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The U.S. Capital Markets Clearance And Settlement Process

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Within the world of securities there are many sectors and facets to explore and understand. To be successful, a public company must have an active, liquid trading market. Accordingly, the trading markets themselves, including the settlement and clearing process in the US markets, is an important fundamental area of knowledge that every public company, potential public company, and advisor needs to comprehend. A basic understanding of the trading markets will help drive relationships with transfer agents, market makers, broker-dealers and financial public relations firms as well as provide the knowledge to improve relationships with shareholders. In addition, small pooled funds such as venture and hedge funds and family offices that invest in public markets will benefit from an understanding of the process.

This blog provides a historical foundation and summary of the clearance and settlement processes for US equities markets. In a future blog, I will drill down into specific trading, including short selling.

History and Background

The Paperwork Crisis

Prior to the advent of modern technology, securities were literally cleared and transferred by providing paper certificates to a company's transfer agent, who would record the transfer on their books and records and issue new securities to the new holders. A transfer agent would receive a bundle of documents from a broker-dealer and physically process all of the paperwork and then send it to a separate registrar to record each of the transfers. In order to reduce time, most brokers, transfer agents and registrars were located in New York City in the Wall Street district. The broker would courier the documents to the transfer agent each day, who would process the paperwork and courier them to the registrar to process the transfers each after following a series of document checks, balances and audits, and then deliver the new certificates to the designated parties using a messenger or courier.

As the volume of transactions increased, numerous clearing brokers and clearing agencies emerged to help with the processing. However, the system was disjointed and as the physical certificate process remained the same, each of these clearing brokers and agencies maintained offices physically near each other to messenger paper back and forth. By the 1960s and early 1970s the sheer volume of paperwork crushed the system and caused what came to be known as the Paperwork Crisis.

At the time the Paperwork Crisis was the biggest crisis to face the securities industry since the Great Depression and to this day remains one of the most difficult and largest challenges the markets have faced. As a result of the Paperwork Crisis, the entire industry, including Congress, state and federal regulators, brokers, banks and security exchanges, all participated in a complete overhaul of the markets' operational systems, which ultimately resulted in the current national clearing and settlement system. Years of expensive studies all came to the same basic conclusion regarding the Paperwork Crisis, which is that the securities industry needed a uniform, coordinated nationwide system for the clearance and settlement of securities transactions.

The birth of DTC

The current system did not pop up overnight, but rather took years and a series of changes and adjustments and then more changes and adjustments. In 1968 the NYSE created the Central Certificate Service as a division of the Stock Clearing Corporation to act as a clearing agency and depository service. In 1973, the Central Certificate Service (“CCS”) changed its name to the Depository Trust Company (DTC).

A clearing agency or depository typically compares member transactions, clears, nets and settles trades, and provides risk management services, such as trade guarantees. Depositories centralize securities by holding them on deposit for their participants and effect transfers of interests in those securities through book-entry credits and debits of participants’ accounts. Currently DTC, through its subsidiaries, is both the only central depository in the United States and the only one registered with the SEC as a clearing agency, but it wasn’t always. In the beginning CCS was only used by the NYSE and soon after by the American Stock Exchange.

In its early years, broker-dealers and banks would deposit their certificated securities with CCS, which would transfer them into the name of the CCS nominee and physically hold them in custody. That nominee account came to be referred to as “street name” and the nominee as CEDE. CCS maintained book accounts for all its members. When a member transferred securities, the transfer was recorded by book entry with a debit and credit between accounts rather than a physical transfer of securities. The securities themselves remained registered to CCS’s nominee account (today CEDE). Today DTC continues to hold physical custody of certificated securities held in street name. As an aside, the flooding from Hurricane Sandy destroyed massive amounts of paper certificates and records held by DTC in its New York storage, taking years to sort out and causing huge delays in the processing of transactions.

Around the same time that the NYSE created the CCS, the NASD formed the National Clearing Corporation (NCC) in an effort to develop and implement a nationwide system of interconnected regional clearinghouses for the clearance of all OTC and NASDAQ securities. In 1977 the NCC merged with CCS and formed the National Securities Clearing Corporation (“NSCC”). The NSCC in turn later merged with DTC. The NSCC net settles securities amongst all the participating broker participants, who in turn maintain records for each client account.

SEC gains regulatory power

It was quickly apparent to the thought leaders of the time that it was imperative to give the SEC the power to regulate the clearance and settlement process, including requiring clearing agencies to register with the SEC and to give the SEC the power to implement rules and regulations related to both the system and its participants. In 1975 Congress enacted the Securities Act Amendments of 1975, making sweeping changes to the federal laws and creating what is today the national market system and national clearance and settlement system.

The 1975 Amendments directed the SEC to “(i) facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities; (ii) end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities; and (iii) establish a system for reporting missing, lost, counterfeit, and stolen securities.” In addition, related to the national market system, the SEC was directed to establish a national market system to link together the multiple individual markets that trade securities to achieve the business objective of efficient, competitive, fair and orderly markets.

In the early '70s the CCS and NCC were not the only clearing agencies; several others had popped up as well. However, using the power of the 1975 Amendments, the SEC required registration of and imposed regulations and compliance on these clearing agencies. In 1982 and 1983 the NASD (now FINRA) and the five major stock exchanges all amended their rules to require members to use an SEC registered clearing firm and depository. By the late '90s DTC was the largest depository and NSCC was the largest clearing firm. In 1999 the two merged and DTC remained the only SEC registered clearing agency and depository.

DTC introduces FAST

By the mid to late '70s, technological advancements were assisting in overall system advancements. In 1975 DTC created the Fast Automated Securities Transfer Program ("FAST"), which was approved by the SEC in 1976. Also, in 1977 Article 8 of the Uniform Commercial Code (UCC) was amended to allow for uncertificated book entry records of security ownership.

Prior to FAST, and today for those securities not eligible for the FAST program, when a security is being deposited into DTC, a broker-dealer physically sends the certificate to DTC, who in turn sends it to the transfer agent to register in CEDE. Again, CEDE is DTC's nominee name for holding legal title to securities in the DTC system. Likewise for the withdrawal of these securities from the DTC system, DTC physically sends the certificate back to the transfer agent, who re-registers it and sends it back to DTC, who then sends it to the participating broker. If the participating broker is a clearing broker, that clearing broker then sends the certificate to the introducing broker, who then sends it to the account holder!

The FAST system allows transfer agents to act as custodians for all shares in the CEDE account. Each individual brokerage firm DTC participant maintains corresponding books representing their customers shareholder accounts for securities held in street name. When securities are deposited into or withdrawn from DTC, the FAST transfer agent makes an electronic adjustment which is electronically confirmed and balanced between DTC and the participating brokers on a daily basis.

Improving matters further, in 1996 the Direct Registration System ("DRS") was implemented, which allowed investors to hold uncertificated securities in registered form directly on the books of the transfer agent. FAST eligibility is a prerequisite to using DRS. Using DRS and FAST together, a shareholder can electronically transfer shares to and from a brokerage account to facilitate their sale or transfer.

To become FAST, and therefore DRS eligible, a FAST approved transfer agent must apply to DTC on behalf of an issuer. The approval is not automatic. All FAST applications undergo a DTC review process. At a minimum, in order to be FAST eligible, an issuer must be eligible for DTC's book-entry-only services, which requires a Blanket Letter of Representation (BLOR) in a form subscribed by DTC. DTC can ask for opinion letters to accompany an application. Beyond the BLOR and standard published DTC eligibility criteria, I was unable to find published criteria by DTC as to exactly what review requirements are included in a FAST application review process. I also spoke to several transfer agents that submit FAST issuer applications on a regular basis, and they likewise were unsure as to the review criteria used by DTC. However, it seems generally agreed that DTC conducts an issuer quality review looking at similar issues that would result in chills and locks, compliance with SEC reporting requirements, trading market price, volume and liquidity, and possibly bad actor reviews.

For further reading on DTC eligibility and chills and locks, see [HERE](#); [HERE](#); [HERE](#); and [HERE](#) (Please note that DTC never implemented the rules discussed in that particular blog; however, the proposed process became a sort of industry practice. Also, note that the advent of chills and locks has dramatically decreased in recent years.)

Many OTC traded securities remain ineligible for the FAST program and DRS services today. The entire process of depositing securities into and removing securities from DTC is time-consuming for these non-FAST securities. The DTC, brokerage firms and transfer agents all charge for their part in the process—thus the current approximate \$1,000 fee to deposit paper securities into DTC. This process, together with heightened regulatory scrutiny related to the deposit of all OTC traded securities and especially penny stocks, adds to the overall difficulty for OTC traded companies and the flow of their securities. See my blog [HERE](#) for a discussion on issues related to depositing penny stocks in today's regulatory environment.

The Current Clearance and Settlement System

Today, DTC provides the depository and book entry settlement services for substantially all equity trading in the US. Over \$600 billion in transactions are completed at DTC each day. Although all similar, the exact clearance and settlement process depends on the type of security being traded (stock, bond, etc.), how the security is owned (registered or beneficial), the market or exchange traded on (OTC Markets, NASDAQ...) and the entities and institutions involved.

The majority of shareholders of a public company are beneficial owners rather than record holders. Beneficial ownership refers to securities held in street name (i.e., legally titled in the name of DTC's nominee, CEDE) which have been deposited with a brokerage firm and are in the DTC system. As discussed, these securities show up on the shareholder list in the CEDE account. Each brokerage firm maintains records and facilitates transfers for its beneficial owner account holders. Transfer agents process the restrictive legend removal for the initial deposit of securities into the brokerage firm but do not process transfers once in the system.

Where securities are held at DTC, the member brokerage firm will be identified on the books and records of DTC as having the entitlement to their pro rata share of all of the securities of that issuer held by DTC. The individual investor will then be identified on the books and records of the DTC member—i.e., the brokerage firm where the investors maintains an account and has deposited the securities. The specific rights of the individual investor are determined by rules and regulations, as well as by contract between the investor/shareholder and the particular brokerage firm.

Also, there may be two brokerage firms between DTC and the customer account holder. Brokerage firms that are direct members with DTC are referred to as “clearing brokers.” Many brokerage firms make arrangements with these DTC members (clearing brokers) to clear the securities on their behalf. Those firms are referred to as “introducing brokers.” A clearing broker will directly route an order through the national exchange or OTC Market, whereas an introducing broker will route the order to a clearing broker, who then routes the order through the exchange or OTC Market.

Only a limited number of clearing brokers will clear penny stocks and accordingly, only introducing brokers with clearing arrangements through those specific clearing brokers will, in turn, accept and clear penny stocks. COR Clearing, Alpine Securities and Wilson-Davis & Co. are the most widely known DTC member clearing brokers that will process penny stocks. Management of companies that issue penny stocks should communicate to their shareholders as to firms that will or will not clear their securities.

All securities trades involve a legally binding contract. In general the “clearing” of those trades involves implementing the terms of the contract, including ensuring processing to the correct buyer and seller in the correct security and correct amount and at the correct price and date. This process is effectuated electronically.

“Settlement” refers to the fulfillment of the contract through the exchanging of funds and delivery of the securities. In the US equities markets, settlement usually occurs three business days after the trade date, commonly referred to as “T+3.” As discussed, delivery occurs electronically by making an adjusting book entry as to entitlement. One brokerage account is debited and another is credited at the DTC level and a corresponding entry is made at each brokerage firm involved in the transaction. DTC only tracks the securities entitlement of its participating members, while the individual brokerage firms track the holdings in their customer accounts.

DTC’s clearing arm generally nets all brokerage transactions each day, making one adjusting entry per day. The net entry debits or credits the brokerage firm’s account as necessary. Likewise, a cash account is maintained for each brokerage firm, which is netted and debited and/or credited each day. This process is continuous. Moreover, brokerage firms can either settle each day or carry their open account forward until the next business day. Because all transactions are netted out, 99% of all trade obligations do not require the exchange of money.

The SEC concept release on transfer agent rules contained a good summary of this process. In particular, "...final settlement of the securities leg of the transaction will involve the following sequential steps: (i) the DTC securities account of the seller's clearing broker will be debited with the securities being purchased; (ii) NSCC's securities account at DTC will be credited with the securities purchased; (iii) the DTC securities account of the buyer's clearing broker will also be credited; and (iv) each broker will credit or debit their respective customers' securities accounts held with the broker. On the cash side, final settlement will involve the following sequential steps: (i) the Federal Reserve bank account of the buyer's clearing broker will be debited for the sale price of the securities; (ii) DTC's Federal Reserve bank account will be credited for the sale price of the securities; (iii) DTC will transfer this cash to the Federal Reserve bank account of the seller's Clearing Broker; and (iv) each broker will credit or debit its respective customers' cash accounts held with the broker."

This process is the same for all buy and sell transactions, whether the transaction involves a long or short sale. However, where the transaction involves a short sale, there are added "locate" and "close-out" requirements, generally governed by Regulation SHO. In a future blog, I will drill down on the short selling process and Regulation SHO.

Although the order flow is all electronic, certain fundamentals cannot be bypassed. For instance, for every sell order there must be a matching buyer, and for every buy order a matching seller. The ability to match a buyer and seller is often referred to as the liquidity of a company's trading market.

Conclusion

It is important for high-level securities attorneys to go beyond the technical ability to draft a contract, 10-K or registration statement, but to also understand how trading markets work and thus be able to provide guidance and advice as to relationships with transfer agents, market makers and financial public relations firm.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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