



Securities Industry Association

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Via Electronic Mail and By Hand

September 10, 2002

Financial Crimes Enforcement Network
Section 326 Broker-Dealer Rule Comments
P.O. Box 39
Vienna, VA 22183-1618
Attention: Section 326 Broker-Dealer Rule Comments

Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Proposed Rule to Implement USA PATRIOT Act Section 326 –
Customer Identification Programs for Broker-Dealers
(SEC File No. S7-25-02)

Ladies and Gentlemen:

The Securities Industry Association (“SIA”)¹ appreciates this opportunity to comment on the proposed rule issued by the Department of the Treasury and the Securities and Exchange Commission² to implement the customer identification provisions pursuant to section 326 of the

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States (More information about the SIA is available on its home page: <http://www.sia.com>.)

² See Joint Notice of Proposed Rulemaking, Customer Identification Programs for Broker-Dealers, 67 Fed. Reg. 48306 (July 23, 2002).

USA PATRIOT Act.³ The rule requires broker-dealers to establish customer identification programs ("CIPs") that obtain information from customers opening new accounts, verify their identity, and check their name against government lists of known or suspected terrorists. The SIA supports the proposed rule and believes it will play an important part in the industry's efforts in the prevention of money laundering and the financing of terrorism.

We commend Treasury and the SEC for proposing a rule that permits broker-dealers to adopt a risk-based approach to their CIPs. Our industry's resources can be utilized most effectively by concentrating on those individuals or accounts that are most likely to present increased risks of money laundering or terrorist financing. We have outlined below suggested modifications to the rule proposal that we believe will enhance the effectiveness of the customer identification procedures.

SIA's Recommendations

SIA's recommendations, which are aimed at providing clarification of the rule's requirements, enhancing the effectiveness of the identification procedures, and ensuring consistency with the CIP rules proposed for other financial institutions, include: (1) allowing for a reasonable implementation period that recognizes the very significant changes broker-dealers will be required to make to their systems, operations and procedures; (2) clarifying the definition and scope of the term "customer," which establishes the individuals and entities subject to the rule's provisions; (3) providing guidance that the focus of customer identification procedures for accounts with intermediaries is the intermediary itself, and not the underlying participants; (4) recognizing the ability of a broker-dealer to rely on an affiliate with similar verification procedures; (5) clarifying that the rule's provision that a firm can rely on the identification and verification procedures performed by another broker-dealer for shared accounts includes prime broker/executing broker and similar "give-up" arrangements, and extending the rule to include similar relationships with banks and other entities; and (6) clarifying certain provisions that relate to introducing brokers and clearing brokers. In addition, we have suggested other areas that need to be clarified. Lastly, we have identified in an Addendum to this letter certain provisions that should be made consistent with the customer identification rules issued by the other financial regulators.

1. Reasonable Effective Date

We strongly urge that the industry be allowed sufficient time after the date the final rule is issued to establish the required customer identification programs because the time and cost of implementing the required programs will be substantial. Although some types of verification have been used by some firms on a limited basis, the new identification and verification procedures have never been required for the industry. Accordingly, firms will be required to make wholesale changes, including operational, systems and procedural changes. In particular,

³ "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001," ("PATRIOT Act") Pub. L. No. 107-56 (2001), signed into law by President Bush on October 26, 2001.

firms will have to develop a written customer identification program, make changes to their overall policy and procedures, change their account opening process and account opening forms (estimates are that for some firms this could be 90 forms), and train appropriate personnel in home offices and all branches. Moreover, firms will have to upgrade their software in their back office systems and effect other massive system changes to ensure that the relevant information is captured and retained. For some firms, further time will be required because they rely on third party vendors for software development of back office systems that will need to be adjusted to the rule.

Although firms have been assessing what changes will be required, compliance systems cannot be finalized until final terms of the rule are known. Once the final rule is issued, firms will need time to assess what changes will need to be put in place. Indeed, the time frame between the issuance of the final rule and the October 25, 2002 statutory date will not be anywhere near sufficient for these changes to be implemented. We believe that the changes required are likely to take firms at least six months, and for larger firms even more time may be required.

We therefore respectfully suggest that firms be permitted at least 180 days, and preferably nine months, from the date the final rule is issued to implement the required CIPs. A delay until the spring of 2003 would also be consistent with the effective date of recent amendments to the books and records requirements under SEC rules 17a-3 and 17a-4 of the Exchange Act of 1934, which take effect on May 2, 2003. One approach could be to consider the October 25 date as the beginning of a voluntary compliance period. The establishment of a voluntary compliance period would encourage those firms that are able to comply sooner to do so, but also recognize the significant changes required by the rule, especially for large firms, and the shortness of time to respond and analyze the final rule.

2. Scope and Definitional Issues

To enhance the effectiveness of the rule and ensure that broker-dealers' efforts are focused on the areas of highest concern, we recommend slight refinements to the definition of "customer," one of the operative terms of the rule. We are concerned that a broad-based, unfocused definition of this key term will cause firms to cast a very wide net, and in doing so, focus resources on areas that are of lesser or little concern. A customer is defined in the proposed rule as: (1) "any person who opens a new account; and (2) "any person who is granted authority to effect transactions with respect to an account with a broker-dealer."⁴

⁴ There is also somewhat of an inconsistency in the definition of customer as used in the preamble and the terms of the rule. The preamble states that a customer is "any person who opens a new account" or "is **granted trading authority** with respect to an account" (emphasis added). In contrast, the text of the rule states that a customer is any person "granted authority to effect transactions." The authority to "effect transactions," as contained in the rule, could be interpreted to be broader than "trading authority." We therefore request that the Treasury and the Commission clarify this ambiguity.

We believe that it will be extremely difficult and inconsistent with a risk-based approach to identify and verify all of the individuals who fall under the proposed definition of “customer.” The second part of the definition is overly broad and would include any and all persons authorized to give instructions on an account for trading, deposit or withdrawals, and those who have debit cards and check-writing capabilities. Firms would thus have to verify all individuals who have such authority for any account on behalf of a corporation, institution or other entity.

The requirement to verify all individuals with authority to effect transactions is particularly overbroad when applied to accounts for publicly traded corporations, financial service companies, mutual funds, pension funds, retirement plans, municipalities and other governmental entities and other institutions, where it is commonplace for multiple parties to be authorized to “effect transactions” and where frequent changes of such parties are equally commonplace. For the most part, firms do not have automated systems that can capture all of the individuals that have authority to “effect transactions” for an account. The proposed rule would require firms to conduct a manual review of every file for every account to determine every individual that has authority to effect transactions -- whether it be securities transactions or debit transactions, and irrespective of whether such persons have actually exercised such authority. Moreover, for accounts of publicly traded companies and other company accounts, as noted above, typically there may be many individuals who have such authority, and these authorized parties change with significant frequency. Verifying all of the individuals contemplated by the proposed rule could not be accomplished without significant business disruption. Nor would this further the PATRIOT Act’s goal of deterring money laundering and terrorist financing. We do not see the benefit of obtaining personal information, such as home address and date of birth from individuals who are acting in their professional capacity and who are often subject to rigorous background checks by their employers.

Accordingly, we believe it should be sufficient for the broker-dealer to verify the identity of the entity, and to adopt a risk-based approach in determining whether it is necessary to verify the identity of individuals who the entity has authorized to act on its behalf, especially in the case of publicly traded corporations and other large institutions. Under this approach, a firm would only have to verify individuals acting on behalf of that entity if the firm believed there was a heightened risk of money laundering based on its assessment of a number of factors, such as, the type of entity, whether it is foreign or domestic, its location (*i.e.*, FATF or non-FATF jurisdiction), its size, its reputation, whether it is regulated and by whom, whether it is publicly traded, the type of business it engages in, and the type of account and services the broker-dealer will be providing. In addition, we believe broker-dealers should be given reasonable discretion as to the minimum amount of personal information they need to obtain from the authorized individual (for example, a business rather than home address may be sufficient and more appropriate in many instances).⁵

⁵ A risk-based approach would also better address the legitimate privacy interests of the individuals who act on behalf of entities. When persons acting in their individual capacity open an account or are given authority to effect transactions in an account, the requirement to provide personal information such as home address and social security number is not unreasonable. However, when they are acting in their professional capacity on behalf of an

We also request that the rule clarify that participants in qualified retirement plans, employee stock option plans, and employee stock purchase plans are not “customers” for purposes of the rule.⁶ In these situations, it is the plan sponsor or employer, not the individual participant or employee, that should be considered the broker-dealer’s customer for purposes of section 326, as the employers are the ones who open the account. This clarification is important because it is common for broker-dealers to establish individual accounts for plan participants, and for participants to have the authority to direct how the funds in their retirement and plan accounts are invested. Under a literal reading of the proposed definition of customer, this authority could require broker-dealers to verify each such participant’s identity. For larger plans, this could cover potentially tens of thousands of individuals.

Because these qualified retirement plan and stock option and stock purchase plan accounts are brought to the firm by the employer/plan sponsor and the information on the individual comes from the employer we think it is appropriate for the broker-dealer to consider the plan sponsor its customer for purposes of section 326 and to rely on the plan sponsor to have adequately identified the plan participants.⁷ Most significantly, these accounts present very low risks of being used to launder money because they are funded through payroll deductions, the stock options cannot be exercised until the employees’ rights have vested under the plans, and early withdrawals from the qualified retirement plans are subject to penalties. Moreover, the participants in such plans need not be subject to the identification procedures because the employer, many of which are publicly traded companies, through the employment and hiring process, has already obtained identification information. Given the significant burden of verifying each participant, we believe it is reasonable for the broker-dealer to rely on the employer to have adequately reviewed its own employees. The broker-dealer should be able to rely on the due diligence that it has conducted with respect to the plan sponsor or employer.

We therefore request that language be added to the preamble indicating that “it is the plan that is the customer of the broker-dealer, not the individual plan participants.” We note that the preamble to the proposed rule for mutual funds contains similar language.⁸

3. Additional Guidance for the Customer Identification Programs

entity (often their employer), requiring them to disclose such information represents, in our view, a greater intrusion into their personal privacy.

⁶ Stock option accounts are used by employees to exercise stock options granted to them by their employer. Stock purchase plan accounts are used by employees to purchase shares of their employer’s stock, usually through automatic payroll withdrawals. This, coupled with the fact that the employers are reputable, publicly traded companies, significantly minimizes the risk that such accounts are being used by individual employees for money laundering or other illegal purposes.

⁷ As noted in the proposed mutual fund rule, this would be consistent with the legislative history of the PATRIOT Act.

⁸ See Joint Notice of Proposed Rulemaking, Customer Identification programs for Mutual Funds, 67 Fed. Reg. 48318, 48321 (July 23, 2002).

We recommend that Treasury and the Commission provide additional guidance for the customer identification programs in the following areas.

- **Intermediated and Omnibus Accounts**

While the rule provides that one of the risk factors to be considered as part of the customer identification program is the risk associated with different types of customers, the rule does not address the customer verification obligations that broker-dealers have for accounts with intermediaries. The broker-dealer rule should provide that for various intermediated accounts, such as omnibus accounts,⁹ the focus of the broker-dealer's customer identification program would be the intermediary itself and not the underlying participant or beneficiaries.

Recognizing the ability of a broker-dealer to rely on intermediaries would be consistent with the approach taken in the proposed rules for other types of financial institutions. For example, the preamble to the proposed rule for mutual funds states that mutual funds are not required to verify the identities of individuals whose transactions are conducted through omnibus accounts, such as those maintained by broker-dealers on behalf of their customers. In such cases, the omnibus accountholder – *i.e.*, the intermediary – is considered the fund's customer, not the individuals on whose behalf the accountholder is acting.¹⁰ The preamble also notes that mutual funds are not required to verify the identities of participants in a qualified retirement plan to whom the fund sells its shares. Referring to the legislative history of the PATRIOT Act, the preamble states that it is the plan that is the fund's customer, not the individual plan participants.¹¹

Similarly, the preamble to the proposed rule for futures commission merchants ("FCMs") and introducing brokers ("IBs") states that:

“With respect to intermediated accounts, such as omnibus accounts and accounts for commodity pools and other collective investment vehicles, a futures commission merchant or introducing broker may have little or no information about the identities and transaction activities of the underlying participants or beneficiaries of such accounts. In most instances, given Treasury's risk-based approach to anti-money laundering programs for financial institutions generally, it is expected that the focus of each futures commission merchant's and introducing broker's CIP *will be the intermediary itself*, and not the underlying participants or beneficiaries.” (Footnotes omitted) (emphasis added).¹²

⁹ Omnibus accounts in the context of introducing-clearing firm relationships are discussed in more depth later in this letter.

¹⁰ See 67 Fed. Reg. at 48321 and n. 14.

¹¹ *Id.* at 48321 n. 14.

¹² See Joint Notice of Proposed Rulemaking, Customer Identification programs for Futures Commission merchants and Introducing Brokers, 67 Fed. Reg. 48328, 48331 (July 23, 2002).

The preamble also explains that futures commission merchants and introducing brokers should conduct a risk-based assessment of the intermediary, taking into account the type of intermediary involved, its location, the statutory and regulatory regime that applies to the intermediary, and other relevant factors.

We believe this same risk-based approach to intermediary relationships should be extended to broker-dealers. Just as in the mutual fund and futures business, it is commonplace for broker-dealers to maintain accounts for intermediaries that trade on behalf of third parties, such as other broker-dealers, banks, mutual funds, pension funds, and investment advisory firms. These intermediaries are often large, well-regarded, publicly traded and highly regulated entities. Indeed, many are themselves subject to the PATRIOT Act or similar anti-money laundering laws and regulations. In these circumstances, the intermediaries not only have performed customer identification and/or verification procedures, but also are also better suited to perform these functions.

Such an approach also takes into account the serious proprietary and privacy issues that arise in the context of intermediated relationships. For example, an intermediary is often unwilling to disclose the identity of its clients to the broker-dealer whom the intermediary often regards as a competitor. Indeed, the very structure of the transaction highlights the fact that the intermediary does not want its customer to be viewed as a customer of the broker-dealer. In addition, because much of the information is considered proprietary (and/or protected by privacy laws), a broker-dealer is often prohibited by the intermediary from obtaining documentation regarding the intermediary's customer.

Thus, if the intermediaries are properly reviewed, reliance on such intermediaries not only is appropriate, but essential to conducting business across borders. While the breadth of relationships with intermediaries is extensive, the following are examples of routine transactions involving intermediaries that have undertaken prior identification and verification of their own customers: purchases or redemptions of mutual fund shares that are conducted through a broker or other intermediary, brokers clearing trades on behalf of introducing brokers or on behalf of another broker's customers in an omnibus account, brokers executing transactions on behalf of large institutions or investment advisers investing funds for third-parties, and prime brokers maintaining accounts for client institutions that execute transactions on behalf of their own clients or collective investment vehicles at multiple executing brokers.¹³

Moreover, intermediaries that open an omnibus account at a broker dealer to execute trades, generally engage in delivery versus payment ("DVP") business. In this type of business, the securities are not held in the account at the broker-dealer but delivered out to a bank as custodian. Thus, the broker-dealer holding the omnibus account is not really "carrying" the intermediary's account in the traditional sense, as it is not maintaining custody of cash or securities, nor providing margin financing to the account. It is only facilitating a brokerage

¹³ Other examples of intermediary relationships can also be found in the fixed income area and with respect to financing generally, e.g., secured lending businesses.

transaction. Given this structure and the fact that DVP business generally presents very little risk of money laundering, we believe a severe burden and unnecessary business disruption would be imposed on this type of business, which encompasses a large volume of institutional securities trading activity, if a broker-dealer were to have to go beyond verifying the identity of the intermediary.

It is also critically important that a firm be allowed to treat an intermediary as its customer for section 326 purposes even when it establishes administrative subaccounts to facilitate transactions with the intermediary. In this regard, it is common practice for firms that do institutional business to open both an omnibus account for the institutional intermediary, as well as administrative subaccounts for the intermediary's clients. However, in some cases the subaccounts are identified by number, in others they may contain the client's name and the name of the client's custodial bank or broker-dealer. In all cases, the subaccounts serve a purely administrative purpose, that is, they are set up, not to establish a customer relationship between the broker-dealer and the intermediary's client, but to facilitate the allocation of block trades and/or the delivery of securities or sales proceeds to the client's custodial bank or broker-dealer. In addition, most such subaccounts are set up through the use of automatic data feeds from third-party vendors.

The practice of setting up administrative subaccounts is essential to the operation of institutional business in the securities industry, and virtually every institution avails itself of these automated third-party systems. Because the type of information received is extremely limited, if these subaccounts were considered accounts for purposes of section 326, thus requiring firms to collect additional information about and verify the identity of the intermediary's client, institutional business would effectively be brought to a halt. Firms simply could not obtain documentary numbers and verify the required information within the time frames necessary to handle their institutional transactions, and the costs of doing so would be enormous, particularly since the use of automated data feeds would almost certainly be eliminated by a verification requirement. Accordingly, we urge the agencies to provide guidance in the final rule that the establishment of such institutional subaccounts does not trigger any obligation by the firm to verify the intermediary's underlying client.

In short, under Treasury's risk-based approach, a broker-dealer should be permitted to treat the intermediary as its customer and should not have to "look through" the intermediary to identify or verify the clients on whose behalf the intermediary is acting, so long as appropriate due diligence has been conducted on the intermediary.

Accordingly, we suggest that the preamble include the following language, similar in concept to the language in the preamble to the proposed rule for FCMs and IBs:

"With respect to intermediated accounts, regardless of whether the intermediary conducts its business on an omnibus basis or through subaccounts, a broker-dealer may have little or no information about the identities and transaction activities of the underlying participants or beneficiaries of such accounts. In most instances, given Treasury's risk-based approach to anti-money laundering programs for financial institutions generally, it

is expected that the focus of each broker-dealer's CIP will be the intermediary itself, and not the underlying participants or beneficiaries."

- **Reliance on Affiliates**

We also recommend that the rule permit broker-dealers in their customer identification procedures to rely on or assess the risks where verification procedures have been performed by an affiliate. Specifically, a broker-dealer should be able to make an assessment of whether it can rely on the verification done by an affiliate, such as an affiliated bank, broker-dealer or investment advisor. For instance, where a bank and broker-dealer are affiliated, and both subject to similar verification procedures, it makes little sense not to allow them to rely on verification performed by an affiliated entity. In these situations, if firms are not permitted to rely on affiliates, customers will have to provide the identical information multiple times. Most significantly, no legitimate anti-money laundering purpose is served by requiring affiliated entities to each perform the same verification on the same customer. We also note that the proposed rule for FCMs recognizes the need to avoid duplication for firms that have both a broker-dealer and a futures commission merchant or introducing broker.¹⁴

Accordingly, the proposed rule should incorporate under section (b) an additional risk assessment factor to be undertaken by a broker-dealer where an account is opened by an affiliate of the firm, as follows: "(8) The broker-dealer's reliance on an affiliate of the firm where the affiliate has performed customer identification and verification procedures." In addition, the preamble should be revised to include the following language: "Given Treasury's risk-based approach to anti-money laundering programs for financial institutions, where another affiliate of the broker-dealer has opened the account and performed the customer identification/verification requirements, the broker-dealer may rely on that affiliate if the procedures utilized by the affiliate are similar to those in place at the broker-dealer."

4. Shared Account or Client Relationships

We appreciate that the proposed rule recognizes that broker-dealers that share an account relationship with the same customer should be able to allocate between themselves the responsibility for verifying the customer's identity. This approach avoids unnecessary duplication of effort while at the same time provides adequate assurance that customer verification obligations will be met.

¹⁴ The proposed FCM/IB rule states: "Treasury and the Commission recognize that a related issue arises in the context of a firm that is registered both with the SEC as a broker-dealer and with the Commission as a futures commission merchant or introducing broker. Neither Treasury nor the Commission intend the effect of this proposed rule to require that both the securities and futures firm identify, and verify the identity of, their customers. For example, if a futures firm has a bifurcated compliance department handling respectively, the securities and futures sides of its business, the futures firm could perform the required customer identification and verification procedures and the securities firm could rely on it." 67 Fed. Reg. at 48331 n. 8.

We respectfully request, however, that the proposed rule provide more specific guidance with respect to the following types of shared relationships, which we address in more detail below: (1) introducing-clearing broker relationships in general; (2) verification issues in the omnibus account context; (3) introducing-clearing relationships involving foreign financial institutions; (4) prime brokerage and other similar "give-up" relationships; and (5) sharing relationships with regulated financial institutions.

(1) Introducing Firm-Clearing Firm Relationships

Several of the issues discussed above have particular import in the context of the relationship between an introducing broker and the carrying firm that clears its trades ("clearing broker"). We appreciate that, in the proposed rule relating to CIPs for broker-dealers, Treasury and the SEC recognized that the structural relationship between an introducing broker and a clearing broker raises unique issues. We respectfully request that, as discussed more fully below, the agencies clarify certain issues relating to introducing brokers and clearing firms in the final rule. Our concerns are best understood in light of the history of the development of the structural relationship between introducing brokers and clearing brokers. We have therefore set forth in the attached Appendix a description of the background and basic structure of the introducing firm-clearing firm relationship.

- **Sharing of Responsibilities for Verification of Identity**

Our threshold comment relates to language in the preamble to the proposed rule which indicates that broker-dealers will be able to share responsibilities under section 326 when one or more brokers is involved with a customer's account.¹⁵ Specifically, the preamble states that "broker-dealers sharing accounts may realize efficiencies by dividing up the requirements in this proposed rule pursuant to their clearing agreements. For example, the correspondent may undertake to obtain the identifying information from customers . . . and the clearing firm may undertake the verification procedures. Nonetheless, both firms would still be responsible for ensuring that each requirement in the rule is met with respect to each customer."¹⁶

We endorse the language in the proposed rule that permits the allocation of responsibilities in those instances in which two or more financial institutions share an account relationship with a customer, and we appreciate Treasury's and the SEC's recognition that such responsibilities can be allocated or apportioned pursuant to a contractual agreement. We note, however, that the example cited in the preamble to the proposed rule regarding the allocation of responsibilities, *i.e.*, that the introducing broker could perform the "identification" function and the clearing broker the "verification" function, appears to be factually flawed. As the background discussion in the Appendix makes clear, the customer contact role lies primarily with the introducing broker. As the initiator and manager of the customer relationship, the introducing broker is in the best position to obtain the documentary number and verify the

¹⁵ 67 Fed. Reg. at 48306, 48308.

¹⁶ *Id.* at 48308.

information through the use of physical documents (*i.e.*, positive verification). In contrast to these document-based "positive verification" efforts, the clearing firm is well-positioned to perform a non-documentary "negative verification" function, *i.e.*, providing the introducing broker with certain screening services, such as OFAC checks, scanning customer names through vendor databases and supplying the introducing broker with any relevant adverse information learned about that broker's underlying customer. Accordingly, the example in the preamble to the proposed rule should be modified to reflect that "the correspondent may undertake to obtain identifying information from customers as required in paragraph (c) and undertake the positive verification procedures and the clearing firm may undertake the negative verification procedures."

Another issue with respect to "positive" verification is the proposed requirement that all individuals granted authority to effect transactions over an account be verified. Specifically, the relevant text of the rule defines "customer" as "[a]ny person who is *granted authority to effect transactions with respect to an account* with a broker-dealer."¹⁷ As noted earlier, this is an extremely challenging issue for any broker-dealer, and is made more difficult in the context of the introducing-clearing broker relationship. In that context, the clearing broker receives its instructions directly from the introducing broker and has no knowledge of the person or persons authorized to trade on behalf of the end customer. In fact, the decision whether to accept a trade (*i.e.*, to recognize the trading authority of the person giving the instruction) is made by the introducing broker. These examples underscore the importance of the fact that the final rule should specifically leave it to the parties to allocate or apportion their responsibilities, including verification responsibilities, consistent with their contractual relationship as approved by their functional regulators.

The language in the preamble to the proposed rule with respect to the apparent responsibility placed on both firms for ensuring that "*each requirement* in the rule is met with respect to *each customer*"¹⁸ raises concerns in this regard. We believe this language is at odds with the fundamental concept of permitting the allocation or apportionment of responsibilities between an introducing broker and its clearing firm. Where the parties have apportioned specific responsibilities pursuant to a contractual agreement, each should be held responsible for satisfying their respective obligations. Indeed, the purpose underlying such an arrangement is to document and confirm that the responsibilities have been sufficiently allocated between an introducing broker and clearing broker and that each is aware of the responsibilities it is expected to perform – not that both are responsible for the performance of all functions with respect to each customer.

For example, where an introducing broker has represented to the clearing firm that it has verified employment information or other data received from the customer, either through contact with the customer or through a credit information service vendor, the clearing firm

¹⁷ 67 Fed. Reg. at 48317. The preamble makes clear that this definition does not apply to persons with trading authority prior to the effective date of the regulation. 67 Fed. Reg. at 48307.

¹⁸ 67 Fed. Reg. at 48308.

should be able to rely on those representations. Conversely, where a clearing firm has represented to the introducing broker that it has scanned a name through its screening process, the introducing broker should not have to duplicate that process. As these examples make clear, the measure of responsibility, as between an introducing firm and a clearing firm, should be that each has been apportioned a particular part of the process for which it is fully responsible, not that both are to be held responsible for fulfilling each and every requirement with respect to each customer. We believe it would be best for the functional regulators to be given the flexibility to determine the responsibilities that should be owed to "each customer" by each of the respective entities based upon their structural functions. We respectfully suggest that by seeking to broaden each entity's responsibility, the proposed rule is changing the entire regulatory scheme in the area of introducing-clearing firms which has been adopted by the securities regulators, and which has worked successfully for many years.¹⁹

Accordingly, we suggest that the language in the preamble that reads "[n]onetheless, both firms would still be responsible for ensuring that each requirement in the rule is met with respect to each customer" be deleted, and the following language inserted in its place: "Treasury recognizes that broker-dealers can contractually allocate in the clearing or carrying agreement between the parties, certain anti-money laundering obligations, including identification and verification responsibilities, subject to the approval and/or examination of its functional regulator. Each firm would be responsible for ensuring that its respective obligations are carried out. Absent an indication that reliance on the other firm is unreasonable (*e.g.*, it becomes clear that one party has failed to satisfactorily perform its allocated responsibilities), each should be permitted to rely upon the other." Of course, to confirm that such reliance continues to be reasonable, such an allocation could include, where appropriate and with the approval of the regulators, a requirement that the parties complete an annual certification attesting to their compliance with their allocated responsibilities. Such a certification would be consistent with the language in the preamble requiring a broker-dealer to "continually assess whether the other firm can be relied on to perform its responsibilities."²⁰

(2) Verification Issues in the Omnibus Account Context

Our next concern relates to omnibus clearing relationships maintained by an introducing broker with its clearing firm. As in any other omnibus relationship (see discussion above), because the clearing broker will typically have little or no identifying information for the

¹⁹ The net capital requirements under the SEC Net Capital Rules under the Securities Exchange Act of 1934, which are designed to protect investors and the markets, require broker/dealers that carry customer assets to maintain minimum capital sufficient to protect the customer. The SEC allows brokers that are not well enough capitalized or otherwise do not wish to maintain custody of their customer's property to engage clearing brokers to undertake this function. The concern underlying the potential for assumption of liability by the clearing broker for the introducing broker's customers is that the clearing broker will ultimately be held responsible for the suitability of investment recommendations made to the introducing broker's customers. Shifting liability from the introducing broker to the clearing broker in any way increases the risks to which the clearing broker is exposed and ultimately threatens the willingness of clearing brokers to provide services to the introducing brokers, thereby threatening the protections that well capitalized clearing brokers offer to introducing brokers.

²⁰ 67 Fed. Reg. at 48308.

introducing firm's customers, the final rule should reflect that a clearing broker's CIP need not include procedures to identify or verify the identity of those customers whose transactions are cleared through an omnibus account. Indeed, the companion rules applicable to mutual funds and futures commission merchants ("FCMs") and futures introducing brokers ("IBs") expressly recognize that those respective entities are not expected to verify the identities of individuals whose transactions are conducted through an omnibus account.²¹ We believe that regardless of the industry involved, a consistent standard should be applied for all transactions conducted through omnibus accounts. This should include transactions for omnibus accounts opened by, or maintained in the name of, an introducing firm.

We therefore suggest that the language in the proposed rule for broker-dealers be harmonized with the language in the proposed rule for FCMs and IBs²² and the proposed rule for mutual funds²³ to make clear that the institution having the omnibus relationship should be the focus the clearing broker's CIP. Thus, assuming that the clearing broker conducts its due diligence on the introducing firm, such efforts should be sufficient to meet its regulatory obligations.

Accordingly, we suggest that the preamble to the proposed rule be revised to include the following language: "Treasury recognizes that, in the context of omnibus accounts, a clearing broker is not required to 'look through' the introducing broker-dealer to identify and verify the identities of the introducing firm's customers. Typically, the clearing broker has little or no information for the individual customers of the introducing firm represented in an omnibus account. This rule does not require that a clearing broker obtain any additional information regarding the identities of the individual customers of the introducing firm whose transactions are conducted through the omnibus account holder. Of course, the omnibus account holder is itself a customer of the clearing broker for purposes of this rule. In assessing the introducing firm, a securities clearing broker could assess the risks associated with different types of introducing firms based upon an evaluation of relevant factors, including the type of introducing firm; its location; the statutory and regulatory regime that applies to that particular introducing firm, such as whether the jurisdiction complies with the European Union anti-money laundering directives or has been identified as non-cooperative by the Financial Action Task Force; the clearing broker's historical experience with the introducing firm; references from other financial institutions regarding the introducing firm; and whether the introducing firm is itself a financial

²¹ See 67 Fed. Reg. at 48321; 67 Fed. Reg. at 48331 (discussing intermediated accounts and the lack of information that an FCM or IB may have about the identities and transaction activities of the underlying participants or beneficiaries.) See also discussion of "Intermediated and Omnibus Accounts," *supra*.

²² See 67 Fed. Reg. at 48331 (referencing Treasury's risk-based approach to anti-money programs generally and noting that, under such an approach, *it is expected that the focus of each futures commission merchant's and introducing broker's CIP will be the intermediary itself, and not the underlying participants or beneficiaries*) (emphasis added). See also discussion of "Intermediated and Omnibus Accounts," *supra*.

²³ See 67 Fed. Reg. at 48321 and n. 14 (specifically stating that the "mutual fund would not be required to 'look through' the broker-dealer to identify and verify the identities" of the individual purchasers of the fund shares or to "look through" a qualified retirement plan to identify the participants of the plan. See also discussion of "Intermediated and Omnibus Accounts," *supra*.

institution subject to the Bank Secrecy Act ("BSA") and required to have an anti-money laundering program."²⁴

(3) Verification Issues Relating to Sharing With Foreign Financial Institutions

We are concerned that the proposed rule, as drafted, does not appear to recognize the fact that introducing brokers are sometimes foreign broker-dealers (or other foreign financial institutions acting in a similar capacity).²⁵ In addressing whether a broker-dealer can rely on another firm with which it shares an account relationship, the preamble defines the term "shared account" to mean "an account subject to a carrying or clearing agreement governed by New York Stock Exchange [NYSE] Rule 382 or National Association of Securities Dealers, Inc. [NASD] Rule 3230 (i.e., a customer account introduced by a correspondent *broker-dealer* to a clearing and carrying broker-dealer)."²⁶ However, NYSE Rule 382 speaks in terms of "*introducing organizations*" and "*carrying (or clearing) organizations*."²⁷ Likewise, NASD Rule 3230 speaks in terms of "*introducing members*" and "*clearing members*" and the NASDR has approved of clearing arrangements between a domestic clearing broker and foreign firms.²⁸ The NYSE and the NASD rules themselves do not limit such agreements to broker-dealers.

In contrast, the rule, as proposed, states that a securities broker-dealer's CIP would be based on, among other things, an assessment of "[t]he broker-dealer's reliance on *another broker-dealer* with which it shares an account relationship."²⁹ While it appears that the proposed rule intends to permit a clearing broker to rely on an introducing firm subject to an approved carrying agreement, it defines the term "broker-dealer" as "any person registered or required to be registered as a broker or dealer *with the [SEC]*."³⁰ As such, foreign financial institutions would not generally fall into this category. We request that the final rule acknowledge that responsibilities can be allocated or apportioned between such entities consistent with NYSE Rule 382 or NASD Conduct Rule 3230, and that the proposed rule be clarified to permit the sharing and allocating of responsibilities between a clearing broker and a foreign financial institution acting as an introducing firm regardless of whether the foreign financial institution is registered

²⁴ 67 Fed. Reg. at 48331 (setting forth the proposed criteria for FCMs and IBs in developing and implementing a CIP).

²⁵ Indeed, introducing brokers may be off-shore banks or other foreign financial institutions whose customers are active in American securities markets.

²⁶ 67 Fed. Reg. at 48308 (emphasis added).

²⁷ In fact, NYSE Rule 382 makes clear that carrying agreements can be entered into between NYSE members or member organizations or between a NYSE member/member organization and "*any foreign or domestic non-member organization. . .*" NYSE Rule 382(a).

²⁸ NASD Regulation Interpretation Letter under NASD Conduct Rule 3230 (July 23, 1999) (approving arrangement between an American clearing broker and German firms that "allocate certain account opening, approval and monitoring functions with respect to those German firms to those firms.").

²⁹ See 67 Fed. Reg. at 48317; see also 67 Fed. Reg. at 48308 (preamble to the proposed rule utilizing similar language).

³⁰ 67 Fed. Reg. at 48307; 48317.

with the SEC. Such an arrangement would be appropriate where the clearing broker has conducted its own due diligence on the foreign introducing entity in accordance with the criteria discussed above.

(4) Prime Brokerage and Similar "Give-Up" Arrangements

As noted above, the proposed rule would seem to allow allocation of verification responsibilities only where two broker-dealers share accounts. However, the preamble only references situations where the broker-dealers have a clearing or carrying agreement covered by NYSE Rule 382 or NASD 3230. However, we believe that allocation of customer verification obligations is equally appropriate in other types of shared account or client relationships, such as prime brokerage arrangements, and we recommend that such a reference be added in the preamble to recognize that such sharing is appropriate in other types of relationships. A prime brokerage arrangement allows investors who maintain a primary account relationship with one broker-dealer (the "prime broker") to have individual trades executed with another broker-dealer (the "executing broker") and cleared and settled into their custody account with the prime broker. Most investors who use such arrangements are sophisticated market participants such as institutions and investment management firms. Like clearing arrangements, prime brokerage relationships are governed by a contract between the prime and executing brokers that specifies the obligations and responsibilities of the parties. There are also agreements between the customer and the prime broker, and the customer and the executing broker, in which the customer acknowledges the different responsibilities undertaken by each of the two brokers. In addition, the prime and executing brokers must comply with strict requirements set forth in various SEC no action letters and their compliance with such requirements is overseen by self-regulatory organizations.

Prime brokers and executing brokers that "share" accounts or clients would realize similar efficiencies as clearing and introducing brokers by dividing up the requirements of the rule. Of course, as with clearing arrangements, the broker's reliance on one another must be reasonable.³¹

Thus, we recommend that the preamble include the following language: "Treasury recognizes the ability of broker-dealers to share the customer identification requirements in other types of arrangements, such as prime brokerage/executing broker ("give-up" arrangements).

³¹ The proposed customer identification rule for FCMs and IBs allows such reliance in analogous circumstances, namely, when an executing FCM executes a customer's order and then "gives up" the filled order to a clearing FCM who carries the customer's account. The preamble to the proposed rule states that, in such circumstances, the executing FCM can obtain from the clearing FCM, "either as part of a give-up agreement or on a transaction-by-transaction basis, a certification that the latter has performed the required customer identification or verification functions." See 67 Fed. Reg. at 48332 n. 10. It further states that, while the executing FCM is still responsible for ensuring that the requirements of the rule are met, it satisfies this responsibility by assessing whether the clearing FCM can be relied upon to fulfill its allocated responsibilities and by ceasing such reliance if it is no longer reasonable. *Id.* at 48332.

(5) Sharing Relationships With Regulated Financial Institutions

Moreover, the rule itself should recognize that such sharing arrangements can occur with other regulated entities, such as banks or broker-dealers. Our firms' experience is that increasingly securities transactions occur through an evolving combination of regulated financial institutions. The rule should therefore permit the allocation of the identification requirements where more than one financial institution may be involved in servicing a customer account. This approach would avoid a duplication of effort and allow institutions the flexibility to apportion the requirements according to the nature of the customer relationship. Of course, the allocation of duties must be reasonable in light of the nature of the relationship of each institution to the customer. Thus, a financial institution should be able to rely on another regulated financial institution's certification that it has satisfied the CIP requirements.

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Thus, in order to appropriately recognize the various sharing arrangements which broker dealers have, we request that section 103.122 (b)(7) of the proposed rule (discussing the relevant risk factors of a broker-dealers "Customer identification program") be revised as follows: "(7) The broker-dealer's reliance on another broker-dealer or entity with which it shares an account or client relationship: (i) pursuant to a carrying or clearing agreement governed by the rules of the self-regulatory organizations; or (ii) other sharing agreement or arrangement that is permissible under the securities laws, rules, or regulations, including as interpreted by the SEC or any self-regulatory organization; or (iii) similar sharing relationships with a different regulated entity. "

5. Other Clarifications Requested

• Verification of Public Corporations

The sixth risk factor to be considered by a broker-dealer is "the customer base" and Treasury appropriately notes that a closely held corporation may pose greater risks than a publicly traded corporation.³² Section 103.122(d)(1)(ii) of the rule, entitled *Verification through documents*, states that "[s]uitable documents for verification may include . . . (ii) [f]or persons other than natural persons, documents showing existence of the entity, such as registered articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument." Obtaining such documents for public corporations would not be an efficient use of resources. Instead, we suggest that subparagraph (ii) incorporate additional examples that would be more appropriate for verification of a public corporation, such as the use of public databases (e.g., EDGAR), company websites and annual reports.

• Identification Numbers For Foreign Institutions

³² 67 Fed. Reg. at 48331.

The agencies seek comment on the use of documentary numbers for non-U.S. entities. Paragraph (c)(1)(iv)(B) of the proposed rule requires broker-dealers to obtain from all non-U.S. persons either a taxpayer identification number, passport number and country of issuance, an alien identification card number, or the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. While these types of identification numbers appear suited to non-U.S. individuals, we are unaware of any such identification numbers that might be appropriate or available for such U.S. entities. Accordingly, the rule should be revised to reflect the unavailability of such information.

- **Recordkeeping Requirement**

We believe the rule should provide additional clarification as to the types of records that must be maintained when verification is done by checking public databases or those databases maintained by third-party vendors. As drafted, the rule requires a broker-dealer to make records of the “methods and results of any measures undertaken to verify” through non-documentary methods. However, it is unclear how a firm might satisfy this requirement when it uses certain types of non-documentary verification methods that do not necessarily result in a documentary record. For instance, there is no documentary record where a search of a public database fails to turn up any negative information. Similarly, where a firm uses a third-party vendor database, the firm may not receive a record where the search did not uncover any negative information.

We think broker-dealers should be able to satisfy this obligation in various ways other than a traditional documentary record. For example, we suggest that when a firm performs a negative database search, it would be sufficient to maintain some form of record showing the account numbers that were run through the search and any account numbers that came back with positive “hits.” Another alternative would be to allow broker-dealers to satisfy the recordkeeping requirements by showing that they have procedures and internal controls for running all new accounts through database checks and that they uniformly comply with such procedures.

Because many firms will use third-party vendors for verification checks, we suggest that the agencies make clear that firms are permitted to contract with these outside vendors to maintain the records showing the results of searches. Firms would have to arrange with these vendors so that such documentation would be available for regulatory purposes.

6. Application of the FCRA to Verification Decisions

The proposed rule strongly endorses the use of non-documentary methods to verify customers, in particular the use of public and private databases. Indeed, the rule requires firms to use such methods in certain situations, and the preamble notes that, in many ways, such methods are superior to traditional documentary methods. We concur in the agencies’ views on this. Many of our members believe that the use of databases to verify customers will be one of the most – if not the only – cost-effective and practical methods for complying with the new requirements in non face-to-face account openings.

We are concerned, however, about the possible application of the Fair Credit Reporting Act ("FCRA") to the use of such databases for verification purposes. To the extent the FCRA were held to apply, it would impose significant obligations on both the firms using the databases and the database vendors that could potentially undermine the availability and effectiveness of such methods. In addition, many database vendors include provisions in their subscription agreements prohibiting subscribers from using their information for any purpose covered by the FCRA. If verification decisions are considered a covered purpose under the FCRA, such provisions could impair the ability of firms to use such databases to comply with their PATRIOT Act obligations.

In order to avoid these problems, we urge the agencies to take the necessary steps to provide some form of exemption from the FCRA for the use of public or private databases to comply with Section 326 obligations.

7. Burden Imposed By the Rule

Although we are not challenging the rule on the basis of burden, we believe that the rule drastically underestimates the burden that will be imposed by the proposed procedures. For example, the Commission states that the cost per firm to establish a customer identification program will be approximately \$2,244. The Commission also estimates that obtaining the required minimum identifying information will take approximately one minute per account, and that the average time spent verifying an account will be five minutes. We believe that the time and cost of establishing and implementing the required customer identification programs, and obtaining the required information and verifying each account will be well beyond the estimates in the rule.

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We appreciate the opportunity to comment on the proposed rule. If you wish to receive additional information related to our comments, please feel free to contact the undersigned.

Sincerely,

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Associate General Counsel
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ADDENDUM TO SIA COMMENT LETTER

Provisions that Should Be Made Consistent with the Rules Issued by the Other Financial Regulators

- **Verification of Existing Customers**

The terms of the rule should expressly provide, as stated in the preamble, that a firm does not have to verify an existing customer seeking to open a new account or who is granted trading authority with respect to an account if the firm previously verified the customer and continues to have a reasonable belief that it knows the customer's true identity. See 67 Fed. Reg. at 48,309. This provision is included in the actual terms of the proposed rule applicable to banking organizations, but is only included in the preamble to the broker-dealer rule. Including this provision in the text of the rule itself will add clarity to the rule, and help ensure that firms are not redoing verification -- and thereby misallocating resources -- for existing customers for which such procedures are not required.

- **Scope of Verification Duty**

Our understanding is that paragraph (d) of the proposed rule does not require a broker-dealer to verify every piece of identifying information obtained from a customer, but rather to verify enough information to reach a reasonable belief that it knows the customer's true identity. It would be helpful if this were stated more clearly in the preamble, as it is in the preamble to the proposed rule for mutual funds.³³

In addition, one other inconsistency in the various proposed rules arises because broker-dealers and mutual funds are required to use non-documentary verification methods when "circumstances" otherwise increase the risk that documents will not be enough. Banks are required to do so only when "the type of account" increases this risk. While we do not know whether this creates any practical differences, we again recommend that the rules should be made to conform.

- **Government Lists Required to Be Checked**

It would be very helpful to our members if the agencies would provide clearer guidance as to the lists firms are required to check as part of the requirement to determine whether a customer appears on any list of known or suspected terrorist organizations. The rule itself states that the requirement is to check government lists "provided" to the broker-dealer, while the preamble says the requirement applies only to lists "circulated by the federal government." The uncertainty as to what is required is heightened by the fact that the preamble to the mutual fund rule states the requirement applies to lists "circulated, directly provided, or otherwise made

³³ See 67 Fed. Reg. at 48321.

available by the federal government,” which appears to be broader than the broker-dealer rule, and could be read to include, for example, lists posted on government websites.

Accordingly, the Treasury and the SEC should specify what lists broker-dealers are required to check, and should ensure uniformity in the requirements for all financial institutions. We believe that the Congress intended that these lists be limited to OFAC’s lists and the “Control List” circulated by the FBI in connection with the terrorist financing investigation.³⁴ Firms should not be required to, for example, monitor various websites to determine what lists may have been posted. Rather, firms should only be required to check lists that they have been sent or for which they have received notice.

- **Definition of account**

The definition of “account” appears broader than the definition under the rule issued by Treasury and the federal bank regulatory agencies. The bank rule defines account as “any formal banking or business relationship established to provide **ongoing services**, dealings or other financial transactions” (emphasis added). In contrast, it is unclear whether the broker-dealer rule is similarly limited to relationships to provide ongoing services since it defines account simply as “any formal business relationship with a broker-dealer to effect transactions in securities.” Thus, we recommend making the definition of “account” consistent with the bank customer identification rules by incorporating the concept that relationship must be one to provide “ongoing” services.

- **Identification Numbers**

The fourth item of required identifying information listed in paragraph (c)(1) of the proposed rule is described as “documentary record.” The rule goes on to describe this information as being a taxpayer identification number for U.S. persons and various types of identification numbers for non-U.S. persons. We recommend that the description of this information be changed to “identification number,” which is the term used in the proposed rule for mutual funds. We believe this term more accurately describes the information and avoids any implication that an actual documentary record of the number must be obtained.

³⁴

The Report of the House Financial Services Committee states:

"The lists of known or suspected terrorists that the Committee intends financial institutions to consult are those already supplied to financial institutions by the Office of Foreign Assets Control (OFAC), and occasionally by law enforcement and regulatory authorities, as in the days immediately following the September 11, 2001, attacks on the World Trade Center and the Pentagon."

H.R. Rep. No. 107-250, pt. 1, at 62-63 (2001).

APPENDIX TO SIA COMMENT LETTER

Background For Clearing Firm/Introducing Firm Issues

The present structural relationship between introducing brokers and clearing brokers had its genesis in the "paper crunch" crisis of 1967-1970, a period that the then-Chairman of the SEC termed the "most prolonged and severe crisis in the securities industry in forty years."³⁵ That crisis nearly paralyzed Wall Street and led to the collapse of numerous NYSE member firms. These firms were unable to process a rising volume of trades, causing a domino effect of failed settlements of securities transactions between and among brokerage firms. Acting under the mandate of Congress to address the crisis, the SEC encouraged the securities industry to develop a modern clearance and settlement system. The present system of introducing-clearing relationships is, in large part, a direct result of the particular and careful regulatory attention accorded this type of business by the SEC and the self-regulatory organizations.

Introducing brokers vary in size, covering a wide spectrum of business activities. These activities extend from retail brokerage to underwriting of newly issued securities to making markets in these and other securities.³⁶ Like self-clearing firms – which they are not – introducing brokers solicit prospective customers, approve the opening of new accounts, monitor their customers' transactions and determine their customers' investment objectives, including the suitability of recommendations made to their customers by their brokers. All customer related data (*e.g.*, name, address, social security number, investment experience, investment objectives, age, income, net worth) are gathered by personnel of the introducing broker.

Indeed, introducing brokers are legally independent broker-dealers, generally registered with the SEC. In addition to being regulated by the SEC, introducing brokers are subject to supervision and inspection by their Designated Examining Authority ("DEA"), generally the NASD or, if they are NYSE members, by the latter. As registered broker-dealers and NASD members, introducing brokers are required to maintain written compliance procedures and compliance staff to monitor and supervise the conduct of their employees, including that of their brokers. Introducing brokers are required to register senior members of their management as "principals" and their brokers as "registered representatives" with their DEA. Finally, introducing brokers and their registered representatives are required to be registered as broker-dealers with each state in which they do business.

³⁵ Letter of SEC Chairman to Congress, dated December 28, 1971, transmitting and summarizing the SEC's Study of Unsafe and Unsound Practices of Brokers and Dealers.

³⁶ The SEC Division of Market Regulation has described introducing brokers as follows: "An introducing broker-dealer is one that has a contractual arrangement with another firm, known as the carrying or clearing firm, under which the carrying firm agrees to perform certain services for the introducing firm. Usually, the introducing firm submits its customer accounts and customer orders to the carrying firm, which executes the orders and carries the account. The carrying firm's duties include the proper disposition of the customer funds and securities after trade date, the custody of customer securities and funds, and the recordkeeping associated with carrying customer accounts." Exchange Act Release No. 31,511, 1992 Fed. Sec. L. Rep. (CCH) ¶ 85,064 at 83,569 (Nov. 24, 1992).

Clearing firms, on the other hand, are hired by the introducing broker to provide back-office services. They play no role in the introducing brokers' sales activities and they have no authority to hire or fire an introducing firms' personnel. Clearing brokers do not recommend the purchase or sale of securities to introduced customers. Rather, the clearing brokers' involvement in any transaction commences only *after* a trade has been ordered or otherwise authorized by the customer. An order to purchase or sell a particular security may be executed by the clearing broker at the direction of the introducing broker, or, as is true in many cases, by the introducing broker itself: trading "away" from the clearing firm, and executing the trade directly with a market maker or on an exchange and "giving up" (*i.e.*, identifying) its clearing broker for clearance and settlement of the trade. In all events, after the execution of a trade, the clearing broker processes, settles, and clears the transaction and prepares an appropriate trade confirmation. Thereafter, the clearing broker issues a statement of account to the customer reflecting this and other trades that may have been done that month. The clearing broker also maintains custody of the customer's securities and funds upon receipt, and may provide margin financing to the introduced customer if the latter has signed a margin agreement with the clearing broker.

Clearing brokers are hired solely to provide processing and administrative services in connection with securities transactions ordered by the introducing broker for the account of either the introducing broker's customers or for the introducing broker's own account(s). These "back-office" services typically include clearance and settlement of transactions, maintenance of books and records related to such transactions, receipt, delivery, and custody of securities and funds belonging to the brokerage firms or their customers, preparation of trade confirmations and monthly statements of account, extension of credit to margin accounts, and, at times, execution of orders for the purchase or sale of securities upon the direction of the introducing broker.

The specific allocation of functions between an introducing broker and a clearing firm that are regulatorily required to be allocated is reflected in the clearing agreement contract and is generally determined by the business needs of the introducing broker and the scope of services offered by the clearing broker, although, as noted above, customer-contact functions are uniformly retained by the introducing broker.³⁷ The party, be it the introducing broker or the clearing broker, to whom a specific function has been allocated in the clearing agreement, has full and exclusive regulatory responsibility for its performance and supervision.³⁸

³⁷ NYSE Rule 382 and NASD Conduct Rule 3230 each sets out key functions and responsibilities that clearing agreements are required to allocate between IBs and CBs. Further, the NYSE has enumerated specific tasks subsumed within the functions listed in NYSE Rule 382(b). Each such task must be "addressed" in the allocation of functions and responsibilities in the clearing agreement. NYSE INTERPRETATION HANDBOOK, Rule 382/02 (Basic Functions).

³⁸ NYSE INTERPRETATION HANDBOOK, Rule 382/03 provides: "Each organization will be accountable for actual performance of all functions performed by employees and other associated persons as well as for overall supervision of functions and activities performed by it pursuant to any carrying agreement. To the extent that a particular function is allocated to one of the parties, the other party is to supply that firm with all appropriate data in its possession pertinent to the proper performance and supervision of that function. The agreement should acknowledge this obligation."

Thus, the retention of all customer-contact functions by an introducing broker (*e.g.*, soliciting customer accounts, determining the customer's investment objectives, recommending transactions in accord with such objectives) gives it full and exclusive regulatory responsibility for the sales practices of its brokers. Accordingly, the clearing broker has no regulatory duty to supervise the brokers or monitor the introducing broker's sales practices.

There are two types of clearing agreements involving transactions with customers, namely, "fully disclosed" and "omnibus" agreements, the former being by far the more common form of agreement. Both types of agreements are required to be filed with and approved by the NYSE or the NASD. Under a fully disclosed clearing agreement, the introducing broker discloses the identity of each of its customers to its clearing broker. The clearing broker then establishes on its books and records an account in the name of each introduced customer. Moreover, the clearing broker prepares trade confirmations and monthly statements for each introduced customer. All introduced customers are required to be notified in writing that their brokerage firm has entered into a fully disclosed clearing agreement and that their accounts will be carried by the clearing firm.³⁹

Omnibus clearing services are an integral part of the clearing business, as well as an important part of the securities business generally. Under most omnibus clearing agreements, the introducing firm neither discloses the identity of its customers, nor informs its customers of the existence of the omnibus clearing arrangement. An omnibus introducing firm opens one "omnibus" account with its clearing broker. This account contains all of its customers' assets and the introducing firm internally allocates its customer trades on its own books. An omnibus introducing firm provides its own trade confirmations and monthly statements to its customers. Omnibus introducing firms are generally large financial institutions that have opted to out-source all or a portion of their "street-side" settlement and clearance functions while retaining full regulatory responsibility for their customers under SEC net capital and financial responsibility rules and maintaining the ability to provide margin financing to their customers. Many of the customer and custody relationships involve providing services for banks, investment companies and affiliates, and are quite typical within the industry. Alternatively, there are omnibus arrangements where the introducing firm sets up undisclosed accounts on the books of the clearing firm, but the clearing firm provides a service to the introducing firm by allocating the trades on the clearing broker's books to the respective undisclosed accounts designated by the introducing firm.

³⁹ See NYSE Rule 382(c), 2 NYSE Guide (CCH) ¶ 2382; AMEX Rule 400(c), AMEX Guide (CCH) ¶ 9,429A; NASD Rule 3230. A so-called "Rule 382 Notice" informs the customers that their brokerage firm has entered into a clearing agreement with a specified clearing broker.