Are your funds safe with your custodian?

A custodian maintains custody of your funds. When you open an account at a bank, brokerage house, or hedge fund, at some point you transfer assets to the institution who holds them for you in your name (Your account name). If funds are not on your person in cash or on your property, they are usually kept with some institution. This could be a bank, broker dealer, hedge fund, futures broker, credit union, or an individual known as a 'fiduciary' who usually is licensed to hold funds. In an electronic world this is mostly cash and cash equivalents, stocks, bonds and other instruments. But our regulations and laws were written before computers existed. As one interesting example, it used to be possible to open an account at a commodity brokerage with land or a herd of cattle. The FCM would create a cash margin account for you with the cattle held as collateral (which made sense for farmers who needed to hedge their business by trading futures contracts).

While financial institutions are generally heavily regulated, you no longer own your funds when held at a custodian. A deposit is not considered bailment, meaning when you deposit money in a bank you are transferring ownership to the bank and your account statement is effectively an IOU.

> *A deposit, by legal definition, is not considered a bailment, but even if there was a question involved, all contracts with all commercial banks explicitly state that deposits of funds are a full title transfer of ownership to the financial institution. The fact that funds can be 'repaid' to you 'on demand' is incidental. When you make any bank deposit, you are giving up title to your funds to the bank, and the bank does not have to store them, and may do with those funds as it pleases. Your funds become the immediate property of the*

bank, in return for what is essentially an IOU.

Under normal conditions, technicalities such as this are irrelevant. But in the case of institutional default or fraud, they can mean the difference between getting your funds back, or not.

We've seen due to the financial crisis situations like PFG, MF Global, and Bernie Madoff, where investors were subject to their custodian default in varying ways. Banks have been considered to be historically speaking the safest of any type of financial institution mostly because of FDIC protection (and similar protection in other countries) and their regulation. But we've seen bank failures since the crisis started. More importantly, we've seen banks in Cyprus have their deposits wiped out to 'shore up' bank balance sheets. Now, the bail-in policy is a template that could happen anywhere, in the US, the EU, and even New Zealand has proposed similar solutions for bad banks. Now there is talk of potential IRA confiscation, based on rumor, but also chilling requests for information such as the US Department of Labor's "Fact Sheet – Lifetime Income Options for Retirement Plans." See what CFTC disclosures are now required to be included in CTA/CPO disclosure documents:

> ***IF THE COUNTERPARTY BECOMES INSOLVENT AND YOU HAVE A CLAIM FOR AMOUNTS DEPOSITED OR PROFITS EARNED ON TRANSACTIONS WITH THE COUNTERPARTY, YOUR CLAIM MAY NOT BE TREATED AS A COMMODITY CUSTOMER CLAIM FOR PURPOSES OF SUBCHAPTER IV OF CHAPTER 7 OF THE BANKRUPTCY CODE AND REGULATIONS THEREUNDER. YOU MAY BE A GENERAL CREDITOR AND YOUR CLAIM MAY BE PAID, ALONG WITH THE CLAIMS OF OTHER GENERAL CREDITORS, FROM ANY MONIES STILL AVAILABLE AFTER PRIORITY CLAIMS ARE PAID. EVEN FUNDS THAT THE COUNTERPARTY KEEPS SEPARATE FROM ITS OWN FUNDS MAY NOT BE SAFE FROM THE CLAIMS OF PRIORITY AND OTHER GENERAL CREDITORS.***

That means if you have an account at an FDM (Forex Dealer Member) and they become insolvent, creditors may be paid before account holders if a judge deems them as 'priority.'

So what is the solution?

For many it's not possible or they are not willing to convert all of their assets into physical assets (even including cash) to keep on their property, and those not in financial services are not sophisticated enough to open their own private bank (which is what the elite do).

Solutions have been presented such as by finding AAA+ rated banks and credit unions, looking at their balance sheets to determine the possibility of failure. This is a very prudent practice, however, it doesn't guarantee that bank won't be seized by the government, bought by a bigger bank, or is managed by a lone fraudster who just got hired recently to improve profits. Before it's collapse, PFG was considered to be one of the most honest and credible futures brokers in the industry. Russ Wasendorf, Sr. would speak about the importance of compliance at industry events, and was on the advisory committee of the NFA.

Actually it's possible to insure your deposit externally by use of derivatives (Buy CDS on your institution), or by non-cash funding of an account by use of letter of credit or bank guarantee. But the minimum transaction for these options is millions if not tens of millions.

Questions to ask about the institution where your funds are held

- What is the legal system in the jurisdiction where the institution is registered?

- Who are the owners of the institution?
- What is the background of the management of the institution?
- Are there any damaging reports or rumors circulating about the institution or it's managers (Google "REPLACE THIS TEXT WITH MY INSTITUTION fraud") – Years before Madoff was uncovered a lone analyst Harry Markopolos published documents proving mathematically that Madoff was running a Ponzi scheme.
- If a bank, what is the leverage of the institution (loan to asset ratio)?
- If regulated, are there any past complaints, fines, or other marks against the institution or it's managers?
- If available, what are CDS trading at and what are the spreads? (CDS indicate chances of default)

Due diligence techniques

DO NOT directly ask questions like this to your institution, it's a waste of time and has no real information value.

Google is a great tool, you can combine your institution name with 'fraud' or 'default' or 'bankrupt' or other terms to see if there is anything returning in search results. If you don't find anything it's not proof of that there's nothing to find, as it's unlikely such information would be found on the public web but it does happen.

Forums and review sites are great ways to engage other concerned customers and read any complaints, if any.

Ask an independent financial adviser to do due diligence for you. With connections inside financial services they may have contacts or other means to collect info not available to the public.

Remember, each type of institution will have a different regulatory structure, which is also different in each jurisdiction. For example hedge funds, although regulated, have reporting requirements in the US but are not required to publish statistics about data such as Assets Under Management and other key data.

Global Intel Hub Due Diligence Services

MEMBER OFFER – Structured Consulting can provide professional due diligence & research services about your institution(s) Please contact SC for more info. Members of Global Intel Hub can also suggest a topic for research that will be published for all members.

Resources

The FDIC failed bank list: http://www.fdic.gov/bank/individual/failed/banklist.html

Likely to fail resources

http://www.businessinsider.com/25-banks-default-2010-5?op=1