

The Importance of Being Clear

By David M. Weiss

If there's one way to inspire a rep to care about a process as esoteric and arcane as securities clearing, it's this: remind him that clearing innovations are what make many of his most creative services possible.

Take, for instance, a situation in which a client presents physical stock certificates to his broker as part of a securities sale. In such a case, the client will expect to be paid immediately for the transaction. Absent clearing innovations that allow a broker's firm to settle this transaction using other clients' securities held under a "street name," the broker and the firm would have to wait for payment until the original securities could be physically delivered to the trade's contra party.

In the Margins

The existence of "street name" securities is also one of the things that allows for margin trading. When a client opens a margin account, he signs not only a margin agreement but a lending agreement as well. The margin agreement permits the firm to hypothecate the clients stock (actually, it is to re-hypothecate the stock, as the client hypothecates the stock to the broker/dealer, which in turn re-hypothecates the stock to a bank). The bank in turn lends the broker/dealer the money to fund the margin debit and charges the broker/dealer interest. This interest charge is passed along to the client with a markup, which belongs to the broker/dealer.

The lending agreement permits the broker/dealer to seek other sources of financing, such as short sales, by the clients. The amount of securities that may be lent is regulated by the Federal Reserve's Regulation T and enforced by the SEC. The rule states that a firm can use up to 140 percent of a client's debt balance. If the firm can secure the amount needed to fund the debit balance (the client's loan) by using less security value than the 140 percent, then that is all it can use. The remainder must be "locked up in seg." However, if the lender wants more collateral than the 140, the firm cannot use more of the clients collateral.

The phrase "locked up in seg" should awaken memories of Series 7 study groups. The phrase, though, is misleading and could affect your dealings with your clients from time to time. What the phrase means is that the firm has control of the required amount of securities. This is the contra side of the firms' ability to pledge the securities themselves.

If for example, the bank doesn't want to lend financing at the usual rate (70 percent for common stock) — maybe because it is concerned about the viability of the company — the firm cannot pledge more of the same stock than permitted by law.

For example: Client Sally May owns 1,000 shares of Zappa Corp., worth \$20,000, in her margin account. The account is properly margined and has a debit balance of \$10,000. The b/d would normally pledge 700 shares, worth \$14,000 (140 percent of the debit balance) at the bank, and the bank would lend \$10,000. However, if for some reason the bank wouldn't lend the full debit balance on the pledged stock, the firm would normally raise the margin rate the client must pay, which would lower the amount the client is borrowing. There are times when the broker/dealer will raise the margin requirement on a particular account or stock to mitigate its exposure to risk, lawsuits or, most commonly, uncollectable debits. All too often I have heard a client refuse to pay an unsecured loan because his broker recommended the position. This is a situation to be avoided at all costs, obviously.

The Borrowers

Banks are not the only source of loans for brokerage firms; one alternative is known as “stock loan.”

When a client sells a security, his account gets credited and the firm will receive payment when it completes the street side of the sale. When the client is purchasing a security, the reverse is true. (While this is a simplification of what occurs, it is creditable enough for this example.) The firm, after exhausting its supply of available stock from excess margin securities and from its propriety account, then turns tries to borrow stock from other broker/dealers. Such exchanges are win-wins. The borrowing firm gets the security it needs to complete a delivery, and the lending firm gets cash as collateral for the stock being lent. The borrowing firm usually receives interest on the cash collateral posted with the security lender.

Another source of financing is short sales. When a client wants to sell security short, the firm must borrow the security from some place. The stock is obtained from other clients' margin accounts, the firm's own proprietary accounts or from “stocks borrow” (the flip side of “stock loan”). Once the source for a borrow transaction is found, the client can sell short. The borrowed stock is sold, the new buyer takes title and the short seller is responsible to the lender of the stock for all corporate actions except the right to vote (in the case of common stock). The short seller closes the position by purchasing the shorted security in the open market, and the broker/dealer returns the newly acquired stock to lending party.

Occasionally, a client is forced to “buy in” a short sale. We are not referring at this point to a case in which the stock has increased in value, creating a

margin call that the client does not wish to satisfy. We are referring to a situation where the supply of “loanable” stock has dried up. A tender offer or merger could cause this situation. In this case, the lender of the stock sells the shares and the broker/dealer of the lender cannot borrow the stock to make delivery. The loan is called in. The short seller's broker/dealer cannot find stock to borrow to satisfy the “called” stock loan, so the short seller must go into the marketplace and purchase the security. On settlement date, the purchased stock is returned to the lender.

Short sales can be tricky — especially with highly volatile stocks.

Equity trades settle three days after trade date, and a lot can happen in that time span. It is possible, for instance, that the “located” stock has been borrowed by some other entity, or that the party to whom the stock belongs decided to sell it. If the security is no longer available for loan, the broker/dealer will look elsewhere for the stock, but if a source cannot be found a “buy-in” may result.

Going, Going, Global

With the advances in worldwide technology and global market information, securities that trade in foreign markets are attracting more interest from U.S. investors. Some clients actually invest in these securities in their native markets; others use an alternative known as ADRs. These instruments trade on domestic exchanges and are structured like domestic issues. ADRs are quoted in U.S. dollars, trade alongside domestic securities, are cleared through domestic clearing corporations and reside in the same depositories as those issues of domestic corporations. The difference is how they are formed.

A foreign corporation will approach a U.S. bank about sponsoring its foreign shares in the U.S. market. The bank will buy the foreign company's stock in its native market, then will then formulate a ratio that converts the foreign shares into shares that can trade in the U.S. market.

With this task completed, the U.S. bank then offers the ADRs in the same manner that an underwriter brings a new issue to market. Included in this process is the establishment of a depository bank to house the securities (typically the Depository Trust Company).

The U.S. bank will offer the securities for trading. It will list the security on an appropriate market, and from this point on it follows the same path as U.S.-issued securities.

The difference between ADRs and domestic securities appears in the corporate-action segment of processing. For starters, the government of the foreign corporation will determine whether or not holders of ADRs will be

allowed to vote, being that they are foreign investors. If the ADR holders are permitted to vote, the U.S. bank will issue proxies, and upon receipt of the voted proxy, convert the ADR share vote back to that country's ordinary share quantities.

Another important difference is in the taxes on dividends. The U.S. bank follows the tax treatment authorized under the tax treaty between the United States and the sovereign government of the issuing country. In dealing with these securities, the investor and the rep must understand that some foreign governments tax dividends at the point of payment, especially those dividend payments being made to foreign shareholders. In this case, the tax will be deducted from the payment before the ADR holder is paid. At the end of the year the bank will issue a 1099 form showing the dividend paid and the amount withheld in taxes. Naturally, if the United State has a reciprocal tax agreement with the foreign government, no taxes will be withheld for the benefit of sovereign government.

These are but a few of the investment vehicles made possible by advances in the clearing and custody system. Of course, not all of the investments require a rep to understand all the ins and outs of the clearing process. But in many cases, a basic understanding of how the transaction clears helps greatly in knowing how to manage the investment in a way that benefits both the rep and his client.

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