and have reduced annual operating expenses by about \$900 million last year alone.

Even with all the capital Schwab has on hand and the financial stability they have right now, there are also several safeguards in place to protect against any financial problems that may arise. If Schwab were to file bankruptcy or if fraud or theft occurred, according to SIPA¹ all broker-dealers must be fully insured. Schwab has mandatory insurance through the Securities Investor Protection Corporation (SIPC) of up to \$500,000 per customer (up to \$100,000 available in cash) and additional insurance through Lloyd's of London of up to \$150 million per client loss, of which \$900,000 may be in cash. Just in case you're wondering, money market funds are treated like securities for SIPC purposes. However, cash that is to be swept into a money market fund is not considered a security and is treated as cash. There is also another benefit of keeping your securities at Schwab as opposed to a bank. Securities held by a **bank** are considered the custody of the customer and are not covered by FDIC, so in order to secure these assets, the bank would need to purchase private bond protection, however it is not required.

1. (SIPA) Securities Investor Protection Act of 1970

In the event of failure (ex: bankruptcy) of a broker-dealer (Schwab), or unlawful business practices, the task of recovering the customer's assets lies with the trustee appointed pursuant to the SIPA. The trustee will attempt to arrange a transfer of customer accounts to other broker-dealers to minimize disruption of customer account access and facilitate the payment of customer claims. From 1970-99, only 0.07% of claims were not fully satisfied by SIPC. To counteract that problem, Schwab has the additional Lloyd's of London Insurance to cover any additional losses, which would eliminate having any unsatisfied claims.

Could a Charles Schwab employee misappropriate client mutual fund shares?

It would be extremely difficult for a Charles Schwab employee to steal client wealth for several reasons. First of all, each time an employee makes any change to an account, they must log-in, and everything is tracked back to that individual employee. Secondly, Schwab has a system of internally auditing each account every quarter and the SEC monitors all broker-dealer activity by requiring them to have external auditors come in annually to check all account activity. Schwab has contracted with Deloitte & Touche, LLP. to do this audit. In addition to the annual audit conducted by Deloitte & Touche, letters are sent to a random sample of 150 clients of advisors with their September statements. The letter requests that the client confirm the accuracy or note any inaccuracies in the information in the September statement by signing and returning the letter to Deloitte & Touche. So as you can see, there are several checks and balances to make sure your money is handled properly!

Even with all these safeguards in place, if a Schwab employee was somehow successful in fraudulently stealing client wealth, losses resulting from such activity would be covered by SIPC and Lloyd's of London Insurance.

Schwab also has a Non-Retaliation Clause. The clause states that it is an employee's obligation to report issues regarding violations of business regulations whenever suspected. No employee will be retaliated against if they report any of these acts. If there is suspected retaliation, the person seeking retaliation will be disciplined up to and including termination of employment.

For more on the safeguards Schwab employs to insure against employee wrongdoing, see the Schwab Code of Conduct, which is available at: www.schwab.com.

How are client mutual funds separated from Charles Schwab assets & how are the shares then tracked and accounted for?

Mutual funds are held in "street name" at the mutual fund company and individualized in the customer's account. When we refer to "street name," we mean that all funds held by Schwab are listed under Schwab's name at the mutual fund company. The customer's statement is proof that they hold their particular securities. This method is a lot safer than having a physical certificate and easier to liquidate. The SEC's Consumer Protection Rule states where funds must be kept.²

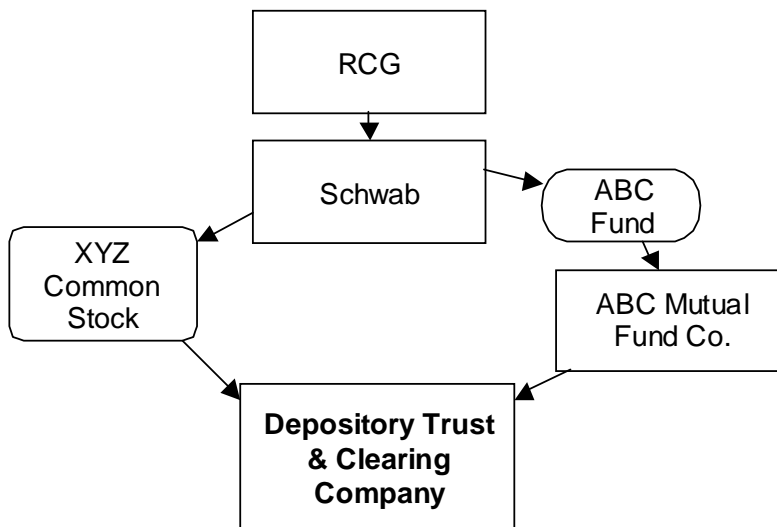
2. SEC's Consumer Protection Rule (15c3-3)

*This rule ensures that a broker-dealer (Schwab) in possession of customers' funds either deployed those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposited the funds in a reserve bank account to **prevent commingling** of customer and firm funds. This rule also seeks to inhibit a broker-dealer's use of customer assets in its business by prohibiting the use of those assets except for designated purposes.*

So where are my assets physically kept?

Good question! However, this is not so easy to answer. Schwab is the custodian of your mutual funds and common stock, however, actual mutual funds are held by the mutual fund company, which in turn has its own custodian which may be a bank, but eventually goes to the Depository Trust and Clearing Company (DTCC). The DTCC is considered the custodian of your assets at the second level. Schwab mutual funds and common stocks are held directly at the DTCC, while all physical certificates are held in the vault at the Schwab headquarters in San Francisco.

To explain the flow, please see the diagram below:



In summary, wealth held at Charles Schwab & Co. is very safe from custodial risk. This safety is a result of their financial strength, procedures and insurance. RCG client wealth is even safer since RCG monitors these accounts and will catch many problems before they surface on a monthly statement. In addition, wealth invested in DFA and Vanguard mutual funds even safer as a result of even more eyes watching the pie. Lastly, the Depository Trust & Clearing Company provides yet another measure of safety. Consolidating wealth at Charles Schwab & Co. might seem at first to be a violation of the “don’t put all your eggs in one basket” principle, but a well-diversified portfolio held at Schwab is spread among the baskets that count.

Note: Here we have outlined custodial risks associated with Charles Schwab and Co. Future documents will focus on the other participants outlined in the article.