

Behind the Scenes

By David M. Weiss

It is 9:30, the market is opening and Jim Nasium is talking to his financial advisor, Stan Tahl, about his trading strategy for the day. The pair decides on a course of action, and Stan enters the required orders. Since the account is a commission-generating one (i.e. not a wrap account), Stan's revenue-counting mechanisms go into motion immediately, then both men turn their attention to the market to see what verdict it will bestow on their trading decisions.

Meanwhile, the transactions themselves have entered a shadow world — a place that, if all goes well, will remain completely transparent to Jim and Stan, save for some residual records changing hands on the back end. It's a place full of complicated mechanisms and machinations, but one that strives, above all, to remain hidden from the people it serves. It is the clearing operation, the invisible backbone of the brokerage industry.

Seeing What's Important

As members of a broker/dealers' front office, reps like Stan get involved with the back office only when there is a problem with a client's account. Even in such situations, branch operations personnel often resolve the problem on the rep's behalf. Therefore, the typical rep has only a rudimentary idea of what happens after a trade is made. Indeed, some reps might be so uninterested in back office processes that they don't know what the term "clearing" means.

It's a mistake to remain so ignorant. Even if the day-to-day clearing operations remain hidden from the average rep, there are good reasons for him to have some understanding of them. For starters, his broker/dealer's decisions on what products to support are often based in part on the clearing costs. But there are other reasons as well.

Some reps, for example, are in the employ of "clearing" firms, while others work at "non-clearing" firms. Some are independents using the services of a broker/dealer, and still others are associated with an insurance company or other financial institution that clears transactions through some third-party arrangement. The terms used to describe the processes and the relationships between these entities are unimportant to the rep until the moment of truth — when something goes wrong with a transaction and the rep's compensation for that transaction hangs in the balance. Unfortunately, at this point it's too late to learn about the clearing process, and the rep

seeking clarification about a transaction is at the mercy of the individual chosen to explain the terminologies.

But it doesn't have to be this way. This article aims to furnish reps with an understanding of clearing fundamentals, arming them with knowledge that can be used to solve problems for clients and to understand the motivations behind some of their firms' product choices.

In the Beginning

Let us begin with a simple question: What is a broker/dealer?

At its heart, a b/d is a firm licensed by the SEC to buy and sell securities for itself and others.

The process of obtaining a license begins with the completion of the b/d application, which requires a description of the type of business the new firm plans to conduct. This description helps determine the amount of regulatory capital the firm will need to commence business (regulatory capital is a minimum amount that must be present at all times and generally increases as the broker/dealer business expands).

The new broker/dealer must also select a self-regulatory organization (SRO) — the NASD, for instance — and register in each state in which it would want to conduct business. As the b/d grows or enters new businesses, the firm must “amend its b/d,” that is, file changes with and get approval by the appropriate regulatory agencies.

There are many types of broker/dealers. Some, such as market makers dealing with options exchanges, do not even conduct business with the investing public, choosing instead to make customers of other broker/dealers. But reps are more concerned with the traditional b/d, which processes trades for reps working on behalf of retail clients.

As was mentioned above, the ability of a broker/dealer to provide a product for their reps to sell is dependent on the firm's ability to “clear” the trade. The term “to clear” refers to the process by which two broker/dealers who have traded against each other (one purchasing, the other selling the security) go through the process leading to the settlement of the trade. When a client purchases or sells a security, it only becomes a valid trade when a contra party to the trade agrees to the terms and the trade clears. Therefore, a broker/dealer's ability to offer a product is entirely contingent upon its ability to clear the transactions such a product would generate.

Some reps conduct their business through a broker/dealer that is itself a clearing firm, meaning it is a member of a clearing corporation. A clearing corporation is an industry facility where the buying b/d and the selling b/d

“clear” their trades — that is, agree to terms. It should be noted that there are several types of clearing corporations, each specializing in particular products.

Clearing corporations have a number of membership requirements and fees, including b/d capital minimums, clearing funds (which protect the clearing corporation from liability if a b/d goes insolvent) and processing fees.

In addition, firms that belong to a clearing corporation are usually members of the depository where the broker/dealer clients' securities reside. Membership to the depository usually comes at additional cost to the broker/dealer.

The Name Game

Here are two of the most prominent clearing corporations and the products they clear:

National Securities Clearing Corp. (NSCC) clears street-side transactions (buying b/d vs. selling b/d) for corporate and municipal securities and listed closed- end mutual funds. It also clears open-end mutual fund transactions between broker/dealers and the mutual fund themselves.

Fixed Income Clearing Corp. (FICC) clears the street side of U.S. Treasury, GNMA, FNMA and Freddie Mac (FHLMC) transactions.

Both of these clearing corporations are divisions of Depository Trust and Clearing Corp. (DTCC). Broker/dealers that offer listed-option trading may be clearing members of Option Clearing Corp. (OCC). International b/ds may be members of Euroclear or Clearstream. But each membership comes at a cost — a cost that must be justified by the broker/dealer.

In addition to trade verification, clearing corporations serve two other major purposes. The first is to “guarantee” trades. This means that if a contra party to a trade with your clearing broker/dealer should cease doing business before the trade's settlement cycle has been completed, the clearing corporation will stand in for the defunct firm and settle the trade. The second key purpose is providing various types of “netting” features, which pair off intra-firm transactions to keep to a minimum the number of receive and deliver movements that actually have to be made on settlement day.

A huge benefit of the clearing corporations is that they deliver one money entry for all entries that occurred at the clearing facility that day. This consolidation simplifies a b/d's processing and reduces related costs.

Some b/ds opt out of participating in clearing corporations. These sign an agreement with a clearing firm to clear and settle their transactions. The

non-clearing firm, known as the "correspondent" or the "introducing b/d," may operate on a full disclosure basis or omnibus basis. Full disclosure means that the clearing b/d carries the correspondent's clients' accounts on their books. The accounts are opened, maintained and serviced by the correspondent's clearing b/d. Omnibus means the clearing b/d carries an omnibus account for the non-clearing firm's clients and another for the non-clearing firm's proprietary accounts.

The firms that provide correspondent clearing offer an array of services. Some firms are retail-oriented, others more institutionally focused. Some have investment banker activity and participate in the distribution of new issues and may make these new issues available to the correspondent b/d reps. Some allow the correspondent to use the clearing firm's research; others will not. Some treat the correspondent b/d as if it were a branch office.

Custodial Intervention

Regardless of where the clients' accounts are being carried, the actual positions are being maintained at a custodian.

The three primary types of security repository are the Depository Trust Co. (for equity, corporate and municipal debt), the Federal Reserve (for government and government agency securities) and custodial banks (for Repo products and other special situations). Most, if not all, of the securities maintained at these depositories are maintained in "book entry (electronic) form."

Broker/dealers maintain control over the securities held at the depositories. Securities held at the Fed are maintained BEO (book entry only), meaning there aren't any paper certificates for the securities. The same is true for listed-option positions that are maintained by Option Clearing Corp.

Depository Trust maintains securities either in BE (book entry) or BEO (Book Entry Only). The issuer of the security determines which convention will be followed. In the case of BE, physical certificates can be prepared on request, whereas in BEO, no new physical certificates exist. Because most inter-agency transactions are computer-to-computer and most retail clients maintain their portfolios either at the broker/dealer or at a custodian bank, the need for physical settlement is diminishing each year. This is good news to broker/dealers, which get charged a fee by the depository when physical securities are requested. Such fees, of course, get passed on to the client.

Hot Topic

"Internalization" is one example of the industry's move towards all-electronic clearing. This term refers to a scenario in which the buy side and sell side of a trade are executed within a b/d and the trade is then settled within the same firm. Such trades result, for example, from a b/d acting as a market maker: On one side of a trade sits a client of the firm and on the other, the firm's trading account. Because the clearing never leaves the walls of the b/d, the transaction is processed at a rock-bottom cost.

In markets that are market maker driven, the dealers compete with each other for public customer order flow. There are rules in place regulating how such markets are to operate and how client orders are to be treated.

For all its benefits, internalization does have a downside — the potential for abuse — and the SEC and other regulators are watching closely. Specifically, there are concerns about the accuracy of the execution price clients would receive when the b/d executes client orders against each other, without exposing the order to security exchanges.

But internalization is far from the only important economic factor in transaction clearing. The way clients maintain the registrations of their securities impacts the profitability of the broker/dealer and its ability to process transactions efficiently. Securities that are requested by clients in physical form are generally registered in the client's ("beneficial owner's") name. Securities that clients own but are maintained in their accounts at the broker/dealer or custodian bank are said to be registered in "street name" or "nominee name." (The most popular of street names, unsurprisingly, is DTC.)

Many clearing firms charge clients fees for maintaining accounts in which there are securities registered in beneficial owners' name. This fee is to cover the added cost in servicing the account. Since the security typically is in non-negotiable form, it is all but unusable, or "not fungible," by the broker/dealer. This fact adds to the processing costs on transactions involving the securities.

For example, let's suppose a client in San Francisco sells 1,000 shares of stock, and on settlement day brings the physical securities, in negotiable form, to the San Francisco office requesting payment. As the client has fulfilled his obligations, the client will be paid. However, since there is no way for the San Francisco office to deliver the newly received stock to New York office in time for the New York office to make delivery to the buying b/d, the San Fran office will have to wait to be paid.

Since it has possession of the stock in San Francisco, the broker/dealer can use street name stock (belonging to another client and residing in New York)

to stand in for the stock it just paid for. Such a move ensures both the b/d and client get paid promptly without exposing any party to undue risk.

However, stock that is registered in the client's name and in non-negotiable form could not be used in the above example.

The b/d would then lose money on the transaction, having paid out to the client promptly and then having to wait until the securities could be delivered to New York and processed before receiving its own payment.

Thus, it helps for a rep to be aware of the capabilities — and shortcomings — of his broker/dealer's clearing firm. A lack of understanding about the process could well come back to haunt a rep — particularly if he can't explain to his client why he cannot be paid promptly for a transaction.

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