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INFORMATION EXCHANGE

In the following consultations, the member was informed that the preliminary advice provided was subject to the accuracy and completeness of the facts recited, including the presence or absence, and the identities, of adverse parties. No attempt was made to investigate the facts represented to us. Any deviations from, or additions to, the facts as described to NSCP staff members could have warranted different conclusions and resulted in different advice. In most cases, it was also recommended that a representative of the appropriate SRO or other governing body of the member's firm be consulted to confirm proposed solutions to the problem at hand.

IA Standards for Compliance with E-Mail and IM Recordkeeping and Review

Although the search for efficiency through electronic means in the arena of corporate recordkeeping is not a new topic for securities firms, the retention and review of electronic messaging continues to plague the industry. The time for successful implementation of effective policies and procedures is now, as regulatory examiners are sure to test firms' compliance in this area in upcoming examinations.

Meeting the standard of regulatory compliance related to electronic messaging requires compliance policies and procedures that address retention, protection, review and ongoing testing. While implementation of other policies within a firm might be effectively carried out through tightly consolidated means using centralized systems and procedures and touching only core

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Key Points for Introducing Broker-Dealers to Understand In Connection With Clearing Arrangements

By Paul B. Uhlenhop, Esq.

I. Introduction

The purpose of this outline is to discuss key business and regulatory issues that every introducing broker-dealer should consider before entering into a clearing arrangement. There are numerous business as well as regulatory complexities to the clearing arrangement between an introducing broker-dealer and clearing broker-dealer. For a detailed and extensive legal and business discussion of the clearing arrangement, see the definitive legal work describing clearing arrangements of Mr. Henry Minnerop entitled "Clearing Arrangements" which appears in the *Business Lawyer.*[1]

II. Understanding the Arrangement

There are essentially two types of clearing arrangements, the most common is what is called a fully-disclosed clearing arrangement. In a fully-disclosed clearing arrangement, the introducing broker-dealer introduces transactions to the clearing firm for clearance, settlement and custody. The arrangement is called fully-disclosed because division of the functions between the clearing firm and introducing firm is disclosed in a notice to the customers of the introducing firm. The other type of clearing arrangement is an omnibus arrangement. In an omnibus clearing arrangement, an omnibus clearing firm carries in a single account the positions for all of the introduced customer transactions of the introducing firm. Proprietary positions may also be carried. The omnibus clearing firm performs clearance, settlement, execution and custody pursuant to contract with the introducing firm. The proprietary transactions must be in an account separate from customer transactions at the omnibus firm. However, in the omnibus arrangement, the introducing firm 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 firm.

In a fully-disclosed introducing broker-dealer arrangement, the introducing broker-dealer will generally have significantly less financial responsibility requirements under the SEC capital rule 15c3-1 and under the

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Paul B. Uhlenhop is a Partner at the Chicago, Illinois law firm of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C. Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York. Mr. Uhlenhop also serves on NSCP's Board of Directors.
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SEC financial safekeeping rule 15c3-3. Furthermore, although the introducing broker-dealer will be responsible for its required books and records, many of those will be generated and maintained by the clearing firm for the introducing broker-dealer pursuant to the clearing agreement with the introducing broker-dealer. The clearing firm also usually provides excess SIPC insurance.

In an omnibus relationship, the introducing firm has a higher capital requirement, must meet the requirements of the SEC safekeeping of customer funds and securities and must maintain the required books and records. Furthermore, in the omnibus relationship, any excess SIPC insurance would be maintained by the introducing firm. One of the advantages of the omnibus arrangement is that, particularly with respect to securities in which the firm does not effect many transactions, such as foreign securities or certain other types of securities, the introducing firm would not necessarily have to be a member of, for example, foreign clearing organizations or other organizations. Likewise under the omnibus arrangement for United States securities or options, clearance and settlement may sometimes be effected by the omnibus broker-dealer without the introducing firm being a member of a clearing organization such as National Securities Clearing Corporation or the Options Clearing Corporation.

Business economics drive the clearing relationship as is explained in more detail below. The fixed cost for clearing, settlement and execution of transactions today is very high because firms that clear transactions must have a large number of electronic systems, memberships in clearing organizations, deposits with clearing organizations and highly experienced personnel in order to effect settlement, clearing and execution of transactions. Start-up cost for a firm to clear all of its transactions is enormous and generally cannot be accomplished economically. In addition, the regulatory approvals and memberships required to establish a clearing relationship for a fully-clearing firm clearing all types of securities are almost impossible to effect from a regulatory standpoint for a startup broker-dealer because the regulators will not give the appropriate approvals nor will the memberships and clearing organizations be available unless the firm has a considerable amount of experience, risk control systems and experienced personnel. Until a firm has a very large number of transactions, the fixed cost for clearing per transaction will be far higher than if the firm clears its transactions at an established clearing firm. Because of the enormous fixed cost of systems, capital, personnel and regulatory requirements, clearing firms have a significant advantage if they can attract additional business because the additional transactional business adds very little incremental cost. Consequently, clearing arrangements costs are very competitive.

III. Key Functions of the Clearing Arrangement

Mr. Minnerop, in his definitive article on clearing, identifies key functions involved in the operation of customer accounts and the settlement and clearance of transactions in such accounts as follows:

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. amending electronic systems for compliance and management of the introducing broker-dealer.[2]

If a firm is self-clearing, it will perform all of the above functions that are applicable to its business. If a firm introduces its accounts on a fully-disclosed basis, the clearing agreement

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Lawrence, Kamin, Saunders & Uhlenhop, L.L.C.
208 South LaSalle Street
Suite 1750
Chicago, Illinois 60604
(312) 372-1947
www.lksu.com

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

The rules of the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD") require that when an introducing broker-dealer and a clearing broker-dealer enter into a fully-disclosed relationship dividing the functions between them, the customer must be notified in a summary statement of the nature of the division of functions and which entity will be performing what function.[3] Most fully-disclosed clearing arrangements provide that all customer relation functions are the responsibility of the introducing broker-dealer. Generally, in the fully-disclosed arrangement the introducing broker-dealer is responsible for opening, approving and monitoring customer accounts, providing any recommendations, dealing with customer complaints and problems, accepting and executing customer orders, collecting margin and compliance related to these areas. Customer orders may be executed by the introducing firm either through the clearing firm or through some third broker-dealer and given up to the clearing firm for settlement. While credit may be extended by the clearing firm that carries the customer's account to the customer, the margin credit is, under most clearing agreements, the financial responsibility of the introducing firm. The introducing firm must indemnify the clearing firm for any margin or credit losses (i.e., customer's failure to pay). While in most clearing arrangements the confirmations are prepared by the clearing firm and are mailed by it, confirmations may be printed and mailed to customers by the introducing firm. Monthly account statements are usually prepared and mailed by the clearing firm.

Under the SEC financial responsibility rules discussed in Section IV below, an introducing broker-dealer may receive customer funds or securities for prompt transmittal to the clearing firm but may not hold or carry customer funds or securities without substantially increased capital and other requirements. Some broker-dealers elect the higher capital requirements even though they introduce on a fully-disclosed basis. However, this is fairly rare because of the additional capital required and is usually limited to firms engaged in certain proprietary securities activities.

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 the clearing arrangement. Likewise, there are generally provisions against solicitation and hiring of employees of the introducing broker-dealer by the clearing firm without the introducing broker-dealer's consent. For further discussion, see Section VIII.A below.

IV. Introducing Broker-Dealer Capital and Financial Responsibility Requirements, in General

SEC Rules 15c3-1 and 15c3-3

The two key financial responsibility rules are SEC Rule 15c3-1, the net capital rule, and SEC 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-dealer in connection with understanding its business options and financial requirements of a clearing arrangement.

Also of importance is SEC Rule 17a-11 which sets a number of minimum thresholds called "early warning thresholds." Rule 17a-11 requires prompt notice to the regulators (1) if the broker-dealer's aggregate indebtedness is in excess of 1200% of net capital, or, (2) if 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, or, (3) if the broker-dealer's total net capital is below 120% of the required minimum, or, (4) if 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 and the firm's designated examining authority and various other regulatory organizations with which the firm may be involved. However, from a practical standpoint, the minimum thresholds of Rule 17a-11 are the true applicable minimum capital level because if the broker-dealer does not meet those thresholds for any but a short period, the self-regulatory organizations or the SEC generally will require the firm to contract its business or cease operations.

The SEC capital rule provides a number of alternatives to a broker-dealer. A broker-dealer that wishes to engage in securities activities without restriction and self-clear its transactions has a significantly higher capital requirement. 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-dealer.

V. Assets Held by Clearing Firm

Proprietary assets of an introducing broker-dealer maintained at a clearing firm are good assets for purposes of computing net capital under Rule 15c3-1 only if the introducing broker-dealer and the clearing firm comply with the SEC interpretation regarding treatment of proprietary accounts of introducing broker-dealers (PAIB accounts).[4] If assets are not held in a PAIB account and pursuant to the provisions of the SEC interpretation, the assets held at the clearing firm by an introducing broker-dealer are considered to be "not readily convertible into cash" and have no value for capital purposes. Consequently, introducing firms hold assets at clearing firms pursuant to PAIB agreements which include notification to the introducing firm's clearing firm. The PAIB regime does not apply to certain assets held offshore.[5] Because of these

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PAIB requirements, it is important in any clearing arrangement that an introducing broker-dealer be certain that there is a PAIB agreement with the clearing broker-dealer, that it is properly executed and that proper notices are given.

VI. Check Writing and Local Cashiering

As discussed above, receipt, delivery and custody of securities of customers generally are the functions of the clearing firm for a variety of reasons, including exemptions in whole or in part from the SEC net capital rule or SEC 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 firm against a local account of the clearing firm.

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 firm. If the introducing firm is a $50,000 broker-dealer, it may receive customers' funds as long as it does not hold them. Using this provision, customer checks may be received by an introducing firm and promptly deposited by it into a local bank account that's held in the name of the clearing firm.

Local check writing is a device by which a clearing firm authorizes specific officers of an introducing firm to write drafts on the clearing firm's bank account payable to introduced customers.[6] This is convenient for the introducing firms and customers. For example, if a customer immediately needs a check for funds that are carried in the customer's account, the customer may immediately receive a draft from the introducing firm on the clearing firm's account at a local bank. This process is effected by the introducing firm 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 firm executes the draft on behalf of the clearing firm and delivers it to the customer. Both of these arrangements require special provisions in the clearing agreement or in a separate agreement between the introducing firm and the clearing firm. Furthermore, specific supervisory procedures are required by both the clearing firm and introducing firm. The introducing firm is required to have specific supervisory procedures and those procedures must be satisfactory to the clearing firm. However, the clearing firm is not required to supervise the introducing broker-dealer's activities with respect to the clearing account except as noted.[7]

VII. Risk Management

Critical to the introducing relationship is risk management by the clearing firm and the introducing firm. From both firms' perspectives, their capital is at risk. The clearing firm must maintain a significant amount of capital to carry the customer or proprietary accounts of an introducing firm. Furthermore, to the extent that there are margin loans, the margin loans will be made using capital of the clearing firm. Although the introducing broker-dealer guarantees its own transactions and the credit of its customers with respect to margin and other liabilities to the clearing firm, the introducing broker-dealer is only as good as its financial position and its continuing risk management. Consequently, clearing firms for their own protection traditionally want regular reports on the capital, assets and obligations of the introducing firm. The financial position of the introducing broker-dealer, its activities, its risk management system, experience of its personnel, its compliance systems and its financial and disciplinary history are all factors that go into the clearing firm assessment of the credit and risk in connection with the clearing agreement. The amount of clearing deposit, the type of activity permitted under the clearing agreement by the clearing firm and other factors will be a function of all of the above.

Clearing firms also constantly monitor accounts of introducing broker-dealers for concentrated positions in a given customer's account or group of accounts, low priced securities and a variety of other risks as part of the clearing firm's own risk management procedures. From time to time, clearing firms may require introducing brokers-dealers to increase capital, increase cash deposits and/or pledge other assets with the clearing firm to secure the risk and liability of the introducing firm's customers or its proprietary transactions.

The NASD has a series of rules called the "ACT Rules"[8] that provide clearing firms with a tool to control excess credit by introducing broker-dealers when the introducing broker-dealers trade away and effect transactions with other broker-dealers, either for customers or for the introducing broker-dealer's own account. Under the ACT Rules, the clearing firm establishes an amount of credit for each introducing firm. If that credit limit is breached by the introducing firm, the clearing firm may reject trades in excess of the credit limit. Under the ACT system, clearing firms are notified electronically when an introducing firm 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 satisfy itself regarding the risk of outstanding trades. Other provisions of ACT provide for notification of the clearing firm if certain trades are above $1 million and under certain other circumstances. If an introducing firm 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 particular broker-dealer to accept the trades of the introducing broker-dealer with the third party broker-dealer.

VIII. Introducing Broker-Dealer Considerations in Negotiating a Clearing Arrangement

A. Business Activities

The scope of the business activities of the introducing broker-dealer are the first consideration. Retail, institutional, options, bonds, mutual funds, DVP/RVP transactions, proprietary trading, OTC market making, agency underwriting, firm commitment underwriting and many more activities are possible. Each of these activities are factors that will affect the clearing relationship and the provisions and terms of the clearing agreement.

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B. The Amount of Clearing Deposit

The amount of the clearing deposit will depend upon the nature of the introducing firm's activity, the firm's financial condition and the risk that the clearing firm perceives that the introducing broker-dealer's business activities present to the clearing firm. In most cases, the amount of the clearing deposit is negotiable.

C. ACT Credit Line

The amount of the ACT credit line will depend upon whether the broker-dealer proposes to execute transactions away rather than executing them through the clearing firm. If either customer or proprietary transactions are to be executed away, the ACT credit line will have to be established. The ACT credit line will depend upon the financial positions of the introducing firm, its risk controls, the types and size of transactions, its history of trading and a variety of other considerations.

D. Cost of Clearing

Costs of clearing have traditionally been based on a transactional basis per transaction and number of shares. In some cases there are caps or reduced fees for volume trading at certain levels. But today clearing firms also offer a variety of additional services besides just clearing to its introducing firms. Some of these services and products are offered as part of the basic clearing services and in other cases the services are offered on a cost basis. In some cases the cost is dependent upon the number of transactions that are effected by the introducing broker-dealer. These services include a variety of proprietary products, retirement plan services, securities research, certain types of trust services, compliance programs and procedures, including exception reports, on-line reports, real time reporting, execution systems, and other services and products. Many of these cost money and must be negotiated individually.

E. PAIB

As discussed in Section V above, proprietary assets of the introducing broker-dealer, including the clearing deposit maintained at a clearing firm, must be held in a PAIB account if the introducing broker-dealer proposes to use those assets in computing its net capital.

F. Financial Reports and Financial Information

The clearing firm will want to receive detailed financial reports and financial information from the introducing broker-dealer at the commencement of the relationship and continually thereafter. The introducing broker-dealer will also want to receive similar financial information concerning the clearing firm to be certain that the clearing firm is able to meet its obligation to the introducing broker-dealer. In addition, clearing agreements generally provide that the introducing broker-dealer will provide to the clearing firm any notices it sends to its regulators under SEC Rule 17a-11 or applicable SRO rules with respect to early warning regarding books and records and financial condition. In some cases but not usually, clearing firms will agree to provide the same type of notice to introducing broker-dealers.

G. Registration

Clearing agreements generally provide that the parties will each be fully registered and members of all of the applicable self-regulatory or exchange organizations required at all times during the term of the agreement. In the event that a firm is no longer properly registered, the agreement may be terminated by the other party.

H. Customer Accounts

Normally, the clearing firm provides documentation for customer accounts which is to be completed by the introducing firms on the forms provided by the clearing firm. The clearing firm generally requires that introducing broker-dealer's customers enter into its form of customer agreement. Some introducing broker-dealers seek additional information from customers and have their own forms and agreements. Sometimes clearing firm customer agreements will cover and protect the introducing firm from a number of liabilities. In other cases, they do not. Sometimes it is necessary for the introducing broker-dealer to use a supplement to the clearing firm's customer agreement or seek modification in the clearing firm's agreements to adequately protect it from liability.

I. Acceptance of Accounts and Sales Practice Obligations

Clearing agreements generally provide that the introducing broker-dealer must approve any account. The clearing agreements generally provide all suitability and similar sales practice compliance is the sole responsibility of the introducing firm. In many cases the clearing firm must also approve the account before there is any margin or other transactions. The clearing agreement will cover sales practice responsibility of the introducing firm and approval of accounts.

J. Compliance Procedures and Exception Reports

Today, clearing firms offer their introducing broker-dealers a variety of software and electronic compliance programs that monitor the business of the introducing firm and that create exception reports for the introducing firm. The introducing firm needs to know what programs are offered by the clearing firm, select those applicable to its business and what, if any, cost there will be in connection with them. In some cases, the introducing firm may have its own specialized programs, but it is usually cheaper to buy and use the software and programs of the clearing firm.

K. Margin and Extension of Credit

The procedures for margin are set forth generally in the customer agreement. It is important to determine who will transmit margin calls. In most cases, the margin calls are generated by the clearing firm, but it is up to the introducing firm to transmit the margin calls, follow up on them and be certain that they are collected. The clearing firm may reserve the right if the margin call is not made or collected to follow up with the customer. Under most clearing agreements, failure to make margin payment by a customer will result in liability to the introducing broker-dealer if there is a customer debit. Margin requirements are usually set by the clearing firm. The introducing firm should determine in the clearing agreement whether it may set higher margin requirements across the board or for individual accounts.

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L. Maintenance of Books, Records and Reports

The clearing agreement should specifically spell out what books and records will be maintained by each party. Generally, this is not by listing of individual books but by categories or areas. Clearing agreements generally also specify specific books and records that the introducing broker-dealer is required to maintain. Clearing agreements or supplements generally set forth the type of information that must be transmitted by the introducing firm to the clearing firm for it to be able to execute transactions and maintain current books and records for each of the accounts of the introducing firm.

Today, clearing firms have a large number of reports that are available to the introducing firm based upon the accounts cleared. The clearing agreement or supplement should cover the reports that the introducing firm is to receive, the information to be contained in the reports and in many cases how the information will be displayed. Today, many of these reports are on-line and books and records are maintained on-line. If certain records are to be maintained on-line, there should be an agreement or understanding as to which books and records will be maintained on-line, on what type of basis, how often they will be updated or whether they will be on a real time basis. Generally, the clearing firm will offer a package of reports from which the introducing firm may choose. However, if the introducing firm wants specialized reports, it generally will be at the introducing firm's cost because the clearing firm will have to reprogram its software and make other modifications to accommodate the introducing firm.

M. Reports by the Introducing Firm to the Clearing Firm

The clearing agreement will provide that the introducing firm is 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 about the introducing broker-dealer that most clearing firms will require. Many of these reports will be covered in the clearing agreement or its supplement.

N. Customer Funds and Securities

The clearing agreement normally provides a clear statement as to what the introducing firm may do with respect to customer funds and securities that it receives. It normally provides that custody of all funds and securities will be maintained by the clearing firm and if customer funds and securities are received at the introducing firm they will be transmitted immediately to the clearing firm.

O. 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 customers of a given broker-dealer. In addition, there may be local check drafting authority. Most clearing agreements cover these provisions or have a supplement to the clearing agreement dealing with these activities. See Section VI above for a further discussion.

P. 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 firm under certain limited circumstances and controls. Likewise, confirmations are generally generated through the records of the clearing firm and may be mailed directly by the clearing firm or they may be printed locally and mailed by the introducing firm. The format of the account statements or confirmations may be, in some cases, changed to accommodate an introducing firm but generally the clearing firm will specify the format of the account statements and confirmations although placement of logos and name are generally negotiable. All of these provisions need to be discussed and an agreement reached regarding them.

Q. Execution of Orders and Transactions

Today there are many systems for order execution for customer or proprietary transactions. Some of those systems provide for transactions to be executed by the introducing firm through the clearing firm. However, in many cases today transactions may be executed away at another broker-dealer by using electronic order entry systems or otherwise. The systems to be used and the methodology of executing orders and reporting them to the clearing firm, including participation in ACT, must be discussed and agreed. See Section VII above for a further discussion.

R. Commissions and Fees

Since all funds are received and held by the clearing firm, the clearing firm initially receives from the customer commissions to be paid to the introducing firm. The method of handling those fees and other customer fees received by the clearing firm that are due to the introducing firm needs to be covered in the agreement. Normally, collected commissions after deducting clearing costs and fees due to the clearing firm are paid from the clearing firm to the introducing firm on a monthly basis. The clearing firm normally provides a statement which the introducing broker-dealer should reconcile. The clearing agreement should have a provision for resolving any disputes concerning commissions due from the clearing firm to the introducing firm or fees due from the introducing firm to the clearing firm.

S. Return of Clearing Firm Deposit

The return of the clearing deposit is also something that is important. Generally, clearing agreements provide that a clearing deposit will be held for contingent liabilities until they are resolved. The length of time that a clearing deposit may be held is a subject for discussion and should be covered in the clearing agreement.

T. Indemnification

The indemnification provisions of the clearing agreement are particularly important. Clearing agreement indemnification provisions for the clearing firm from the introducing firm are usually very broad and the clearing firm prices its services based upon the indemnification. The introducing firm receives a somewhat lesser level of indemnification from the clearing firm. The introducing firm should carefully review the indemnification provisions and be certain that it is willing to

undertake the indemnification of the clearing firm and that it has adequate indemnification from the clearing firm.

U. Exclusive Services

The clearing agreement should specifically state whether its exclusive or non-exclusive. Some clearing firms may only offer limited clearing services dealing with most equities, options and bonds traded in the United States. However, the clearing firm may not offer certain other execution or carrying services. This is particularly true with respect to certain foreign securities and exchange specialists, market makers or floor broker clearing. If the clearing firm does not offer worldwide or other clearing services and the broker-dealer proposes to engage in them, the broker-dealer should consider a non-exclusive provision or a carve-out in the clearing agreement.

V. Proprietary Trading, Underwriting, Market Making and Specialist Activities

Normally, an introducing firm will not be allowed to engage in proprietary trading without a specific provision regarding the same, particularly if it involves market making, firm commitment underwriting or specialist activities. If there are proprietary activities, the clearing agreement may have a supplement detailing payment and a variety of other specific provisions dealing with transactions that are proprietary to the introducing broker-dealer.

W. Disciplinary Action, Regulatory Forms and Notices

Most clearing agreements provide that the introducing broker-dealer will provide to the clearing broker-dealer current copies of its Form BD, U-4s, any complaints, investigations or disciplinary action on an on-going basis. Some clearing agreements also provide that the clearing firm will notify the introducing firm of certain types of investigative or disciplinary activities with respect to the clearing firm. However, this is relatively unusual.

X. 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. Generally, use of the clearing firm's logo and name by the introducing firm is limited by the clearing agreement. If the introducing firm proposes to use the clearing firm's logo or name in advertisements or otherwise with customers, the clearing firm's consent must be specifically obtained.

Y. Excess SIPC Coverage

Many clearing firms offer excess SIPC coverage. The amount and the coverage should be specified in the agreement.

Z. Termination

The provisions with respect to termination in clearing agreements are fairly complex. Because of the cost of setting up a clearing arrangement, including transferring customer accounts, the termination of a clearing agreement can result in considerable expense to the clearing firm as well as to the introducing firm. These 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 that the clearing firm is entitled to certain costs in the event of termination that are involved in the transferring of customer or proprietary positions to another firm. As discussed above under "Clearing Deposit," many agreements provide the clearing deposit can be held for either a period of time to determine if there will be contingent claims or if there are contingent claims until the claims are resolved.

AA. Non-Solicitation Provisions

Generally, clearing agreements provide that the introducing firm's customer information will be held confidential and not disclosed to third parties or affiliates of the clearing firm. Furthermore, clearing agreements generally provide that the clearing firm will not solicit the accounts or employees of the introducing firm during the term of the agreement. The introducing firm 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.

BB. Arbitration

All clearing agreements contain arbitration provisions. Since the arbitrations are member-to-member in many cases, they would be required under the self-regulatory organization arbitration rules under any circumstances. However, there are provisions as to which arbitration forum rules (NASD, New York Stock Exchange, or other) will govern. In addition, the location of the arbitration may be important and should be discussed and specified. In most cases, the clearing firm will want the arbitration at its headquarters locale and it is usually difficult for an introducing broker-dealer to change that.

CC. Anti-Money Laundering Provisions

Today, because of the recent anti-money laundering rules in place in the securities industry, the clearing agreement or a supplement to it, will provide a division of anti-money laundering responsibilities between the clearing firm and the introducing firm. In most cases, the introducing firm will have the primary responsibility with respect to verification of customer identity, background, obtaining the necessary information and monitoring transactions in the account. Many clearing firms today offer and provide a variety of electronic systems with exception reports to assist the introducing firm in identifying transactional discrepancies that may be required to be reported under suspicious activity reporting. However, the primary responsibility for anti-money laundering compliance under most clearing agreements will rest with the introducing broker-dealer.

IX. Proposed Rules Affecting Introducing Broker Arrangements with Clearing Firms

A. Mutual Fund Breakpoint Discounts

As a result of a study of broker-dealers, the SEC and the NASD became concerned that customers were not receiving all of the discounts that were available to customers in purchasing shares of mutual funds. Most mutual funds with sales charges offer a percentage discount at various accumulation levels. Furthermore, many

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fund groups offer the discount based upon total purchases within the fund group. Further, various funds and fund groups permit accumulation not only by the investor but by related parties to the investor. Since each mutual fund and fund group have their own rules which vary considerably, broker-dealers may not have in the past been aware that an accumulation discount was available to an investor. Also, in other situations a broker-dealer may not know that a particular customer is related to another customer whose sales may be aggregated to obtain the lowest breakpoint. In most cases, the customer must inform the broker-dealer of a relationship so the broker-dealer can seek the lower discount. In still other cases, a customer may have purchased mutual funds at another broker-dealer and the broker-dealer may not be aware that the customer will qualify for a lower discount on an accumulation because of the total number of shares held, albeit part are at another firm. The SEC and the NASD noted all of the above relationships, but nevertheless found that in a number of cases broker-dealer records reflected a relationship or prior positions, but there was no aggregation to obtain the lowest breakpoint discount. As a result of the NASD study, the NASD ordered broker-dealers to review their records to determine if customers should be obtaining breakpoint discounts which were not given.[9] In that release, the NASD recognized that in many cases the availability of discounts would depend upon the customer disclosing to the broker-dealer its relationship with another customer or that it had purchased mutual funds at another broker-dealer that would qualify for a breakpoint discount.

As a result of the breakpoint study and subsequent reviews of broker-dealer records, the industry is attempting to develop a methodology to determine breakpoints for customers more accurately. This includes providing information concerning a customer's other positions at other broker-dealers and the customer's relationship to other people that are eligible for breakpoint discounts. While this is primarily an introducing broker's obligation, clearing firms are working to be able to provide systems to introducing brokers to assist them in determining breakpoints and for obtaining information from mutual fund complexes with respect to the availability of breakpoint discounts and relationship to fund shares held elsewhere in the name of the customer or purchased at other broker-dealers.

B. Confirmation and Point-of-Sale Information Proposed Requirements

The SEC has proposed detailed confirmation and point-of-sale disclosure requirements for transactions in certain mutual funds and other securities.[10] These proposed requirements would require a considerable amount of additional information with respect to confirmation of a particular transaction, primarily in connection with mutual funds, including 12b-1 fees, discounts, non-cash compensation and other types of compensation received by a particular selling dealer. Furthermore, there would need to be a point-of-sale disclosure document which will be quite complex. These documents will have to be tailored to a particular transaction. Clearing firms are working to develop a methodology to obtain the necessary information from the selling dealer and mutual funds so that the information can be promptly and accurately in the point-of-sale disclosure document and in the confirmation to the customer. Based on the proposed rule, it will require a significant amount of software programming, but more importantly it will require an interface in many cases between clearing firms, mutual funds and introducing brokers.

C. 4:00 O'Clock Hard Close for Mutual Fund Purchases

Because of the recent problems with respect to late trading in mutual funds after 4:00 p.m. Eastern Time, the SEC has proposed to have what it calls a "hard 4:00 close," meaning that no orders may be accepted after 4:00 p.m. Eastern Time.[11] The SEC investigation of late trading found a number of instances where certain traders or hedge funds were submitting trades after the 4:00 p.m. close and the trades were being accepted. Broker-dealers will be required to have procedures to enable them to be certain that mutual fund orders reach either the Depository Trust Corporation from which they are transmitted for execution or the fund itself by 4:00 p.m. This creates a number of problems, particularly on the West Coast. The Securities Industry Association and other industry groups are working with the SEC on a number of issues that arise out of a hard close at 4:00 p.m. Such close will particularly disadvantage the individuals on the West Coast. For example, to be able to meet the 4:00 p.m. hard close deadline, orders will need to be submitted to a broker-dealer on the West Coast by noon in most cases at the latest to be certain that they are eligible for the 4:00 p.m. close. Furthermore, broker-dealer systems will have to be able to transmit orders quickly and accurately. All of this will require additional software and programming. Clearing firms are working with the industry to develop a model so that execution of customer orders will be facilitated. However, both introducing broker-dealers and clearing broker-dealers will need to spend some considerable amount of time on systems. The SEC is also considering modification of the rules but at this point the outcome is uncertain.

1. 58 *Bus Law* 917 (May 2003).
2. *Id.* at p. 924, fn 28.
3. NYSE Rule 342; NASD Rules of Conduct 3230.
4. *Letter to Michael Macchiaroli, Associate Director Securities and Exchange Commission, to Messrs. Raymond J. Hennessey*, New York Stock Exchange, Mr. Thomas Casella, NASD Regulation, Inc., November 3, 1998; NASD Notice to Members 99-44.
5. NASD Notice to Members 99-44.
6. NYSE Rule 382; NASD Rule 3230.
7. NASD Guide to Rule Interpretation 75 (1996); Self-Regulatory Organizations, Exchange Act Release No. 34-41469, 1999 SEC LEXIS 1114, at *3 & *6 (June 2, 1999).
8. *See* generally NASD Rules 6100 *et seq.*
9. *See* NASD Notice to Members 03-47.
10. SEC Release 34-49148 (January 29, 2004); www.sec.gov\rules\proposed\33-8358.htm.
11. SEC Release IC.26288 (December 11, 2003); www.sec.gov\rules\proposed\ic-26288.htm.