Chapter 17A

Clearing Arrangements for Introducing Broker-Dealers

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§ 17A:1 Introduction

This chapter highlights key business and regulatory issues relevant to the clearing arrangement between an introducing broker-dealer ("introducing broker") and a clearing broker-dealer ("clearing firm"). We do not intend to detail clearing firm operations or regulation, clearing agency membership, or securities clearance and settlement, except as relevant to introducing broker-dealers.[1]

The National Association of Securities Dealers, Inc. (NASD), has changed its name to the Financial Investment National Regulatory Agency (FINRA). FINRA has also assumed responsibility for certain regulatory functions of the New York Stock Exchange (NYSE). At the present time, FINRA is combining the former NASD rulebook with the NYSE rules with the goal of having a consolidated rulebook, which project should be completed in the next year. At this time, there are some NYSE regulatory rules that have been integrated and consolidated with former NASD rules and are referred to herein as FINRA rules. In other cases, particularly with respect to NASD Rule 3230 and NYSE rule 382 dealing with clearing arrangements, the rules have not been consolidated. Where a NYSE rule has not been consolidated, it will be referred to as NYSE rule. All other former NASD rules and currently consolidated rules will be referred to as FINRA rules.[2] Transitional Rulebook. Former NASD Notices to Members will continue to be referred to as NASD NTM or NTM. FINRA Notices will be referred to as Regulatory Notices.

1. For a detailed legal and business discussion of the clearing arrangement, see Henry Minnerop's definitive legal work, Henry Minnerop, *Clearing Arrangements*, 58 BUS. LAW. 917 (May 2003) [hereinafter Minnerop].
2. *See* FINRA, Rule Conversion Chart, *available at* www.finra.org/Industry/Regulation/FINRARules/p085560.

§ 17A:2 Background of Clearing and Depository Organizations

For many years, a broker-dealer settled a securities transaction directly with the counter broker-dealer. For example, if broker-dealer *X* bought Ford Motor Company common stock for a customer by purchasing from broker-dealer *Y*, *X* would settle the transaction directly with *Y*. A confirmation would be generated by each broker-dealer confirming the trade as known to that broker-dealer. *X* also would confirm the purchase to its customer, and *Y* would confirm the sale to its customer.

If the trade was confirmed by both broker-dealers, the trade would be settled by *X* having a messenger take a check to *Y*'s back office, which surrendered to *X* a stock certificate with blank stock power. *X* would then hold the security certificate for its customer or have the certificate transferred into the customer's name and facilitate delivery to the customer. If the confirmations between broker-dealers did not match, an out trade would occur. If the transactions did not settle within the required time, there was a default or failure and the transaction would not close until the securities were delivered.

By the late 1950s and early 1960s, large broker-dealers attempted to improve this process by settling on a net basis once a day. In such case, *X* would aggregate all transactions with *Y* as a counterparty, determine the total net amount bought and sold in a security, and the net amount to be received or paid for all securities. For example, if *X*'s customers bought 500 shares, and sold 300 shares, of Ford Motor Company with *Y* as the contra broker, *Y* would be obligated to deliver 200 net shares to *X*. Likewise, the total amount to be received or paid from all transactions with a specific counter broker-dealer during the day would be netted. However, this procedure limited clearance and settlement only between two broker-dealers, and still involved the movement of money and delivery of physical securities certificates between broker-dealers.

Exchange and over-the-counter trading increased enormously during the 1960s, and by the early 1970s, the financial community experienced a "paper crunch" because of the high volume of transactions. The industry, with the SEC's prodding, established clearing operations for net clearance and settlement.[3] Each exchange generally established its own clearing agency to provide net clearance and settlement.

In the clearance process, the clearing agency compares trades submitted by its broker-dealer "members" or "participants." The clearing agency matches the submitted trades, and verifies that they will "clear," that is, the trades submitted by each side are consistent.

3. *See generally* Exchange Act § 17A; 15 U.S.C. § 78(Q)-1 *et seq.*

In the settlement process, cleared trades are "settled" by movement of securities positions, or corresponding transfers of money.

Depository trust companies hold in safekeeping and custody certificates for securities. Depositories hold all of a member's or participant's securities certificates for customers and proprietary positions, thereby immobilizing securities certificates and facilitating transfer by book entry. If a participant had 10,000 shares of Ford Motor Company in its depository trust account and its customers sold 5,000 shares and bought 3,000 shares, the net amount of 2,000 shares could be transferred by book entry to the participant whose customers are owed the securities.

By using clearing corporations and depositories to clear and settle once a day, the net amount could be compared, and then settled by wire transfer of funds due on a net basis. Likewise, securities would be netted and transferred largely by book entry. Over time, interfaces between clearing corporations and the depositories developed to enable a member of one clearing agency to settle its trades with a broker-dealer that was a member of another clearing agency. The SEC regulates these clearing corporations and depositories.

More recently, smaller clearing corporations and depositories were terminated or merged, resulting today in the Depository Trust & Clearing Corporation (DTCC). DTCC is a holding company that owns the National Securities Clearing Corporation (NSCC), the Depository Trust Company (DTC), the Fixed Income Clearing Corporation and other affiliates, and provides net clearance and settlement services to participant broker-dealers—the clearing firms. NSCC performs net clearing and other services. DTCC provides custody and safekeeping, holding certificates or other indication of ownership to facilitate book-entry transfer.[4]

The Fixed Income Clearing Corporation provides real-time trade matching and clearing and settlement services for government, municipal and fixed income securities. The services of the Fixed Income Clearing Corporation also include pool notification, net settlement service and repurchase agreement services.

DTC also provides DTC LOAN/SERV, which reconciles lender positions daily between agents and lenders around the world.

DTCC Deriv/SERV LLC is a wholly-owned subsidiary of DTCC, and provides automated matching and confirmation services for over-the-counter derivatives, including credit, equity, and interest

4. DTCC offers other services, such as a reorganization service, direct registration system, dividend services, legal notification service, proxy service and restricted securities services. For example, the reorganization service provides participants with information about corporate reorganizations such as a merger or bankruptcy.

rate derivatives. It also provides certain other services, including matching of payment flows and bi-lateral netting services. European Central Counterparty Limited is also a DTCC subsidiary that provides automation, centralization, standardization, and streamline process in the European market for certain firms.[5]

When secondary options trading was introduced by the Chicago Board of Exchange (CBOE), the Options Clearing Corporation (OCC) was formed to issue and clear options. The OCC clears all options listed on U.S. options markets, and also clears security futures and interfaces with other clearing houses.

Because of the globalization of the financial service business, most offshore markets include clearing corporations and depositories. Offshore clearing agencies offer substantially the same services as DTCC, OCC and the futures clearing houses provide in the United States. Many large domestic clearing firms also are direct or indirect members of foreign clearing agencies, because of the number of international transactions in securities and futures effected in foreign markets.

Most broker-dealers are not members of a clearing corporation or a depository. Only clearing firms, who can meet the membership requirements of substantial assets, liquidity, and capital, are permitted to be clearing agency participants. These clearing firms also must maintain a large back office of expert employees and state of the art information facilities, since most communications between a participant and a clearing agency are by electronic communication. In addition, substantial banking relationships are required for regular movement of money.

Because of these infrastructure and capital requirements, the number of clearing agency participants is limited. Broker-dealers who are not clearing agency participants require access through a clearing firm. These accessing broker-dealers are called introducing brokers, described in more detail below.

§ 17A:3 Understanding the Arrangement

There are essentially two types of clearing arrangements, called "fully disclosed" and "omnibus" arrangements. The fully disclosed clearing arrangement is more common. In a fully disclosed arrangement, the introducing broker introduces transactions to a clearing firm that is a DTCC participant for clearance, settlement and custody.

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5. The DTCC, through its other subsidiaries, offers certain services in connection with newly issued securities in connection with underwritings, mutual fund services, certain insurance services, stock borrowing and loan services and direct settlement services for large institutions.

The arrangement is called fully disclosed because division of the functions between the clearing firm and introducing broker is disclosed to the customers of the introducing broker.

In an omnibus arrangement, an omnibus clearing firm carries in a single account the positions of introduced customer transactions of the introducing broker. The introducing broker's proprietary positions also may be carried, but introducing broker proprietary transactions are effected in an account separate from customer transactions. The omnibus clearing firm performs clearance, settlement, execution and custody pursuant to contract with the introducing broker. In an omnibus arrangement, the introducing broker remains legally responsible for custody, clearing, capital requirements, reserve deposits, books and records as a clearing firm, but the omnibus broker-dealer contractually performs certain of these functions for the introducing broker.

In a fully disclosed arrangement, the introducing broker will generally have significantly lower financial responsibility requirements under the SEC capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act") and under the SEC financial safekeeping rule, Exchange Act Rule 15c3-3. Although the introducing broker will be responsible for certain required books and records, the clearing firm will generate and maintain many of such records for the introducing broker pursuant to the clearing agreement. The clearing firm also usually provides excess SIPC insurance.

In an omnibus relationship, the introducing broker has a higher capital requirement, must meet the requirements of the SEC safekeeping of customer funds and securities, and must maintain required books and records. Furthermore, in an omnibus relationship, any excess SIPC insurance must be maintained by the introducing broker. One of the advantages of the omnibus arrangement is that, particularly with respect to securities in which the introducing broker does not effect many transactions, such as foreign securities, the introducing broker would not need to be a member of foreign clearing agencies or other foreign organizations. Likewise under the omnibus arrangement for U.S. securities or options, clearance and settlement may sometimes be effected by the omnibus clearing firm without the introducing broker being a member of a clearing agency such as NSCC or OCC.

A facilities management agreement is somewhat similar to an omnibus clearing arrangement. Some broker-dealers that wish to be a clearing firm and have the adequate capital may lack the requisite back-office infrastructure, personnel, or communications systems. Such broker-dealers may outsource their back-office operations settlement clearing service through a facilities management agreement to another clearing firm that has such infrastructure and is also a clearing

member. Some broker-dealers that wish to be clearing members enter into a facilities management agreement with another clearing member, outsourcing all or part of the back-office clearing and settlement. In any event, the clearing member that outsources these functions through a facilities management agreement remains responsible to the regulators for its capital as a clearing member, and for all functions performed under the facilities management agreement by the clearing firm.

The clearing agreement is a classic outsourcing arrangement under which certain functions of the correspondent or introducing broker are delegated to the clearing firm. Clearing agreements must conform with FINRA Rule 3230, or its counterpart, NYSE Rule 382, as explained in more detail below.

Economics drives the clearing relationship as explained in more detail below. The fixed cost for clearing and settling transactions is high because clearing firms must maintain memberships in clearing agencies, participants' deposits, experienced personnel and sophisticated systems.

Clearing firm start-up costs are substantial and generally cannot be economically justified, absent a significant volume of business. In addition, regulatory agencies are reluctant to approve a start-up broker-dealer for full service status, since approval is contingent on demonstration of experience, risk control systems and personnel. Until a broker-dealer's business involves a significant volume of transactions, the fixed cost for clearing per transaction will be far higher than if the firm introduces to an established clearing firm for clearance and settlement. Because of the inherent fixed costs, clearing firms have a significant advantage if they can attract additional business.

§ 17A:4 Key Functions of the Clearing Arrangement

Mr. Henry Minnerop's definitive article on clearing identifies key functions involved in maintaining, clearing and settling customer accounts:

1. opening, approving, and monitoring customer accounts;
2. providing investment recommendations or accepting customer orders;
3. executing customer orders;
4. extending credit in margin accounts;
5. providing written confirmations of executed orders to customers;
6. receiving or delivering funds or securities from or to customers;

7. maintaining books and records that reflect transactions, including rendering monthly or periodic statements of account to customers;
8. providing custody of funds and securities in customer accounts;
9. clearing and settling transactions effected in customer accounts; and
10. providing electronic systems for compliance and management of the introducing broker.[6]

For brokers introducing accounts on a fully disclosed basis, the clearing agreement will divide the above functions between the introducing broker and the clearing firm. In most clearing arrangements, all back-office operations are handled by the clearing firm, and the front office or customer relationships are performed by the introducing broker. In the omnibus relationship, some of the back-office and execution functions are performed on a contract basis for the introducing broker but the introducing broker is responsible for all of those functions as if it was performing them itself.

NYSE and FINRA rules require that a fully disclosed clearing agreement divide the functions between the firms. Customers must be notified in a summary statement of the nature of the division of functions and which entity will be performing what function.[7] Most fully disclosed clearing arrangements provide that customer relation functions are the responsibility of the introducing broker. The introducing broker generally is responsible for opening, approving and monitoring customer accounts, providing any recommendations, dealing with customer complaints and problems, accepting customer orders for execution, collecting margin, and compliance matters arising from those areas. Customer orders may be executed by the introducing broker either through the clearing firm or through some third-party broker-dealer and given up to the clearing firm for settlement. While margin credit may be extended by the clearing firm to an introducing broker's customer, the margin credit is, under almost all clearing agreements, the financial responsibility of the introducing broker. The introducing broker must indemnify the clearing firm for any margin or credit losses (that is, customer's failure to pay).

While in most clearing arrangements transaction confirmations are prepared and mailed by the clearing firm, confirmations may be printed

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6. Minnerop, *Clearing Arrangements*, 58 BUS. LAW. 917, 924, n.28 (May 2003).
7. NYSE Rule 382; FINRA Rule 3230. For further details, see *infra* section 17A:5. *See* FINRA Rule 4311.

and mailed to customers by the introducing broker. Monthly account statements are usually prepared and mailed by the clearing firm.

In most cases, both the clearing agreement and the customer agreement provide that the introducing broker act as agent of the customer and not as agent of the clearing firm. The customer agreement usually provides that the clearing firm, with respect to any individual customer account, may rely on instructions from the introducing broker on behalf of the customer, without further inquiry.

Under the SEC financial responsibility rules discussed in section 17A:6 *infra*, an introducing broker may receive customer funds or securities for prompt transmittal to the clearing firm, but may not hold or carry customer funds or securities without incurring substantially increased capital and related requirements. Some introducing brokers elect the higher capital requirements even though they introduce on a fully disclosed basis. However, this is fairly rare because of the additional capital cost, and is usually limited to firms engaged in certain proprietary trading.

In most clearing arrangements, the clearing firm agrees not to disclose the details of the customer accounts to affiliates or third parties and not to solicit the customer accounts for its own business during the term of the clearing arrangement, and in some cases after termination of the clearing arrangement. Likewise, there are generally provisions against solicitation and hiring of employees of the introducing broker by the clearing firm without the introducing broker's consent.[8]

§ 17A:5 NASD Rule 3230—Clearing Agreements; NYSE Rule 382—Carrying Agreements; Proposed FINRA Rule 4311

The two principal self-regulatory organization rules applicable to clearing are FINRA Rule 3230—Clearing Agreements and NYSE Rule 382—Carrying Agreements. The rules are very similar and cover approximately the same area. As a result of the FINRA-NYSE consolidation, the two rules will be consolidated into one rule.[9] The NYSE Rule applies to any NYSE member organization, including members that are also members of FINRA or other self-regulatory organizations. The FINRA rule applies to all members that are not parties to an agreement that is subject to a rule comparable to 3230 of a national securities exchange. Most major clearing firms are members of the NYSE and thus subject to its rules. However, there are clearing firms

8. For further discussion, see *infra* section 17A:16.27.
9. *See* discussion of Proposed FINRA Rule 4311 *infra.*

that are not members of the NYSE. Many introducing firms are members of FINRA and not members of NYSE. For purposes of simplicity we will discuss FINRA Rule 3230 since the proposed consolidated Rule 4311 resembles Rule 3230. However, FINRA Rule 4311 has additional provisions discussed below.

Rule 3230 specifies that a clearing agreement shall cover certain minimum things:

(1) opening, approving and monitoring customer accounts;

(2) extension of credit;

(3) maintenance of books and records;

(4) receipt and delivery of funds and securities;

(5) safeguarding of funds and securities;

(6) confirmations and statements;

(7) acceptance of orders and execution of transactions;

(8) whether, for purposes of the Commission's financial responsibility rules adopted under the Act, and the Securities Investor Protection Act, as amended, and regulations adopted thereunder, customers are customers of the clearing member; and

(9) the requirement to provide customer notification under paragraph (g) of this rule. (This requires that each customer whose account is introduced on a fully disclosed basis be notified in writing before the opening of his account of the existence of the clearing or carrying agreement and the relationship between the clearing firm and the introducing firm.)

Clearing firms are required to submit clearing agreements and any material amendments to FINRA for approval, or in the case of the NYSE, to FINRA's NYSE regulation for approval, or its otherwise designated examining authority (DEA). Likewise, an introducing member must submit for approval to its respective DEA (in the case of FINRA to its local district office) its clearing agreement and any changes.

Both rules require that a clearing firm must furnish to its DEA and to the introducing broker's DEA, and to the introducing broker any complaint received by the clearing firm with respect to the functions and responsibilities of the introducing broker pursuant to the clearing agreement. The clearing firm must also notify the customer in writing that it has received the complaint and that the complaint has been furnished to the introducing broker and its DEA. The reporting of customer complaints by both the introducing broker and the clearing

firm is required by other rules and is done electronically. See Regulatory Notice 08-71 (November 2008) for details of reporting.

As discussed later at section 17A:16.13, both the FINRA and NYSE rules require that the clearing firm, at the commencement of the relationship and annually, furnish to the introducing broker a list of all reports, including exception and other reports, offered to the introducing broker to supervise its business, monitor its accounts, and carry out the provisions of the clearing agreement. The introducing broker must promptly notify (immediately under the NYSE Rules) the clearing firm in writing of those specific reports offered that it needs to supervise its accounts, monitor its accounts and carry out the clearing agreement. Copies of the reports requested and/or supplied to the introducing broker must be retained and preserved by the clearing firm as part of its books and records. Such records and reports may be retained electronically. Annually, within thirty days of July 31 of each year, the clearing firm must give written notice to the introducing broker's chief executive officer and chief compliance officer, the list of reports offered to the introducing broker, and specify those reports that were actually requested or supplied. A copy of that notice must also be sent to the introducing broker's DEA. Clearing or carrying firms may, pursuant to agreement, permit the use of drafts (notes) against a local bank account to enable an introducing broker to pay funds directly to a customer.[10]

In Regulatory Notice 09-03, FINRA proposed a new FINRA Rule 4311 with respect to clearing agreements. It would replace NYSE Rule 382 and NASD Rule 3230. As of the date of this supplement, the Rule had not become effective, but it is expected to become effective in 2010. While it is reportedly a codification, it adds some new provisions. Any customer clearing agreement for customer accounts omnibus or fully disclosed basis must be carried by a FINRA member under the new rule.

Proposed FINRA Rule 4311(a)(1) requires that if an introducing broker acts as an intermediary with another introducing firm or firms (piggyback or intermediary clearing arrangements) for purposes of clearing services from the clearing firm, the introducing broker must notify the clearing firm of the existence of the arrangements with the other introducing firm and disclose additional information concerning the other introducing firm. This is essentially the same as the current practice.[11]

The proposed rule continues to require that clearing agreements for carrying of accounts, whether on an omnibus or fully disclosed basis, be filed with FINRA. Likewise, any proposed material change in the

10. *See infra* section 17A:9.
11. *See infra* section 17A:14.

clearing arrangement must be submitted to FINRA. Generally, the clearing agreement or material change must be submitted for approval not later than ten business days prior to the carrying of any accounts of a newly introducing firm. To expedite approval, clearing firms may use a standard agreement that is filed with FINRA. However, <u>each</u> clearing agreement with a non-U.S. registered dealer must also be submitted to FINRA for approval. Certain additional information must be submitted to FINRA regarding each clearing agreement, such as the CRD number and other material that FINRA may require.

The proposed rule requires each clearing firm to conduct appropriate due diligence with respect to any new introducing relationship, including its business mix, customer account activity, proprietary and customer positions, FOCUS and similar reports, audited financial statements, and complaints and disciplinary history. Records must be maintained of such due diligence.

The proposed rule continues to require that each customer whose account is introduced on a fully disclosed basis must be notified in writing upon the opening of the existence of the carrying account and the responsibilities allocated to each party. The new provision provides in proposed Rule 4311(d) that the customer must be notified promptly and in writing of any change in the agreement or any material change to the allocation of responsibilities. The new rule requires that each introducing broker designate for which proprietary and customer accounts it acts as an intermediary in obtaining clearing services, in such a manner as to enable the clearing firm and FINRA to specifically identify the specific proprietary and customer accounts belonging to each introducing broker.

Regulatory Notice 08-76 (December 2008), provided for electronic reporting of clearing arrangements and other information. This is part of FINRA's ongoing effort to integrate NASD and NYSE technology systems. Effective December 15, 2008, firms that carry accounts and/ or clear transactions or act as intermediaries to facilitate clearance of account of another firm must report the clearing method, clearing arrangements, and other information in a standard format through the FINRA gateway technology. (This system now provides firms consolidated access to FINRA applications.) Firms that are members of both FINRA and NYSE must report electronically their clearing arrangements under incorporated NYSE Rule 416. FINRA-only member firms are "requested" to provide the information on a voluntary basis, but FINRA as part of its Rulebook rule consolidation, has proposed a similar rule that will apply to all FINRA member firms.[12] The proposed changes require an electronic report that is quite complex

12. Regulatory Notice 09-02 (Jan. 2009).

and lengthy, describing the firm's clearing method, clearing arrangement details, memberships and clearing organizations, Securities Exchange Act Rule 15c3-3 reserve bank account information, and the EDP systems for books and records for the firm. Firms are cautioned to continue to follow the review and approval requirements of NYSE Rule 382 and FINRA Rule 3230 with respect to the current process for obtaining regulatory approval of their clearing agreements or amendments. A firm using the system is required to update its clearing information no later than thirty days after the information has changed. The Regulatory Notice states that when a clearing firm files additional information, or adds or removes an arrangement with an introducing or correspondent firm, the chief compliance officer and chief financial officer listed in the FINRA contact system for the introducing broker will receive an email informing them of the clearing firm's filing that will include certain information.

This rule provides a good tool for introducing brokers to review the arrangements of their clearing firms and the arrangements of the clearing firms of other introducing broker-dealers. It will also be helpful to introducing brokers in negotiating clearing agreements.

§ 17A:6 Introducing Broker Capital and Financial Responsibility Requirements, in General

§ 17A:6.1 Exchange Act Rules 15c3-1 and 15c3-3

The two key financial responsibility rules are Exchange Act Rule 15c3-1, the Net Capital Rule, and Exchange Act Rule 15c3-3, the rule regulating safeguarding customer funds and securities. Although both rules are fairly complex, a basic understanding of the choices presented under the rules is important for an introducing broker in connection with assessing business and financial aspects of a clearing arrangement. The discussion below gives a general overview of the rules without discussing all of their complexities.

Also relevant is Exchange Act Rule 17a-11, which sets a number of minimum thresholds called "early warning thresholds." Rule 17a-11 requires prompt notice to the regulators if (1) the broker-dealer's aggregate indebtedness is in excess of 1,200% of net capital; (2) the broker-dealer is operating under the alternative standard and its net capital is less than 5% of the aggregate debit items in the reserve formula; (3) the broker-dealer's total net capital is below 120% of the required minimum; (4) the broker-dealer fails to maintain current books or records; or (5) if the broker-dealer is notified of a material inadequacy by its independent public accountants. In any such event, notice must be given to the SEC, the broker-dealer's designated examining authority and other regulatory organizations where the firm is a member.

The discussion of the Net Capital Rule *infra* sets forth the minimum net capital requirements for various types of broker-dealers. However, from a practical standpoint, the higher Rule 17a-11 early warning thresholds are the true applicable minimum capital levels, since regulators require a broker-dealer failing to maintain those thresholds to reduce its business or cease operations.

The Net Capital Rule provides a number of alternatives. A broker-dealer that wishes to engage in securities activities without restriction and self-clear its transactions has a significantly higher capital requirement. As explained below, firms that engage in more limited activity subject to certain restrictions have a lesser capital requirement. There are a number of different types of clearing arrangements offering a choice of capital requirements to the introducing broker.

The SEC has proposed amendments to Rules 15c3-1, 15c3-2, 15c3-3, 17a-11, and certain books and records requirements. However, the proposal remains outstanding.[13]

In Regulatory Notice 09-71 (December 2009), FINRA adopted new rules with respect to financial responsibility in FINRA Rules 4110, 4120, 4130, 4140, 4521, 9557, and 9559 effective as of February 8, 2010. Under new Rule 4110, FINRA is permitted to proscribe greater capital requirements for carrying and clearing members or require any such member to restore or increase its capital or net worth when it is deemed necessary "for the protection of investors or public interest." The authority to increase capital requirements in Rule 4110(a) does not apply to certain introducing firms and certain limited activity firms. Unless otherwise permitted by FINRA, the amended rules also require, as do the current rules, suspension of business operation by a member firm and notification to FINRA and the SEC if the member is not in compliance with Exchange Act Rule 15c3-1 or 15c3-3.

There are additional restrictions with respect to clearing firms' withdrawal of equity capital. The new rule also prohibits withdrawing equity capital for a period of one year, unless otherwise permitted. This has essentially been a past interpretation by the SEC. Also, there are restrictions on sale and lease backs, factoring, financing, loans, and similar arrangements for clearing members. FINRA Rule 4110(e) deals with subordinated loans, notes collateralized by securities and capital borrowings and generally parallels Exchange Act Rule 15c3-1 Appendix D and prior interpretations.

FINRA Rule 4120 provides that clearing and carrying members must within twenty-four hours notify FINRA when certain early warning financial triggers are reached. FINRA Rule 4120(b) places restrictions on business expansion and requires reduction of business by clearing members. FINRA Rule 4120 provides for notification if

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13. *See* SEC Release No. 34-55431 (Mar. 9, 2007).

certain early warning thresholds are exceeded with respect to net capital. They parallel the SEC's early warning notifications, except that a member that is registered as a futures commission merchant pursuant to the Commodity Exchange Act must maintain net capital not less than 120% of the minimum risk-based capital requirements of Commodity Exchange Act Rule 1.17. Rule 4120(b) is self-operative and requires that a clearing member, unless otherwise permitted by FINRA, refrain from expanding its business during a period in which certain conditions of FINRA Rule 4120(a)(1) continue to exist for a specified period of time. FINRA may also issue a notice requiring any FINRA member to refrain from expanding its business under FINRA Rule 4120(c), which is self-operative and requires a clearing member, unless otherwise permitted by FINRA in writing, to reduce its business to enable it to meet capital standards set forth in Rule 4120(a)(1) when any of the enumerated conditions exist for a specified time period. However, FINRA may also place restrictions on the business or expansion, or require reduction of the business. The definitions of "business reduction" and "prohibition on expansion" are defined in the Rule.

If a member firm is below the minimum early warning levels of the SEC or FINRA, the firm may be required by FINRA upon notice to suspend, reduce or limit the expansion of its business. There is a series of procedures by which the firm may appeal any determination by FINRA through an expedited process. See FINRA Rules 9557 and 9559.

§ 17A:6.2 Net Capital Rule Requirements

[A] Top Tier Firms That Do Not Have Restrictions on Type of Activity

The Net Capital Rule provides alternative minimum requirements for a broker-dealer that engages in general securities activity without restrictions. Under either of the two alternatives, a broker-dealer must have $250,000 minimum capital.[14] In addition, under one alternative, the broker-dealer must also maintain an aggregate indebtedness ratio not to exceed 1,500% of its net capital (or 800% of its net capital for its first twelve months of business). Under the other alternative, the broker-dealer is not subject to the aggregate indebtedness standard, but must maintain minimum net capital of not less than the greater of $250,000 or 2% of the aggregate debit items as computed under the Exchange Act Rule 15c3-3 reserve formula. There are additional conditions to the second alternative such as making regular Exchange

14. Exchange Act Rule 15c3-1(a)(1) & (2)(i).

Act Rule 15c3-3 computations, certain deductions and related provisions.

[B] The Two Most Common Capital Rule Minimum Requirements Used by Introducing Brokers

1. Broker-Dealers that Introduce Customer Accounts and Receive, But Do Not Hold, Customer Funds and Securities

An introducing broker must maintain a minimum of $50,000 if it introduces customers on a fully disclosed basis to a clearing firm that carries the accounts.[15] Under this provision, an introducing broker may receive, but not hold, customer or other broker-dealer funds or securities. The introducing broker may be a member of a selling group, but may not be a member of an underwriting group purchasing securities in a fixed underwriting. Most introducing brokers elect to operate under this section.

2. $5,000 Broker-Dealers

Under this category, an introducing broker may only engage in agency transactions or riskless principal transactions as defined in the rule.[16] A $5,000 broker-dealer may not engage in many of the activities described in this section. It may *not* receive or hold funds or securities for customers, carry any customer accounts, or owe money or securities to customers.

[C] Additional Alternatives and Provisions

1. Broker-Dealers That Do Not Carry Customer Funds or Securities

Introducing brokers that do not carry customer funds or securities, and promptly transmit them to a clearing firm and are exempt under Exchange Act Rule 15c3-3(k)(2)(i), generally have a $100,000 minimum net capital requirement.[17] Under this exemption, an introducing broker must carry no margin accounts, promptly transmit all customer funds, and deliver all securities received in connection with its activities as a broker-dealer, not otherwise hold funds or securities for or owe money or securities to customers, and effect all financial transactions between the introducing broker and its customers through one or more bank accounts titled "Special Account for the Exclusive Benefit of Customers of [Introducing Broker]."

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15. Exchange Act Rule 15c3-1(a)(2)(iv).
16. Exchange Act Rule 15c3-1(a)(2)(vi).
17. Exchange Act Rule 15c3-1(a)(2)(ii). For a description of Exchange Act Rule 15c3-3(k)(2)(i), see *infra* section 17A:6.3[C].

2. Dealers' Rule

Dealers of securities have a minimum net capital requirement of not less than $100,000.[18] Included within dealers are introducing brokers that are engaged in option transactions otherwise than on a registered national securities exchange or NASDAQ, and any broker-dealer that effects more than ten proprietary transactions for its own investment account. Dealers do not include market makers, discussed in section 17A:6.2[C]4 below.

With respect to the ten proprietary transaction conditions, there are exceptions for transactions under Exchange Act Rule 15c3-1(a)(2)(v), (a)(2)(vi) or (a)(8).

A "dealer" may not engage in firm commitment underwriting activities, but may participate in best efforts, agency or all-or-none underwritings, in accordance with paragraph (b)(2) of Exchange Act Rule 15c2-4, so long as the broker-dealer engages in no other dealer activities.

3. Mutual Funds and Variable Annuity Dealers and Agents

A firm must maintain $25,000 net capital if it acts as a broker or dealer with respect to mutual funds or variable annuities.[19] All funds and securities must be promptly transmitted, and the broker-dealer may not hold customer funds or securities or owe money or funds to customers.

4. Market Makers, Specialists and Floor Brokers

An over-the-counter market maker generally must maintain net capital of $2,500 for each security in which it makes markets up to $1,000,000.[20] There are additional exemptions for exchange market makers, specialists and floor brokers who do not deal with customers.[21]

5. Municipal Brokers and Dealers

There are special requirements for certain municipal securities brokers who act as "brokers' brokers."[22]

6. Broker-Dealers Engaging in Repo Transactions

There are special capital provisions for broker-dealers that engage in repo transactions.[23]

18. Exchange Act Rule 15c3-1(a)(2)(iii).
19. Exchange Act Rule 15c3-1(a)(2)(v).
20. Exchange Act Rule 15c3-1(a)(4).
21. Exchange Act Rule 15c3-1(a)(6) & 15c3-1(b).
22. Exchange Act Rule 15c3-1(a)(8).
23. Exchange Act Rule 15c3-1(a)(9).

§ 17A:6.3 Exchange Act Rule 15c3-3: Safeguarding Customer Funds and Securities

Exchange Act Rule 15c3-3 regulates broker-dealer custody of customer funds and securities. Subsection (k) of the rule provides exemptions applicable to introducing brokers who do not carry or hold customer funds or securities. In most clearing relationships, the introducing broker attempts to operate under one of the Rule 15c3-3(k) exemptions, described below.

[A] Mutual Fund, Separate Account and S&L Solicitation Exemption

Subsection (k)(1) provides an exemption for a broker-dealer whose transactions are limited to (1) the purchase and sale of mutual funds or participation in insurance company separate account products, either as principal or agent; (2) agency transactions involving solicitation of accounts for insured savings and loan institutions; or (3) the sale of securities for customers for immediate reinvestment in mutual funds. Customer funds and securities received must be promptly transmitted and may not be held by the introducing broker. The introducing broker must not owe money or securities to customers. There is also an exemption in (k)(1) for insurance companies that are engaged in certain activities not applicable to this chapter.

[B] Special Account Introducing Brokers

Under subsection (k)(2)(i) of Exchange Act Rule 15c3-3, an introducing broker is exempt if it (1) does not carry margin accounts, (2) promptly transmits all funds and securities received, (3) does not hold customer funds or securities, (4) does not owe money or securities to customers, and (5) effects all transactions between the introducing broker and its customers through one or more bank accounts which are designated as a "special account for exclusive benefit of customers" of the introducing broker. Some introducing brokers rely on this exemption.

[C] Introducing Brokers

Under subsection (k)(2)(ii), an introducing broker is exempt if it clears all transactions on a fully disclosed basis and promptly transmits all customer funds and securities to the clearing firm. The clearing firm must carry all accounts of customers and maintain required books under Exchange Act Rules 17a-3 and 17a-4. Most introducing brokers rely on this exemption.

§ 17A:6.4 Summary

As can be seen under the above rules, a fully disclosed clearing arrangement provides significant reduced capital for an introducing broker, provided its activities are limited in accordance with such rules. Such introducing brokers will have significantly lessened financial responsibility requirements.

§ 17A:7 Proprietary Assets Held by Clearing Firm

An introducing broker's proprietary assets maintained at a clearing firm are good assets for purposes of computing net capital under Exchange Act Rule 15c3-1 only if the introducing broker and the clearing firm comply with the SEC interpretation regarding treatment of proprietary accounts of introducing broker-dealers (PAIB accounts).[24] The SEC has proposed to codify its PAIB no-action letters by amending Exchange Act Rules 15c3-1 and 15c3-3.[25] If introducing broker assets are not held in a PAIB account and pursuant to the SEC interpretation, the assets are considered to be "not readily convertible into cash" and have no value for capital purposes. Consequently, introducing brokers hold assets at clearing firms pursuant to PAIB agreements. The PAIB regime does not apply to proprietary assets of foreign broker-dealers and certain assets held offshore.[26] Thus, any clearing arrangement should include a PAIB agreement with the clearing firm, with required notices sent to the self-regulatory organizations.

§ 17A:8 Clearing Deposits

Regulatory Notice 08-46 (September 2008) provided interpretative guidance on net capital treatment under Rule 15c3-1 of clearing deposits of introducing broker-dealers. Clearing firms typically require a clearing deposit from introducing brokers. The deposit is held by the clearing firm to secure the introducing broker's obligation to the clearing firm. In the case of a new introducing broker or when an introducing broker changes clearing firms, the clearing agreement may

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24. Letter to Michael Macchiaroli, Associate Director Securities and Exchange Commission, to Messrs. Raymond J. Hennessey, New York Stock Exchange; Thomas Casella, NASD Regulation, Inc., Nov. 3, 1998; NASD Notice to Members 99-44.
25. *See* SEC Release 34-55431 (Mar. 9, 2007). The proposed amendments would have a broader scope, addressing proprietary accounts of foreign broker-dealers and banks acting as broker-dealers. In addition, the SEC notes that proprietary broker-dealers clearing through another broker-dealer may be customers for purposes of SIPA.
26. NASD NTM 99-44.

also have a provision that if the clearing arrangement is terminated, certain monetary penalties will be deducted from the clearing deposit. Clearing agreements provide in many cases that part or all of a clearing deposit may be held until all obligations of the introducing broker to the clearing firm have been resolved and settled. Pursuant to the SEC interpretation of its Rule 15c3-1, clearing deposits may be treated as an allowable asset provided that the clearing agreement explicitly states that the deposit will be returned to the introducing broker within thirty calendar days after termination of the agreement. The SEC's interpretation further requires that a written proprietary account introducing broker PAIB agreement has been executed. Moreover, the clearing agreement must state that the introducing broker's clearing deposit does not represent an ownership in the clearing firm in order for the clearing deposit to be deemed allowable for capital purposes. Regulatory Notice 08-46 makes clear that the commencement of the thirty-calendar-day period shall commence five days after the initial transfer of the introducing broker's customer accounts from the clearing firm. To the extent that the clearing deposit is not returned, in whole or in part, within the thirty-calendar-day period after the five-business-day grace period, it will be treated as a non-allowable asset in the introducing broker's net capital computation on the thirty-first day.

With respect to clearing agreements that have a deposit requirement but also have a termination penalty, the amount of the termination penalty will not be considered a good asset for purposes of SEC Rule 15c3-1 unless the clearing agreement contains the subordination language specified in Regulatory Notice 08-46. In the event that a termination penalty is deductable from the clearing deposit and treated as a non-allowable asset, the introducing broker must also make a determination under generally accepted accounting principles whether it must accrue a liability to reflect the effect of the termination penalty clause. An introducing broker that accrues a liability for the full amount of the termination penalty may reduce the deduction from net capital charge for the termination penalty by the amount of such accrued liability. The accrued liability must also be included in aggregate indebtedness of the introducing broker that uses the basic method of computing net capital requirements pursuant to Rule 15c3-1.[27]

§ 17A:9 Check Writing and Local Cashiering

As discussed above, receipt, delivery and custody of securities of customers generally are clearing firm functions for several reasons, including favorable treatment under the Net Capital Rule or Exchange

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27. *See also supra* section 17A:6.2.

Act Rule 15c3-3. However, under tightly controlled conditions, interpretations permit the local deposit of funds to an account in the name of the clearing firm and/or local check drafting by the introducing broker against a local account of the clearing firm. FINRA Rule 4311(f) provides for the use of check writing and local cashiering provided it complies with the SEC Rule 15c3-3 and its interpretations.

Local cashiering is local deposit of funds to the account of the clearing firm. This works to the advantage of both the clearing firm and the introducing broker. If the introducing broker is a $50,000 net capital level broker-dealer, it may receive customer funds as long as it does not hold them. Using this provision, customer checks may be received by an introducing broker and promptly deposited by it into a local bank account held in the name of the clearing firm.

Local check writing is a device by which a clearing firm authorizes specific introducing broker officers to write drafts on the clearing firm's bank account payable to introduced customers.[28] This is convenient for the introducing brokers and customers. For example, if a customer needs a check for funds carried in the customer's account, the customer may immediately receive a draft from the introducing broker on the clearing firm's account at a local bank. This process is effected by the introducing broker notifying the clearing firm that a customer is requesting a draft in a specific amount. The clearing firm then funds its zero balance account at a local bank overnight with the funds for a draft to clear the next day. The introducing broker executes the draft on behalf of the clearing firm and delivers it to the customer. Both of these arrangements require special clearing agreement provisions, or a separate agreement, between the introducing broker and the clearing firm.

Specific supervisory procedures must be drafted for both the clearing firm and introducing broker. Normally, the introducing broker's procedures must be submitted to the clearing firm. However, the clearing firm is not required to supervise the introducing broker's activities with respect to the clearing account except as noted above.[29]

§ 17A:10 Risk Management and ACT

Risk management is critical to the relationship between the clearing firm and the introducing broker. From both firms' perspectives, their capital is at risk. The clearing firm must maintain significant

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28. NYSE Rule 382; FINRA Rule 3230.
29. NASD Guide to Rule Interpretations, at 75 (1996); Self-Regulatory Organizations, Exchange Act Release No. 34-41469, 1999 SEC LEXIS 1114, at *3 & *6 (June 2, 1999).

capital to carry the customer or proprietary accounts of its introduced brokers. Any margin loans will be made from clearing firm capital.

Although the introducing broker guarantees its own transactions and the credit of its customers with respect to margin and other liabilities, the introducing broker's guarantee is only as good as its financial position and its continuing risk management. Consequently clearing firms, for their own protection, traditionally require regular reports of the introducing broker's capital, assets and obligations. Before entering into a clearing relationship, the clearing firm will assess the introducing broker's financial position, activities, risk management, personnel, compliance systems, and financial and disciplinary history. The clearing deposit amount, permitted activities and risk review will be a function of the above.

The clearing firm, as part of its own risk-management system, will monitor accounts of introducing brokers for concentrated positions in any customer's account or a group of accounts, low-priced securities, and other risks. Clearing firms may require introducing brokers to increase capital, increase cash deposits and/or pledge other assets with the clearing firm to secure the risk and liability arising from introducing brokers' customers or proprietary transactions.

Under the "ACT system,"[30] clearing firms have a tool to control excess credit by introducing brokers who effect transactions with other broker-dealers, either for customers or for the introducing broker's own account. Under ACT, the clearing firm may establish a credit limit for each introducing broker. If that credit limit is exceeded by the introducing broker, the clearing firm may reject trades in excess of the credit limit. Under the ACT system, clearing firms are notified electronically when an introducing broker has reached 70% of its credit limit, and again if it reaches 100% of the credit limit. This allows the clearing firm to cease accepting trades or implement other steps to protect itself against the risk of outstanding trades. Other provisions require notification to the clearing firm if certain trades are above a set amount. If an introducing broker is not subject to ACT, a third-party broker-dealer dealing with that firm has the risk that its trades may be rejected by the clearing firm unless the clearing firm agrees in advance with that third party to accept the trades of the introducing broker with the third party.

§ 17A:11 AML and OFAC Issues

In addition to applicable regulatory requirements, the anti-money laundering (AML) program of an introducing broker must take into consideration the resources and the AML program of its clearing firm.

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30. *See generally* NASDAQ Rules 6100 *et seq.*; FINRA Rules 6100 *et seq.*

A smooth integration and understanding as to who is going to do what is critical and has become more critical as AML has risen in importance. Most clearing agreements include relatively detailed provisions setting forth the AML obligations of each of the introducing broker and the clearing firm.

These provisions generally place primary responsibility for AML compliance on the introducing broker, but also provide for cooperation between the clearing firm and the introducing broker. The clearing firm generally agrees to furnish certain types of reports to the introducing broker with respect to frequency of transactions and type of transactions. In some cases, particular types of accounts may be prohibited or limited, such as accounts for residents of jurisdictions deemed non-cooperative with respect to AML issued by the Financial Action Task Force.

These agreements provide that both parties must comply with AML laws. One of the key provisions of such agreements is with respect to customer identification. Under 31 C.F.R. § 103.22, each broker-dealer must have a Customer Identification Program (CIP) that enables the broker-dealer to form a reasonable belief that it knows the true identity of each customer. Under the CIP rules, the U.S. Treasury Financial Crimes Enforcement Network (FinCEN) permits one broker-dealer to rely on another broker-dealer to fulfill CIP responsibilities, provided certain requirements are met and the agreement provides for such arrangement. However, it is important to be aware that reliance on another broker-dealer for CIP does not obviate the need to "know the customer" through background checks and comparison with government watch lists. Consequently, the clearing firm needs to maintain basic documentation with respect to the customer. However, the introducing broker generally has the responsibility to obtain and verify the required information. Both the clearing firm and the introducing broker have the opportunity and responsibility to refuse to accept a customer if appropriate under AML policies.

Filing of suspicious activity reports (SARs) is a responsibility of each of the introducing broker and the clearing firm. While there is generally no requirement to file duplicate reports, each firm may be required to submit a SAR in instances where the other firm's SAR is believed to be incorrect or incomplete. Generally clearing agreements provide that when one party obtains information that might warrant a SAR, the other party will be notified. Financial institutions must make a brief filing with FinCEN prior to sharing information, known as a "314(b)" filing after the relevant section of the USA PATRIOT Act. In most cases, the sharing of information is covered in the clearing agreement or the AML addendum.

Unlike FinCEN, the Office of Foreign Asset Control (OFAC) requires each firm to be responsible to OFAC for verifying that there is not a violation of the OFAC provisions. In a recent release,

OFAC stated that it "does not generally permit businesses, including securities and futures firms, to reallocate their legal liability to a third party with respect to statutes which it administers." If there is such reallocation, the firm remains responsible to OFAC if there is a violation of its regulations.[31]

The SEC, other agencies and regulators are increasingly focusing on AML and OFAC compliance. Consequently, introducing brokers need to stay current with respect to published AML and OFAC releases and ensure that their programs dovetail with that of their clearing firms. Many clearing firms are capable of providing a significant amount of AML help to their introducing brokers, but it is generally up to the introducing brokers to implement and carry out their own AML and OFAC programs.[32]

§ 17A:12 Fair and Accurate Credit Transactions Act of 2003 and Privacy Requirements

In Regulatory Notice 08-69 (November 2008), FINRA alerted members to the Federal Trade Commission's implementation of the Fair and Accurate Credit Transactions Act of 2003 (the "Fact Act"). The Federal Trade Commission (FTC) recently promulgated significant regulations that are effective May 1, 2009. The SEC has implemented the Fact Act with extensive regulations.[33] The effective date is June 1, 2010. Not all broker-dealers will be subject to the Fact Act, but most introducing and clearing firms will need to comply with the Fact Act's stringent privacy provisions, including provisions with respect to anti-theft technology for their systems dealing with customer transactions, accounts and similar records of customer financial information.[34] Both introducing and clearing broker-dealers have been subject to SEC Regulation S-P,[35] the privacy regulations mandated by the Gramm-Leach-Bliley Act. However, now both introducing brokers and clearing firms will need to be familiar with the provisions of the Fact Act, which are different and in some respect more stringent than the current privacy regulations. The clearing agreement should specifically cover the particular provisions of the Fact Act and its regulations thereunder, which are quite complex and will be expensive to

31. Department of the Treasury, OFAC, Risk factors for OFAC Compliance in the Securities Industry (updated Nov. 5, 2008), *available at* www.treas.gov/offices/enforcement/ofac/policy/securities_risk_11052008.pdf.
32. For a more detailed discussion, see *infra* chapter 18, "Anti-Money Laundering Regulation of Broker-Dealers."
33. *See* Regulation S-AM33, 17 C.F.R. § 248.101–.128; 74 F.R 40398 (Aug. 11, 2009).
34. *See* 17 C.F.R. § 248.101–.128. *See also* Pub. L. No. 108-159 (2003).
35. Regulation S-P; 17 C.F.R. pt. 248.

implement. If there is a delegation to the introducing broker or vice versa, it should be spelled out clearly in the clearing agreement.

§ 17A:13 Introducing Broker Best Execution

Regulators increasingly review whether broker-dealers obtain best execution for customer transactions. An introducing broker may route all or most customer orders through its clearing firm for execution. Alternatively, it may send its order flow to a third-party executing broker-dealer, and clear the transactions through the introducing broker's clearing firm.[36] Best execution criteria are complex, and this section will focus only on NASD NTM 01-22 (April 2001) (the "Best Execution Notice").

As agents, all broker-dealers have duties of loyalty and due care to their customers. These duties require a broker-dealer to exercise care to obtain the most advantageous terms for a customer order, unless the customer otherwise directs the broker-dealer. The complexity of the best execution obligation is heightened by the evolution of the trading markets, including electronic trading and automation.

Although the best execution obligation is undisputed, the contours of best execution in evolving markets are less clear. Regulators usually require that the following factors be considered: order size; execution speed; trading characteristics; availability of market information; execution technology; access to various market centers; and the cost and difficulty associated with achieving such access.

Importantly, the Best Execution Notice requires "regular and rigorous" review of best execution by all broker-dealers handling retail or institutional orders, including introducing brokers.[37] FINRA requires specific disclosure with respect to fees.[38]

With the advent of electronic execution systems, some introducing brokers funnel order flow to one or more executing brokers, who execute the transactions and give up the transactions for clearing at the introducing broker's clearing firm.[39] The Best Execution Notice requires that NASD broker-dealers, when handling customer orders,

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36. For a more detailed discussion, see *supra* section 17A:10 and *infra* section 17A:15.
37. Other considerations, not discussed in this section, include: Section 28(e) of the Securities Exchange Act of 1934 (safe harbor for brokerage and research services in connection with securities transactions provided by a broker-dealer to a money manager that has investment discretion provided the commissions are reasonable in relationship to the services provided); and disclosure requirements (*see, e.g.*, Securities Act of 1933, § 17(a); Securities Exchange Act of 1934, § 10(b) and SEC Rule 10b-5).
38. *See also* FINRA Rule 2320 (best execution and inter-positioning); FINRA Rule 2440 and IM-2440 (fair prices, commissions and mark-ups).
39. *See supra* section 17A:10 and *infra* section 17A:15.

conduct "regular and rigorous" reviews of executions of the market and market makers to which their orders are routed.[40] The introducing broker must ensure its execution facilities provide best execution.

Importantly, an introducing broker routing order flow to a clearing firm or to executing broker-dealers may rely on the other firms' "regular and rigorous" reviews, as long as the results and rationale are fully disclosed to the introducing broker and the introducing broker periodically reviews such data. The introducing broker must analyze the data from its clearing firm and consider the quality of execution of other market centers and other venues where the orders may be executed. Introducing brokers' supervisory procedures must describe the required review and analysis of the executions by the executing firms. Any payments or consideration for order flow must be disclosed to customers. Many broker-dealers have a committee that meets regularly, at least quarterly, to review quality of executions. Minutes of such meetings and the underlying data should be preserved.

In Regulatory Notice 08-80 (December 2008), FINRA requests comments on a proposed FINRA rule addressing best execution. FINRA's proposal for comments includes:

1. The adoption of a new provision providing that if certain conditions are met, a member has met its best execution obligation regarding transactions in foreign securities with no U.S. market.
2. Replacement of NASD Rule 2030(g) with supplementary material addressing a member's best execution obligations in handling orders for securities with limited quotation information.
3. Codification of member firm's obligation to rigorously review execution quality.
4. Adoption of supplemental material addressing a member firm's obligation when handling an order that a customer has instructed the firm to route to a particular market for execution. This proposal is expected to be adopted in large part and be effective in 2010.

An introducing broker also should be familiar with SEC National Market System (NMS) Rules 605, 606 and 607.[41] Rule 605 requires disclosure of certain order execution information by market centers.[42] Rule 606 requires disclosure of order routing information by the

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40. *See also* NTM 01-22 (Apr. 2001), 99-11 and 99-12 (Feb. 1999), 98-96 (Dec. 1998), 97-57 (Sept. 1997) and 96-65 (Oct. 1996).
41. 17 C.F.R. §§ 242.605–.607.
42. Rule 605 was previously Rule 11Ac-5.

clearing firm or executing broker-dealer. Furthermore, customer account statements under Rule 607 are required to contain certain information concerning order routing practices.

In summary, best execution is a complex area requiring introducing brokers to coordinate and monitor trade executions.

§ 17A:14 Piggybacking Arrangements

Piggybacking generally involves two introducing brokers and one clearing firm. NASD NTM 05-72 summarizes this arrangement:

> [S]ome introducing firms choose not to contract for clearing services directly with a clearing firm. The reasons vary. For example, the firm may not do sufficient business to satisfy clearing firm financial and other requirements to support a separate clearing agreement. In such cases, the firm may contract for clearing services with an introducing, or "intermediary" firm that, in turn, contracts directly with a clearing firm for clearing services. Firms that contact for clearing services with an intermediary firm are often referred to as "piggybacking" firms, or "piggybackers."
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> Under this arrangement, only the intermediary firm has a contractual arrangement with the clearing firm, which clears for both the intermediary firm and the intermediary firm's piggybacking firm(s).[43]

The SEC has issued a letter to the NYSE concerning piggybacking arrangements.[44] Failure to follow the specific no-action letter requirements would cause clearing deposits or other proprietary funds to be classified as non-allowable assets for regulatory net capital.

The piggybacking broker's clearing deposits are deemed allowable assets for net capital only if certain conditions are met:

1. Option 1: The intermediary firm designates the cash or securities representing the clearing firm's deposit from the piggybacking broker to be placed in a separate account at the clearing firm in the name of the intermediary for the benefit of the piggybacking broker.
2. Option 2: The intermediary firm can send a notification to the clearing firm advising that the cash and securities representing the deposits of the piggybacking broker have been placed into the deposit account of the intermediary firm.

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43. NASD NTM 05-27 (Oct. 2005).
44. New York Stock Exchange Capital Guide, SEC staff to NYSE, No. 00-6, September 2000—Piggybacking Arrangements.

3. If option 1 or option 2 is not selected, the intermediary firm must make its own PAIB computation and include the deposit of the piggybacking broker.

4. Additional requirements:

    a. The clearing firm must send the PAIB agreement to the intermediary firm who in turn must send the agreement to the piggybacking broker if it has complied with either of the above options.

    b. The intermediary firm must also send a letter to the piggybacking broker advising that its deposits are being sent to the clearing firm, which is including them in its PAIB calculation.

Regulatory Notice 09-03 (January 2009) proposed to codify these schemes in a FINRA rule.

§ 17A:15 Prime Brokerage Arrangements

§ 17A:15.1 Introduction

Since the early 1990s, prime brokerage has become an increasingly important part of the securities business. Prime brokerage arrangements have presented a number of compliance and risk management issues to broker-dealers of all sizes and types.

Prime brokerage consists of executing a transaction with one broker-dealer (the executing broker-dealer) who transfers the position to another broker-dealer (the clearing or prime broker) that carries the customer's account and clears the transaction. Institutions, particularly hedge funds, increasingly use prime brokerage accounts, not only to facilitate execution, but also to gain perceived business advantages, such as operational and custodial services. Such institutions seek assurances that their accounts are carried with prime brokers who maintain superior resources and financial strength. Small broker-dealers may not have the capital to carry and clear large transactions for institutional clients. Nevertheless, institutional clients often go to a smaller broker-dealer who can supply expertise for effecting transactions in a particular market.

§ 17A:15.2 Background

In the early 1990s, a Securities Industry Association (SIA) (now known as the Securities Industry Financial Markets Association) Prime Brokerage Committee requested an SEC no-action position to clarify that prime brokerage arrangements were permissible. At that time, there were concerns with respect to margin requirements and

the applicability of sections 7, 10, 11(d), 15(c)(3), and 17 of the Exchange Act,[45] Regulation T[46] and Exchange Act Rules 10a-1 (short sales), 10b-10 (confirmations), 11d-1, 15c3-1, and 15c3-3.[47] In a response dated January 25, 1994, the SEC granted a no-action position provided certain requirements were met.[48]

The requirements for a prime broker are as follows:

1. The prime broker must notify its Designated Examining Authority it intends to act as a prime broker.

2. The prime broker must have net capital of at least $1,500,000. If the net capital of the prime broker drops below this amount, immediate notice must be given to all parties with whom it engages in prime brokerage activity, either individually or through the facilities of a clearing agency.

3. The prime broker may not settle prime broker trades for a customer unless the customer keeps a minimum net equity with the prime broker of at least $500,000 in cash or securities with a ready market.[49]

4. The prime broker may settle prime broker trades on behalf of customer accounts managed by a registered investment adviser, if each account has a minimum net equity of $100,000.

5. The prime broker may settle prime broker transactions on behalf of a customer who keeps a minimum net equity with the prime broker of $100,000 if the account is subject to a written cross-guarantee by another customer of the prime broker. The guarantor account must have net equity of at least $500,000. Each additional cross-guarantee requires an additional net equity of $400,000 for each individual account that is cross-guaranteed.

6. Prior to commencement of prime brokerage, the prime broker and the executing broker must execute a written contract that

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45. 15 U.S.C. § 78(g), (j), (k), (o)(c)(3) and (q).
46. 12 C.F.R. § 220 *et seq.*
47. 17 C.F.R. §§ 10a-1, 10b-1, 11d-1, 15c3-1 and 15c3-3.
48. SEC No-Action Letter (Jan. 25, 1994).
49. If market fluctuations cause the customer's net equity to drop below this level, the customer will have until noon on the fifth business day after the date when the net equity fell below the minimum to restore it to the $500,000 level. If the customer fails to do so, the prime broker must, by the close of business on the fifth business day, notify all broker-dealers with whom it has a prime broker contract on behalf of the customer that it is no longer acting as a prime broker for the customer.

specifies obligations and responsibilities of the parties regarding the prime brokerage relationship. This contract must be consistent with the conditions in the January 25, 1994 no-action letter.

7. The prime broker must execute a contract with each customer on whose behalf the prime broker will settle prime brokerage transactions. This contract must be signed by the customer and must specify the obligations and responsibilities of the prime broker arrangement. The customer contract and the contract with the executing broker referenced above must be maintained in an easily accessible place and produced upon request of the SEC or self-regulatory organization (SRO).

8. The prime broker must keep separate records identifying all customers using a prime broker arrangement, and executing brokers used. These records must be maintained in an easily accessible place and produced upon request of the SEC or SRO.

9. Parties to a prime brokerage arrangement must use a clearing firm for issuance of trade confirmations and affirmations.

10. The prime broker must be responsible to settle each of the customer's transactions placed with an executing broker and confirmed to and received by the prime broker, unless the prime broker disaffirms or does not know (DK) a particular transaction no later than the close of business on T+1.

11. The prime broker must keep a record of all trades disaffirmed during the previous three years, specifying the identity of the customer and the executing broker.

12. If the executing broker sends confirmations under Exchange Act Rule 10b-10 to the prime broker, the prime broker must inform the customer in writing that the confirmation is available to the customer without charge.

13. On the day following the transaction, the prime broker must send the customer notification of each trade placed with the executing broker based upon information provided by the customer.

14. If the prime broker disaffirms a transaction, it must send a cancellation notification to the customer to offset the notification sent on the day following trade date.

15. The prime broker may not extend credit on a security that it has sold or arranged for the executing broker to sell to the customer, if the prime broker was a member of a selling

syndicate or group for the security in the prior thirty days; however, a prime broker may extend credit in a prime brokerage account for a security sold by the executing broker if the prime broker had not otherwise arranged for that sale.

16. The prime broker must treat the customer as its own customer for all purposes if it does not disaffirm or DK the trade as provided above.

17. The prime broker may not engage in prime brokerage activities with executing brokers or customers if they actually or have reason to know that the other party is not in compliance with the January 25, 1994 no-action letter.

The requirements for an executing broker wishing to take advantage of a prime brokerage relationship parallel to the above requirements, and are as follows:

1. The executing broker must have net capital of at least $1,000,000. If the net capital of the executing broker drops below this amount, immediate notice must be given to the other parties.

2. Prior to commencement of prime brokerage, the executing broker and the prime broker must execute a written contract that specifies their respective obligations and responsibilities.

3. The executing broker must execute a written contract with each customer.

4. For all transactions, the executing broker must inform the prime broker of the following: (i) contract amount; (ii) security involved; (iii) number of shares or units; and (iv) whether the transaction was a long or short sale or a purchase. The executing broker must do so by the morning of the next business day following the transaction.

5. The executing broker must undertake its own credit review of the customer to ensure that it knows the customer.

6. The executing broker must comply with all applicable short-sale provisions. Prior to executing any short sale, the executing broker must determine that securities can be borrowed to deliver against the short sale.

7. Exchange Act Rule 10b-10 requires that the executing broker send confirmations of transactions directly to the customer. However, confirmations may be sent to the customer through the prime broker if the customer and the prime broker have a written agreement to that effect.

8. If the prime broker disaffirms a transaction, the executing broker must immediately send a confirmation of the replacement transaction to the customer.

9. The executing broker must keep and preserve all records required under Exchange Act Rule 17(a)(6), (a)(7) and (a)(9).[50]

10. If the executing broker was part of a selling syndicate or group for a security within the previous thirty days, the executing broker may not extend credit on that security.

In documenting prime brokerage agreements, most firms use SIFMA Form 150 or SIFMA Form 151.

In NTM 07-58 (November 2007), FINRA solicited comments on its proposed guidance regarding international prime brokerage practices. Because of the explosion of global trading and electronic system interconnectivity, this proposed guidance is important not only for international prime brokerage firms, but any firm that participates in international prime brokerage transactions, including executing brokers, prime broker custodians and customers because it sets forth a structure and details about what FINRA expects from a regulated member. Although this is a proposed guidance, it is a sound list of things that should be covered in the supervisory and operating procedures of the international prime brokerage custodian, the executing broker and any member of FINRA, or any other customer engaged in prime brokerage, such as a hedge fund.

These requirements are relatively straightforward. However, in practice, a number of compliance issues have arisen.

§ 17A:15.3 Execution of the Prime Brokerage Agreements

A prime brokerage agreement between the prime broker and the executing broker is critical for risk compliance, and for the protection of both parties. The prime brokerage agreement provides that the executing broker may transfer a transaction to the clearing broker for clearing and settlement. However, the SIFMA prime brokerage forms also provide that the prime broker, which is the clearing firm, may reject trades of the executing broker within certain time frames. Unless such agreement is in place, the executing broker will have

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50. These subparagraphs relate, respectively, to the obligation to make: (i) a memorandum of each brokerage order; (ii) a memorandum of each purchase and sale; and (iii) a record of each cash and margin account, including the name and address of the beneficial owner, whether the beneficial owner objects to disclosure of its identity to issuers, and the signature of the owner for margin accounts.

capital charges and Exchange Act Rule 15c3-3[51] obligations for the transaction, and also is responsible for its customers' margin requirements.

The prime broker wants the option to not accept a trade if the ultimate customer does not have the financial ability to finance the transaction. For example, if a customer's account at the prime broker has approximately $2,000,000, and the executing broker executes an equity transaction for $5,000,000, the prime broker will require additional margin from the customer, to avoid exposure to the significant credit risk of the customer's possible default. For this reason, the prime broker has the right to reject trades under certain circumstances, usually within a short time period, and subject to notification pursuant to the prime brokerage agreement.

§ 17A:15.4 Lack of Appropriate Customer Documentation

Both the prime broker and the executing broker should have complete documentation from the customer. Regulators require such documentation because the clearing broker has the right to refuse to accept the transaction under certain circumstances if prompt notice is given. Regulatory sweeps have found significant deficiencies in this area.

Supervisory procedures of both the executing broker and the prime broker should provide that all customer documentation must be in place prior to the initial transaction. Full customer documentation includes margin agreements, margin disclosure and related documents.

§ 17A:15.5 Customer Credit and Suitability Obligations

Although prime brokerage transactions are effected only for large institutions and high-net-worth customers, suitability obligations still exist. More importantly, the executing broker must know its customer's financial position, even if it has an agreement with a prime broker under which the prime broker will accept any transactions executed by the executing broker. Under standard SIFMA forms, the prime broker need not accept a transaction from an executing broker. Sometimes prime brokers will agree to accept certain types of transactions, or accept up to a certain dollar amount or number of shares. It is rare that the prime broker will accept any transaction without a right of rejection. For these reasons, it is critical that the executing broker know that its customer has the financial capability to pay for or

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51. 17 C.F.R. § 240.15c3-3.

finance transactions, in case the transactions are rejected by the prime broker. Obviously, the clearing firm needs to be certain that the customer and the executing broker have the wherewithal to pay for the transactions or finance them once they are accepted.

§ 17A:15.6 Executing Broker Risk Control

An executing broker should have a risk-control procedure with respect to any trades that it executes with a customer pursuant to a prime brokerage arrangement to ensure that the clearing firm will clear the transaction and not reject it. The executing broker should either have an agreement with the prime broker to accept trades within certain parameters or, alternatively, that the transactions are within the credit capabilities of the customer. If the transaction is rejected by the prime broker, the executing broker must clear the transaction itself or through its own clearing firm.[52]

§ 17A:15.7 Clearing (Prime) Broker Risk Control

The prime broker must have risk-control procedures to evaluate transactions from an executing broker that the prime broker proposes to clear. These risk controls address knowing the customer's positions when the executing broker notifies the prime broker of a transaction. The prime broker at that point must make a decision as to whether to accept or reject the trade. If there is an agreement with the executing broker, the prime broker is contractually obligated to accept the trade. If the trade is rejected there may be a claim.

§ 17A:15.8 Extension of Credit on Syndicated and Other Public Offerings

Compliance procedures should provide that the prime broker will not extend credit on a security to be sold through the executing broker if the prime broker was a member of the selling syndicate for the securities in the prior thirty days. However, the prime broker may clear the transaction and extend credit in a prime brokerage account for a security sold by an executing broker if the prime broker has not arranged for that sale.

§ 17A:16 Considerations in Negotiating a Clearing Arrangement

§ 17A:16.1 Business Activities

The introducing broker's proposed business activities should be the overriding consideration. Activities may include retail, institutional,

52. *See also* discussion in *supra* section 17A:10.

options, bonds, mutual fund transactions, or proprietary trading, market making, underwriting, firm commitment underwriting and related areas. Each of these activities will affect the clearing relationship and the provisions of the clearing agreement.

§ 17A:16.2 The Amount of Clearing Deposit

The required clearing deposit amount will depend upon the nature of the introducing broker's activity, the firm's financial condition and the risk of the introducing broker's business activities as perceived by the clearing firm. In most cases, the amount of the clearing deposit is negotiable. Many clearing agreements provide that the clearing deposit will be increased based upon the volume and type of transactions over time.[53]

§ 17A:16.3 ACT Credit Line

The amount of the ACT credit line will depend upon whether the introducing broker proposes to execute transactions away, rather than executing all transactions through the clearing firm. If either customer or proprietary transactions are to be executed away, an ACT credit line will have to be established. The ACT credit line will depend upon the introducing broker's financial position, risk controls, types and size of transactions, history of trading and related considerations.[54]

§ 17A:16.4 Cost of Clearing

Costs of clearing have traditionally been based on the number of transactions or shares traded. In some cases there are caps or reduced fees based on trading volume. Clearing firms now also offer several additional services besides clearing transactions. Some services or products may be part of a basic clearing package, while other services may be offered separately under a negotiable fee structure. Some service costs may be dependent upon the number of transactions effected by the introducing broker. Services may include proprietary products, retirement plan administration, securities research, or trust services. Some clearing firms assist with compliance programs and procedures, including exception reports, on-line reports, real-time reporting, and execution systems.

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53. *See supra* section 17A:8, Clearing Deposits. *See also infra* section 17A:16.26, Termination.
54. *See also supra* section 17A:10.

§ 17A:16.5 PAIB

As discussed in section 17A:7 *supra*, proprietary assets of the introducing broker, including the clearing deposit maintained at a clearing firm, must be held in a PAIB account if the introducing broker proposes to use those assets in computing net capital.

§ 17A:16.6 Financial Reports and Financial Information

The clearing firm will want to receive detailed financial reports and financial information from the introducing broker at the commencement of the relationship, and continually thereafter. The introducing broker will also want to receive financial information concerning the clearing firm, to ensure that the clearing firm is able to meet its obligation to the introducing broker.

Clearing agreements generally provide that the introducing broker will provide to the clearing firm any notices it sends to regulators, usually with respect to early warning regarding financial condition or required books and records. Very few clearing agreements provide that the clearing firms provide the same type of notice to an introducing broker.

§ 17A:16.7 Registration

Clearing agreements generally provide that the parties each will be fully registered and members of all applicable self-regulatory organizations or exchanges required to effect their transactions. A firm that is no longer properly registered will usually be deemed to have terminated the agreement.

§ 17A:16.8 Customer Accounts

Normally, the clearing firm provides required documentation for the introducing firm's customer accounts. The clearing firm generally requires that the introducing broker's customers enter into the clearing firm's standard customer agreement. Some introducing brokers seek additional information from customers through separate forms or agreements.

Clearing firm customer agreements not only protect the clearing firm from customers' claims, they may also extend certain provisions and protections to the introducing broker. It is advisable for the introducing broker to analyze such provisions and protections and, if necessary, supplement the clearing firm's customer agreement.

Most clearing firm customer agreements provide that the introducing broker is acting as agent for the customer, and the clearing firm may act on any instructions, oral or written, from the introducing broker without further inquiry. Some clearing agreements specifically state that the introducing broker is not the agent of the clearing firm.

§ 17A:16.9 Acceptance of Accounts and Sales Practice Obligations

Clearing agreements generally provide that the introducing broker must approve any account, and that suitability determinations and similar sales practice considerations are the sole responsibility of the introducing broker. In many cases the clearing firm must also approve the account before it is approved particularly for margin or other types of transactions, such as options trading. A well-drafted clearing agreement should delineate the respective sales practice and account opening responsibilities of the clearing firm and the introducing broker.

§ 17A:16.10 Compliance Procedures and Exception Reports

Clearing firms offer introducing brokers a variety of software and electronic compliance programs that monitor the business of the introducing broker, such as exception reports. The introducing broker should inquire as to what programs are offered by the clearing firm, select those applicable to its business and determine the associated costs. In some cases, the introducing broker may have its own programming, but clearing firm systems often are more comprehensive and timely. Clearing firms are required to provide introducing brokers with a list and description of compliance programs and exception reports at the commencement of the relationship and annually thereafter.[55]

§ 17A:16.11 Margin and Extension of Credit

Margin procedures generally are set forth in the customer agreement. Margin requirements are usually set by the clearing firm. It is important to determine who is responsible for transmittal of margin calls. In most cases, the margin calls are generated by the clearing firm, but the introducing broker must transmit the margin calls, and follow up to see they are satisfied. Clearing firms generally retain the right to proceed against customers failing to meet margin calls.

Under most clearing agreements, failure to make margin payment will result in liability to the introducing broker if there is a customer debit. The introducing broker should determine whether it may set higher margin requirements as needed.

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55. For details regarding clearing firm and introducing firm responsibility regarding certain reports, see *supra* section 17A:5.

§ 17A:16.12 Maintenance of Books, Records and Reports

The clearing agreement should delineate what books and records will be maintained by each party. Generally, required records are listed by category.

Clearing agreements also specify specific books and records to be maintained by the introducing broker. Clearing agreements or supplemental schedules generally set forth the information that must be transmitted by the introducing broker to the clearing firm for execution purposes, and current books and records requirements.

Today, clearing firms have a large number of reports that are available to the introducing broker relevant to the broker's accounts. The clearing agreement or supplement should specify such reports, the information to be contained in the reports, and how the information will be displayed. Many of these reports now are on-line, and various books and records also may be maintained on-line. There should be a provision as to which books and records will be maintained on-line, on what basis, how often they will be updated or whether they will be on a real-time basis.

The clearing firm may offer a package of reports from which the introducing broker may choose. Specialized reports generally will be at the introducing broker's cost because the clearing firm will have to reprogram its software or make other modifications.[56]

§ 17A:16.13 Reports by the Introducing Firm to the Clearing Firm

The introducing broker will be obligated to provide certain reports and information to the clearing firm on a real-time or daily basis, including real-time reporting of transactions. In addition, there will be weekly and monthly reports, including financial information regarding the introducing broker. Many of these reports will be covered in the clearing agreement or in supplemental schedules.

§ 17A:16.14 Customer Funds and Securities

The clearing agreement should set forth what the introducing broker may do with respect to customer funds and securities that it receives. Normally, custody of all funds and securities will be maintained by the clearing firm, and customer funds or securities received at the introducing broker should be transmitted immediately to the clearing firm.[57]

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56. *See also id.*
57. For a discussion of net capital and financial responsibility options and requirements, see *supra* section 17A:6.

§ 17A:16.15 Local Deposit of Funds and Drafting Authority

As discussed above, there may be provisions with respect to local deposit of funds in a special account for the benefit of the introducing broker's customers. In addition, there may be local check drafting authority.[58]

§ 17A:16.16 Confirmations and Account Statements

The clearing agreement generally provides that the clearing firm will prepare and transmit customer account statements. However, in some cases account statements may be transmitted or mailed by the introducing broker under certain limited circumstances and controls. Likewise, confirmations are usually generated and mailed by the clearing firm. They may also be printed locally and mailed by the introducing broker. The format of the account statements or confirmations may, in some cases, be changed to accommodate an introducing broker, but generally the clearing firm will specify their format. Placement of logos and names should be negotiated.

§ 17A:16.17 Execution of Orders and Transactions

Today there are many systems for order execution. Some of those systems provide for transactions to be executed by the introducing broker through the clearing firm. However, in many cases transactions may be executed away at another broker-dealer, usually by electronic order entry systems. Such systems and execution methods, including participation in ACT, should be documented.[59]

§ 17A:16.18 Commissions and Fees

Since all funds should be received and held by the clearing firm, it will initially receive customer commissions to be shared with the introducing broker. Fee handling should be covered in the agreement. Normally collected commissions, after deducting clearing costs and fees, are paid from the clearing firm to the introducing broker monthly or more frequently. The clearing firm should provide a statement to the introducing broker, subject to reconciliation. The clearing agreement should have a provision for resolving any disputes concerning commissions or other fees.

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58. For further discussion, see *supra* section 17A:9.
59. For further discussion, see *supra* section 17A:10.

§ 17A:16.19 Return of Clearing Firm Deposit

Return of the clearing deposit is an important consideration. Some clearing agreements provide that, upon termination, all or part of the clearing deposit will be held for contingent liabilities. The length of time that a clearing deposit may be held is a subject for discussion and should be covered in the clearing agreement.[60]

§ 17A:16.20 Indemnification

Clearing agreement indemnification provisions also are important. The clearing firm usually is broadly indemnified, and the clearing firm may even price its services based upon the degree of indemnification. In most clearing agreements, the introducing broker receives a somewhat lower level of indemnification from the clearing firm. The introducing broker should carefully review the indemnification provisions and be certain that it is willing to undertake such indemnification obligations and whether the indemnification from the clearing firm is adequate.

§ 17A:16.21 Exclusive Services

The clearing agreement should specifically state whether it is exclusive or non-exclusive. Some clearing firms may only offer limited clearing services dealing with U.S.-traded equities, options or bonds. The clearing firm may not offer certain other services, such as execution or clearance of certain foreign securities, or of industry professionals such as exchange specialists, market makers or floor brokers. The introducing broker should consider requiring a non-exclusive provision or a carve-out in the clearing agreement's exclusion provisions.

§ 17A:16.22 Proprietary Trading, Underwriting, Market Making and Specialist Activities

Clearing agreement provisions may restrict an introducing broker from engaging in proprietary trading without the clearing firm's consent. Other provisions may restrict market making, specialist or underwriting activities. Proprietary activities often are addressed in a supplement, detailing allowed activities and payment provisions.

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60. For a discussion regarding clearing deposits, see *supra* section 17A:8. *See also infra* section 17A:16.26.

§ 17A:16.23 *Disciplinary Action, Regulatory Forms and Notices*

Most clearing agreements provide that the introducing broker will provide to the clearing firm current copies of its Form BD, personnel U-4s, U-5s, and any complaints, investigations or disciplinary actions on an on-going basis. A few clearing agreements also provide that the clearing firm will notify the introducing broker of certain types of investigative or disciplinary activities with respect to the clearing firm.

§ 17A:16.24 *Use of Clearing Firm's Name*

While the clearing firm's name will appear on confirmations and account statements as the carrying broker-dealer, it generally does not appear prominently. Use of the clearing firm's logo and name by the introducing broker is limited by the clearing agreement. If the introducing firm proposes to use the clearing firm's logo or name in advertisements or otherwise, the clearing firm's consent must be specifically obtained under the provisions of most clearing agreements.

§ 17A:16.25 *Excess SIPC Coverage*

Many clearing firms offer excess SIPC coverage of customer accounts carried at the clearing firm. The amount, coverage, and conditions should be specified in the agreement.

§ 17A:16.26 *Termination*

Clearing agreement termination provisions are fairly detailed. Because of the costs in setting up a clearing arrangement, such as transferring customer accounts, termination can result in considerable expense to the clearing firm as well as to the introducing broker. Termination provisions should be carefully thought out and negotiated.

Many clearing agreements provide that they may not be terminated for a period of one or two years without payment of a significant penalty. Furthermore, many clearing agreements provide in the event of termination that the clearing firm is entitled to recoup certain costs involved in the transferring of customer or proprietary positions to another clearing firm. As discussed *supra* under "The Amount of Clearing Deposit" (section 17A:16.2), many agreements provide the clearing deposit can be held for a period of time pending resolution of contingent claims.[61]

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61. *See also supra* section 17A:10.

§ 17A:16.27 Confidentiality and Non-Solicitation Provisions

Generally, clearing agreements provide that the introducing broker's customer information will be held confidential and not disclosed to third parties or affiliates of the clearing firm. SEC Regulation S-P,[62] Fact Act and state laws require that customer information be secure. This necessarily means that the introducing broker and the clearing firm both have a responsibility to keep confidential customer information and handle it in accordance with SEC Regulation S-P and the Fact Act regulation. Other information, such as unexecuted orders, must be held confidential. A number of clearing agreements today have a data protection addendum as to each party's responsibility with respect to handling of customer data, including its disposal.[63]

Clearing agreements generally provide that the clearing firm will not solicit the accounts or employees of the introducing broker during the term of the agreement. The introducing broker should consider whether these provisions should extend for a period of time after the clearing arrangement is terminated. Many clearing agreements provide for non-solicitation of employees or customers by the clearing firm or its affiliates for a period of twelve months after termination.

§ 17A:16.28 Arbitration

Clearing agreements invariably contain arbitration provisions. Provisions as to the arbitration forum should be reviewed. In addition, the location of the arbitration may be important. In most cases, the clearing firm will demand that any arbitration hearing take place at its headquarters locale.

§ 17A:16.29 Anti-Money Laundering, OFAC and Fact Act Coordination Provisions

As discussed in section 17A:11, because of the recent AML rules in place in the securities industry, the clearing agreement will provide a division of AML responsibilities between the clearing firm and the introducing broker. In most cases, the introducing broker will have primary responsibility with respect to verification of customer identity and background, and monitoring transactions in the account. Many clearing firms offer a variety of electronic systems with exception reports to assist the introducing broker in identifying transactional discrepancies that may be required to be reported under suspicious

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62. 17 C.F.R. pt. 248.
63. *See also supra* sections 17A:11 and 17A:12.

activity reporting. However, the primary responsibility for AML compliance under most clearing agreements will rest with the introducing broker. As noted above in section 17A:11, OFAC does not recognize a delegation of responsibilities between a clearing firm and introducing broker. Both are responsible for OFAC compliance. In most cases the clearing firm will make an OFAC check, but an introducing broker should have the ability to do such a check either through the clearing firm system or some other system, and maintain appropriate records. These issues should be addressed in the clearing agreement or supplement to the agreement.

As noted in section 17A:12 above, Fact Act provisions should be coordinated in the clearing agreement. As part of the Fact Act privacy provisions, the clearing agreement should allocate responsibilities between the clearing firm and introducing broker. The allocation to the introducing broker or vice versa should be spelled out clearly in the clearing agreement.

§ 17A:17 Negative Consent Letters and Bulk Account Transfers

It is important for an introducing broker, unless it is a start-up broker-dealer, to be able to transfer accounts from a current clearing firm to a new clearing firm. The most expeditious means is a mass transfer of accounts, after a negative consent letter is furnished to customers. Mass transfer of accounts requires regulatory approval as discussed *infra*.

In October 2004, the NASD in NTM 04-72 advised members that negative consent letters for bulk trust transfers of customer accounts would not be appropriate to effect a change of broker-dealer of record for a mutual fund or variable insurance product held directly with the issuer, except in certain specified situations. The NTM advised that a member must obtain affirmative consent from a customer in order to direct a change in the broker-dealer for either a mutual fund or variable annuity account. The staff, however, identified in NTM 04-72 five specific situations in which it believed negative consent letters would be appropriate to transfer customer accounts:

1. A member experiencing financial or operational difficulties;
2. An introducing firm no longer in business;
3. Changes in a networking arrangement with a financial institution;
4. An acquisition or merger of a member firm; and
5. A change in a clearing firm by an introducing firm.

NTM 02-57 (September 2002) also prohibited negative consent letters for bulk transfers of customer accounts except in the five situations above. As a result of NTMs 02-57 and 04-72, customer consent may be required for transfers of special products such as mutual funds or variable annuity accounts, including changing the broker-dealer of record.

After NTM 04-72 was published, the NASD promulgated a further explanation in the form of an interpretive letter.[64] In the interpretive letter, the NASD reaffirmed its position that affirmative consent should be obtained for most account transfers, including changes of the broker-dealer of record, where the mutual fund, variable annuity or other securities are held by the issuer. The NASD did acknowledge that in addition to the five exceptions described in NTMs 02-57 and 04-72, there were compelling reasons to permit a negative consent letter in lieu of affirmative consent in the following situations:

1. Where the registered representative assigned to the customer's account is no longer available to provide services to the account and the member firm currently named as the broker-dealer no longer intends to provide the services performed by the registered representative. Such accounts essentially are called abandoned accounts.

2. When a broker-dealer is going out of business, a negative consent may be used to change the broker-dealer of record on the customer's directly held mutual fund variable insurance product accounts to another service provider.

3. A registered representative exiting a firm, where the firm will not be providing services that the registered representative was performing for the directly held account.

4. Changes in networking arrangements with a financial institution.

The interpretive letter also specified that any negative consent letter must have adequate time and information for a customer to decide whether to object to the transfer. See Notice to Members 02-57 for further details on the required disclosures. SEC Regulation S-P also impacts bulk transfers.

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64. *See* NASD, Interpretive Letter, The Use of Negative Response Letters to Change the Broker-Dealer of Record on a Mutual Fund or Variable Insurance Product Account Held Directly at the Issuer, *available at* www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/p012109.

§ 17A:18 Third-Party Liability of Clearing Firm and Introducing Brokers

Generally, the introducing broker will be liable to its customer for violation of the securities laws, including fraud, or breach of contract with its customers, since the customer relationship is with the introducing broker. The clearing firm's liability is limited, generally to failure to appropriately clear transactions, or for misappropriations by the clearing firm. But the clearing firm generally is not liable for the acts of the introducing broker, including securities laws violations or fraud. In a few instances, clearing firms have been liable to customers for introducing broker fraudulent activity or securities law violations where the clearing firm knowingly and actively participated in the violations. Discussion of third-party liability is beyond the scope of this chapter.

As noted *supra* in section 17A:4, the clearing agreement and the customer agreement normally provide that the introducing broker acts as agent of the customer and not as agent of the clearing firm. Further, the agreements provide that the clearing firm may rely upon the instructions of the introducing broker, orally or in writing, without further inquiry.[65]

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65. For a detailed discussion of third-party liability of clearing firms, see Minnerop, *supra* note 1. *See also* chapter 17, "Clearing Broker Liability and Responsibility."