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Clearing Arrangements for Introducing Firms – Who's Responsible?

by:

Paul B. Uhlenhop
LAWRENCE, KAMIN, SAUNDERS & UHLENHOP, L.L.C.
Chicago, Illinois

Co-Panelist
Bryan D. Pfister, Vice President of Operations
NORTHERN TRUST SECURITIES, INC.
Chicago, Illinois

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NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS
NATIONAL MEMBERSHIP MEETING

By: Paul B. Uhlenhop, Esq.[1]
Lawrence, Kamin, Saunders & Uhlenhop, L.L.C.
Chicago, Illinois

CLEARING ARRANGEMENTS FOR INTRODUCING FIRMS – WHO'S RESPONSIBLE?

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*.[2]

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 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.

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[1] Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York.
[2] 58 *Bus Law* 917 (May 2003).

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.

The clearing agreement is a classic outsourcing arrangement under which certain functions of the correspondent or introducing broker-dealer are outsourced to the clearing firm. Clearing agreements have to conform with National Association of Securities Dealers, Inc. ("NASD") Rule 3230 or its counterpart New York Stock Exchange, Inc. ("NYSE") Rule 342. In addition, the NASD in its recent Notice to Members 05-48 (July 2005), discusses members' responsibility when outsourcing other activities to third-party service providers. Both rules and outsourcing are discussed in separate sections below.

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, 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.[3]

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 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 NYSE and the 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.[4] 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 V 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.

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[3] Id. at p. 924, fn 28.
[4] NYSE Rule 342; NASD Rules of Conduct 3230.

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 IX.AA below.

IV. New Developments

A. Outsourcing.

In July 2005, in NTM 05-48, the NASD called to members' attention their responsibilities when outsourcing activities to third-party service providers. In that release, the NASD noted that for many years under NASD Rule 3230 clearing arrangements have been permitted. The release points out that allocation of certain functions and responsibilities, such as execution services, custody, margin, maintenance of books and records, and other activities, are subject to NASD Rule 3230. However, NTM 05-48 states that outsourcing arrangements with entities have grown substantially over the last 10 years. Some of these entities to which functions may be outsourced, such as data service providers, may be unregulated. Under NTM 05-48, the NASD cautions members that in dealing with third-party service providers, the service provider must be a registered broker-dealer if any of the outsourced activities or functions would be required to be the subject of the broker-dealer's supervisory system and written supervisory procedures pursuant to Rule 3010. NTM 05-48 also specifically stated that outsourced activities and functions require registration because the person performing the activity would be an associated person of the member irrespective of whether such person is registered with the member. An exception to this is where the third-party service provider is separately registered as a broker-dealer and contractual arrangement between the member and service provider is contemplated by specific NASD, other SRO rules or other applicable federal securities regulations. An example would be the clearing agreement. Although responsibility for supervisory and compliance activities may not be outsourced, this does not preclude a member from outsourcing certain activities that support the performance of its supervisory and compliance procedures. This would include monitoring reports from the clearing firm, including exception reports which are discussed below.

The outsourcing memorandum points out that a member's supervisory system and written supervisory procedures must include procedures regarding outsourced activities to ensure compliance with applicable laws and regulations. Specifically, the procedures should include:

1. Due diligence analysis of all current and prospective third-party service providers to determine their capability to perform the outsource activities.

2. Continuing procedures to oversee, supervise and monitor the service provider's performance of covered activities, designed to assess the service provider's continued fitness and ability to perform the outsourced activities.

3. Access for all appropriate regulators to the service providers work product in the same manner as if it was performed in-house.

4. Specific policies to determine whether outsourced activities are appropriate, including review of such factors as financial, reputational, and operational impact if the third-party service provider fails to perform, including impact on customers and impact on member's ability to conform with regulatory requirements.

B. Outsourcing of Document Preparation and Storage Under SEC Rules 17a-3 and 17a-4

Any outsourcing of records and documents required to be maintained under SEC Rule 17a-3 and 17a-4 are subject to specific requirements contained in both Rule 17a-3 and 17a-4. SEC Rule 17a-4(f) sets forth the requirements for maintenance of documents in electronic storage media by the broker-dealer or by a third party, including a clearing firm. Rule 17a-4(f), with respect to electronic media, requires that a broker-dealer notify its examining authority 90 days prior to employing an electronic media for records. If a third-party outsource is used to prepare or maintain electronic records, documents or data, the third-party must execute an undertaking required by 17a-4(f)(3)(vii). Furthermore, 17a-4(i) requires an undertaking with respect to books and records maintained or preserved on behalf of the broker-dealer permitting examination of such books and records by the representatives or designees of the SEC and requires that they be available at any time during business hours. It also requires that the outsource be able to furnish true and correct and current hard copy of any and all books and records.

C. Best Practices Regarding Customer Notification of Service Fees

The NYSE in Information Memo Number 05-41, June 13, 2005, discusses notification of customers of service fees and service fee changes. While the NASD does not have a similar Notice to Members, the NASD's position is the same as the New York Stock Exchange's position. For Introducing Brokers, these practices are particularly important because they have to be coordinated with the clearing firm and sometimes include the clearing firm's fees. Most clearing fees will work with Introducing Brokers to facilitate notification, sometimes at the cost of the Introducing Broker.

The memo sets forth best practices regarding customer notification of service fees as follows:

1. When opening accounts, provide customer with written notification of all Fees that are in effect for the type of account being opened at the time of account opening, or scheduled to take effect within 30 days of account opening.

2. Mail written notification of any increase in Fees, at least 30 days prior to the increase, to the last known address of every customer whose account is subject to such fees.

3. Modes of written notification OTHER THAN traditional letters whose sole purpose is to inform customers of Fee increases, such as "statement stuffers" (written notices of increased Fees included with account statements), newsletters, or announcements of increased Fees included in the account statements themselves, should contain clear, concise, conspicuously located information about the Fee increases. In other words, notices of Fee increases should be written in "plain English," and should not be "buried" among other text, circulars, or correspondence.

4. Post all Fees on any internet website maintained for the purpose of communication or interaction with customers. Post all anticipated Fee changes, and the projected date of those changes, to such websites. Promptly update such websites to reflect Fee changes.

D. AML Correlation Issues

The anti-money laundering program of an introducing broker must take into consideration the resources and the anti-money laundering program of its clearing firm. 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 today have as part of the clearing agreement or as part of an addendum to it detailed provisions setting forth the anti-money laundering obligations of each of the introducing broker and the clearing firm.

These provisions generally spell out the introducing broker's responsibility, which is the primary responsibility, but it also provides for cooperation between the clearing firm and the introducing broker. The clearing firm generally agrees to provide 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 are prohibited or limited, such as non-resident alien accounts. These agreements provide that both parties must comply with an anti-money laundering laws. As far as customer identification, the responsibility in most cases is joint. 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 certain of that documentation 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 is a responsibility of each of the introducing broker and the clearing firm. Each firm is required to submit a report if they have the information even though they know the other party is going to be submitting a report. Generally these agreements provide that when one party obtains information that might warrant a suspicious activity report, the other party will be notified. With respect to sharing information, AML requires that there be a sharing agreement that meets the regulatory requirements to share information. In most cases, the sharing of information is covered in the clearing agreement or the AML addendum.

The SEC as well as other federal agencies are increasingly focusing on AML as terrorist activity increases. Consequently, introducing brokers need to focus on new information that is coming out and to be certain that their programs dovetail with that of their clearing firms. Most clearing firms provide a significant amount of AML help to their introducing brokers, but it is generally up to the implementing brokers to implement and carry out the programs with respect to their responsibilities.

E. Introducing Broker Best Execution

The NASD staff, in connection with examination of introducing brokers, has recently focused on best execution. In many cases, a correspondent broker-dealer may execute all or most transactions for customer retail orders through its clearing firm. 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. *See* Section VIII below for a more detailed discussion. A discussion of best execution is a complex issue that is worthy of a full seminar. For that reason, this section focuses only on NASD NTM 01-22 (April 2001).

The best execution obligation of an introducing broker has become much more complex and difficult as a result of electronic trading, automation in the market and the evolution of the trading markets. All broker-dealers have as an agent a duty of loyalty and a duty of due care. The duty of due care requires a broker-dealer as an agent of a customer to exercise care to obtain the most advantageous terms for the customer unless the customer otherwise directs the broker-dealer.

Most importantly, NTM 01-22 requires "regular and rigorous" review of best execution by all broker-dealers handling retail or institutional orders including introducing broker-dealers. There are also a number of other legal provisions which we will not discuss in this section. For example, Section 28(e) of the Securities Exchange Act of 1934 provides a 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. In addition, there are specific disclosure requirements in the federal securities laws and the anti-fraud provisions.[5] As discussed above in Section IV.C., the NASD requires specific disclosure with respect to fees. NASD Rule 2320 deals with best execution and inter-positioning. NASD Rule 2440 deals with fair prices and commissions and IM-2440 deals with a mark-up policy. If orders are internalized, special procedures need to be in place to review those transactions to ensure compliance with the many applicable laws and regulations involving internalized executions.

Although the obligation of best execution is undisputed, the definition of what is best execution in evolving markets is much less clear. The SEC's view is that the following things should 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 success.

Many introducing correspondent brokers transmit all of their customer orders to their clearing firm for execution. 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. *See* Section VIII. Recognizing these complexities and difficulties, the NASD, in NTM 01-22, provided guidance on best execution compliance.[6] Specifically, NTM 01-22 requires that NASD broker-dealers, when handling customer orders, conduct "regular and rigorous" reviews of executions of the market and market makers to which their orders are routed to ensure compliance with their best execution obligations. The introducing broker must make sure its executing broker-dealers are complying with the duty of best execution according to NTM 01-22. Importantly, the NASD permits a correspondent that routes its order flow to a clearing firm or other executing broker-dealers to rely on the clearing firm or the executing firm's "regular and rigorous" review as long as the results and

[5] *See, for example,* Securities Act of 1933, §17(a); Securities Exchange Act of 1934, §10(b) and the rules thereunder.
[6] *See also*, NTM 01-22 (April 2001); *see also*, NTMs 00-22 (June 2000), 99-11 and 99-12 (Feb. 1999), 98-96 (Dec. 1998), 97-57 (Sept. 1997) and 96-55 (Oct. 1996).

rationale are fully disclosed to the introducing firm and the introducing firm periodically reviews such data. This requires the introducing broker to 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 who send order flow to their clearing firm or to third party executing firms need to have supervisory procedures showing their review and analysis of the executions by the executing firms to which they funnel order flow. Furthermore, if there are any payments or consideration for such order flow it must be disclosed to customers. Many small broker-dealers have a committee that meets regularly, at least quarterly, to review the executions that it is receiving. Minutes of such meetings and the underlying data should be preserved.

An introducing broker should also be familiar with SEC rules 605, 606 and 607.[7] Rule 605 requires disclosure of certain order execution information by market centers.[8] Rule 606 of NMS requires disclosure of order routing information by clearing firm or executing broker-dealer and if applicable the correspondent must comply with it or if it is routing its orders to another broker-dealer for execution, review the information provided by the executing broker as part of its due diligence obligation. Furthermore, customer account statements under NMS Rule 607 are required to contain certain information concerning order routing practices.

In summary, this is a very complex area that introducing brokers must consider and coordinate with firms through which they execute, including its clearing firm if the clearing firm is a primary executing broker-dealer for the correspondent's or customer's orders.

F. Regulation SHO

Regulation SHO regulating short sales became effective September 7, 2004[9] with a compliance date of January 3, 2005. Regulation SHO provides a new regulatory framework for short selling of securities. For an introducing broker and clearing broker, there are several key objectives: (1) the creation of a uniform marking requirement for sales of all equity securities; (2) the establishment of locate and delivery requirements in order to address issues associated with fails-to-deliver; (3) a requirement that when the "Threshold" of fails of a particular security reaches a defined level, broker-dealers must buy in the securities or have prearranged for delivery prior to a short sale. There also is a new price test for short sales, but it is subject to a one year pilot program.

The SEC Division of Market Regulation has Responses to Frequently Asked Questions concerning Regulation SHO on the SEC web site.[10]

Rule SHO applies to any transaction that involves the use of jurisdictional means to effect short sales in securities traded in the United States. This means that many international securities are within the scope of the Rule. Rule SHO does not apply to bonds, but it does apply to convertible securities. Short sales do not include short sales in connection with underwritten offer.

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[7] 17 CFR 242.605-607.
[8] Rule 605 was previously Rule 11Ac-5.
[9] SEC Release 34-50103 (July 28, 2004) 69 F.R. 48008 (August 6, 2004); www.sec.gov\rules\final\34-50103.htm; see also NTM 04-93 (December 2004).
[10] www.sec.gov\divisions\marketreg\mrfaqregsho1204.htm.

All sales have to be marked "long," "short" or "short exempt." A security may be marked long only if the person has a net long position. Securities may be marked "SL" for long sale "SS" for short sale and "SX" for a short sale exempt. Regulation SHO provides an exception for certain short sales such as bona fide market makers, block positioners and in certain other cases. These should be marked "short except." Since OTC bulletin board stock short sales are not subject to a price test, such short sales do not have to be marked.

The locate and delivery requirement provides a uniform rule requiring a broker-dealer, prior to effecting a short sale in an equity security, to locate securities available for borrowing in order to be able to deliver securities on settlement date. Under SHO, a broker-dealer may not accept a short sale in an equity security if the broker-dealer does not have reasonable grounds to believe that the security can be borrowed so that it can be delivered on settlement date. Reasonableness is determined on the facts and circumstances basis. Broker-dealers are specifically permitted to use easy-to-borrow lists from their clearing firm or other reliable easy-to-borrow lists. If an easy-to-borrow list is from a clearing firm through which the introducing broker does not generally clear, it would not be reasonable to rely on the list if there is otherwise a relationship with the clearing firm so that delivery would be made to the broker-dealer's clearing firm. The burden of performing the locate prior to effecting a short sale is on the executing broker. Broker-dealers may rely on assurances from customers that a customer has the security or may obtain assurance from another identified source in time to settle the trade. The source should be identified at the time of execution of the trade. If, however, a customer has given prior assurances of an identified source with a resulting failure to deliver, assurances from the customer or the source would not be considered reasonable absent unusual circumstances. Likewise, reliance on an easy-to-borrow list would not be reasonable if there were fails as a result of using the list. Executing brokers must take steps, either before or after a short sale, to confirm the locate information provided by a customer.

If a security becomes a Threshold security based on the number of fails at a national clearing organization, a participant in a registered clearing agency that has fails to the agency for a "Threshold" security for thirteen consecutive settlement days must, beginning the next business day: (1) immediately take steps to close out the fails-to-deliver; and (2) until the fails-to-deliver position is closed out the participant and any broker-dealer which it clears, must borrow the security that is the subject of the fail in advance of any short sale or enter into bona fide arrangement to borrow such security in advance of the short sale.

The most recent Q&A as of March 17, 2006, describes the required methodology under Regulation SHO for clearing firms to apply reductions in fails. If the clearing firm reduces its open fail-to-deliver position prior to the 13th consecutive settlement day and such reduction is reflected at NSCC, the participant may apply the reduction to the most recent increase in its fail-to-deliver position reflected at NSCC and then to any increase in its fail position that existed at NSCC on the date preceding that day and so forth until the entire amount of the reduction has been applied. This is a required methodology. In determining the close out requirement, the participant must look to fail positions that NSCC and not fails at the customer level. Unfortunately, there is a disconnect for clearing firms and correspondent brokers. The clearing firm may have net fails to NSCC but its correspondent's customers may not have fails to the clearing firm or customers may be long as a result of particular types of transactions but securities have not been delivered into the clearing firm to enable it to close the fail at NSCC. In such cases, the clearing firm may be required to buy

in the position. Whether the buy in is to be assigned to a correspondent firm customer or whether the clearing firm assigns the buy in to its error account is a troubling question because the clearing firm that assigns it to its error account is unable to close the position without creating a new short until the securities are delivered to it that are causing the fail, thus putting the market risk on the clearing firm in its error account.

The NASD, effective July 3, 2006, adopted a short sale delivery requirement similar to those in Regulation S-H for non-reporting OTC equity securities.[11] Rule 3210 requires clearing agency participants to close out all failures in non-reporting threshold securities that have existed for 13 consecutive settlement dates. A non-reporting security is an equity security of a company that is not reporting under Section 12 of the 34 Act and for five consecutive days has (1) aggregate fails-to-deliver at the registered clearing agency of 10,000 shares or more <u>and</u> (2) a reported last sale during normal market hours for the security on that settlement date that would aggregate to a fail-to-deliver position of position of 50,000 or more.

G. <u>Piggybacking Arrangements</u>

The SEC recently issues a letter to the New York Stock Exchange concerning piggybacking arrangements.[12] Failure to follow the specific requirements of the no-action letter would result in clearing deposits or other proprietary deposits being non-allowable assets. The conditions as set forth in the letter are described below.

Piggybacking generally involves two introducing firms and one carrying firm and one clearing firm. One introducing firm introduces to the other which introduces all accounts to the clearing firm. The initial introducing firm's clearing deposits are deemed allowable assets for net capital only if certain conditions are met:

1. Option 1: The intermediary introducing firm designates the cash or securities representing the clearing firm's deposit of introducer 1 to be placed in a separate account at the clearing firm in the name of introducer 2 f/b/o introducer 1.

2. Option 2: Introducer 2 can send a notification to the clearing firm advising the firm that the cash and securities representing the deposits of introducer 1 have been placed into the deposit account of introducer 2.

3. If option 1 or option 2 is not done, the intermediary introducing firm must do its own PAIB computation and include the deposit of introducer 1.

4. Additional requirements:

    a. The carrying and clearing firm sends the PAIB agreement to introducer 2 who must in turn send the agreement to introducer 1 if introducer 1 has complied with either of the above options.

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[11] NTM 06-289 (June 2006).
[12] New York Stock Exchange Capital Guide, SEC staff to NYSE, No. 00-6, September 2000 – Piggybacking Arrangements.

b. The intermediary must also send a letter to the first introducing firm advising the introducing firm that its deposits are being sent to the carrying and clearing firm which is including them in its PAIB calculation.

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

A. 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. The discussion below is designed to give a general overview of the rules without discussing all of their complexities.

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. The discussion of the SEC capital rule 15c3-1 below sets forth the minimum net capital requirements for various types of broker-dealers. 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. 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-dealer.

B. SEC Rule 15c3-1 Capital Requirements

1. Top Tier Firms That Do Not Have Restrictions on Type of Activity

The SEC 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.[13] In addition, under one alternative, the broker-dealer must also maintain an aggregate indebtedness ratio not to exceed 1500% of its net capital (or 800% of its net capital for its first 12 months of business). Under the other alternative standard, 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 SEC Rule 15c3-3 reserve formula. Furthermore, there are additional conditions to the second alternative such as making the Rule 15c3-3 computation on a regular basis, certain deductions and other provisions.

2. The Two Most Common Capital Rule Minimum Requirements Used by Introducing Broker-Dealers

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

A broker-dealer must maintain a minimum of $50,000 if it introduces customers on a fully disclosed basis to another broker-dealer that carries the accounts.[14] Under this provision, a broker-dealer may receive but not hold customer or other broker-dealer funds or securities. Under this provision, a broker-dealer 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 broker-dealers elect to operate under this section.

b. $5,000 Broker-Dealers

Under this category, a broker-dealer may only engage in agency transactions or riskless principal transactions as defined in the rule.[15] A $5,000 broker-dealer may not engage in the activities described in Sections B.1 and 2(a) above and Sections B.3(a), (b), (c) and (d) below. It may not receive, directly or indirectly, or hold funds or securities for customers or carry any customer accounts or owe money or securities to customers.

3. Other Options and Provisions for Certain Activities

a. Broker-Dealers That Do Not Carry Customer Funds or Securities and Engage in Limited Activity of Mutual Funds, Variable Annuities and Savings and Loan Accounts

Broker-dealers that do not carry customer funds or securities and promptly transmit them to a clearing firm and are exempt under SEC Rule 15c3-3(k)(2)(i), generally have a $100,000 minimum net capital requirement.[16] See Section IV.C.2 below for a description of SEC Rule 15c3-3(k)(2)(i). Under this exemption, a broker-dealer that carries no margin accounts, promptly transmits all customer funds and delivers all securities received in connection with its activities as a broker-dealer, does not otherwise hold funds or securities for or owe money or

[13] SEC Rule 15c3-1(a)(1) & (2)(i).
[14] SEC Rule 15c3-1(a)(2)(iv).
[15] SEC Rule 15c3-1(a)(2)(vi).
[16] SEC Rule 15c3-1(k)(2)(ii).

securities to customers and effects all financial transactions between the broker-dealer and his customer through one or more bank accounts entitled "Special Account for the Exclusive Benefit of Customers of ___________" will qualify.

b. Dealers Rule

Dealers of securities have a minimum net capital requirement of not less than $100,000.[17] Included within dealers are broker-dealers that are engaged in options 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. See Section IV.B.3(d) below. With respect to ten proprietary transactions, there are exceptions for transactions under Rule 15c3-1(a)(2)(v), (a)(2)(vi) or (a)(8). Rule 15c3-1(a)(2)(v) permits principal and agency transactions in variable annuities and mutual funds and transactions to sell securities for immediate reinvestment in mutual funds or variable annuities provided the broker-dealer promptly transmits all funds and delivers all securities received and does not hold funds or securities for or owe money or securities to customers. Rule 15c3-1(a)(2)(vi) provides an exception for broker-dealers that do not hold funds or securities for or owe funds or securities to customers nor carry accounts of customers that engage in riskless principal transactions cleared through another broker-dealer. Rule 15c3-1(a)(8) deals with a specific exception for municipal securities brokers' broker that is beyond the scope of this outline.

The dealer rule also limits the broker-dealer from engaging in firm commitment underwriting activities but permits the broker-dealer to engage in best efforts or agency or all-or-none underwritings in accordance with paragraph (b)(2) of Rule 15c2-4, so long as the broker-dealer engages in no other dealer activities.

c. Mutual Funds and Variable Annuity Dealers and Agents

A broker-dealer is required to maintain $25,000 net capital if it acts as a broker or dealer with respect to mutual funds or variable annuities.[18] 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.

d. Market Makers, Specialists and Floor Brokers

An over-the-counter market maker generally has to maintain net capital of $2,500 for each security in which it makes market up to $1,000,000.[19] There are additional exemptions for exchange market makers, specialists and floor brokers that do not deal with customers contained in the capital rule which are beyond this discussion.[20]

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[17] SEC Rule 15c3-1(a)(2)(iii).
[18] SEC Rule 15c3-1(a)(2)(v).
[19] SEC Rule 15c3-1(a)(4).
[20] SEC Rule 15c3-1(a)(6) & 15c3-1(b).

e. Municipal Brokers and Dealers

There are special requirements for certain municipal securities brokers who act as "brokers' broker".[21]

f. Broker-Dealers Engaging in Repo Transactions

There are special provisions for broker-dealers that engage in repo transactions.[22]

C. SEC Rule 15c3-3: Safeguarding Customer Funds and Securities

Rule 15c3-3 regulates broker-dealer custody of customer funds and securities. Subsection (k) of the rule provides exemptions that are applicable in many cases to introducing broker-dealers if they do not carry or receive customer funds or securities. In most clearing relationships, the introducing broker-dealer attempts to operate under one of the exemptions of subsection (k) of Rule 15c3-3 which are described below.

1. Mutual Fund Variable Annuity Exemption

Subsection (k)(1)(i) provides an exemption provided that the broker-dealer's transactions are limited to (1) the purchase and sale of mutual funds or variable annuity products, either as principal or agent or, (2) agency transactions involving solicitation of accounts for insured savings and loan institution or, (3) the sale of securities for customer for immediate reinvestment in mutual funds. Customer funds and securities received must be promptly transmitted and may not be held by the introducing broker-dealer. The introducing broker-dealer 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 the discussion.

2. Special Account Introducing Broker-Dealers

Under subsection (k)(2)(i) of Rule 15c3-3, a broker-dealer is exempt if that introducing firm (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 broker-dealer and its customers through one or more bank accounts which are designated as a "special account for exclusive benefit of customers" of the broker-dealer. Some introducing firms rely on this exemption.

3. Introducing Broker-Dealers

Under subsection (k)(2)(ii), an introducing broker-dealer is exempt if it clears all transactions on a fully disclosed basis and promptly transmits all customer funds and securities to the clearing broker-dealer. The clearing broker-dealer must carry all accounts of customers and

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[21] SEC Rule 15c3-1(a)(8).
[22] SEC Rule 15c3-1(a)(9).

maintain required books under Rules 17a-3 and 17a-4 normally kept by a clearing broker-dealer. Most introducing firms rely on this exemption.

D. Summary

As can be seen under the above rules, a fully disclosed clearing arrangement provides significant benefits to an introducing broker-dealer depending upon the type of activities in which the broker-dealer is engaged. If the introducing broker-dealer limits its activities as described under various of the sections above, it will have significant less financial responsibility requirements.

VI. Proprietary 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).[23] 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.[24] Because of these 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.

VII. 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.

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[23] 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.

[24] .NASD Notice to Members 99-44.

Local check writing is a device by which a clearing firm authorizes specific officers of an introducing firm to write drafts on clearing firm's bank account payable to introduced customers.[25] 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 introducing broker-dealer's activities with respect to the clearing account except as noted.[26]

VIII. 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"[27] that provide clearing firms with a tool to control excess credit by introducing broker-dealers when the introducing broker-dealers

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[25] NYSE Rule 382; NASD Rule 3230.
[26] 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).
[27] *See* generally NASD Rules 6100 *et seq.*

trade away and effect transactions with other broker-dealers, either for customers or for the introducing broker-dealers 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.

IX. 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.

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 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.

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 the 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 less 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 to assist 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 agreement will rest with the introducing broker-dealer.

X. Negative Consent Letters and Bulk Account Transfers

In October 2004, the NASD in NTM 04-72 advised members that negative response 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 record 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 response letters would be appropriate to transfer customer accounts, which are as follows:

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.

Notice to Members 02-57 (September 2002) generally 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 is now required for transfers of special product accounts such as mutual funds or variable annuity accounts, including changing the broker-dealer of record or for specific securities. NTM 04-72 clarifies that an affirmative consent is required when seeking to change a broker-dealer of record for securities held at an issuer.

After 04-72 was published, the NASD promulgated a further explanation in the form of an interpretive letter (http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=287). In this NASD 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 to the registered representative that the registered representative was performing for the directly held account.

4. Changes in networking arrangements with a financial institution.

The examples above are not exclusive. If there are similar situations involving "abandonment," negative consent letters can be used.

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 of the required disclosures. A firm should also keep in mind that they must be in compliance with SEC Regulation S-P with respect to the new firm.

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