Title: The DTCC has a program that allows any broker accept counterfeit shares. This is not getting enough attention.
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Created 2021-12-07 18:51:01 UTC
Permalink: /r/TheGloryHodl/comments/rb6cq4/the_dtcc_has_a_program_that_allows_any_broker/
Url: /r/DDintoGME/comments/rb3wjo/the_dtcc_has_a_program_that_allows_any_broker/

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I've been doing a deep dive into the entire securities clearing/Continuous Net Settlement process and while every single part of the process seems to have a rule that should concern retail investors, the one I find the most problematic is the DTCC's ["Fully Paid For Account"](https://www.dtcc.com/clearing-services/equities-clearing-services/the-fully-paid-for-account). I'm not trying to spin a conspiracy theory; if I'm misinterpreting this I'd LOVE to hear where I'm going wrong. I tried to ask my broker about this but Fidelity keeps deleting my question from their subreddit, dropping my chat session, and putting my on hold indefinitely or dropping my call when they transfer me...

Here's the ELIape version:

* The NSCC's job is to "clear" financial transactions. This means that they keep track of who owes what and makes sure that when a broker makes a trade there's someone on the other side of that trade who will complete the transaction. They are the guaranteed counterparty to pretty much every transaction as it applies to retail traders.

* The DTC's job is to "settle" transactions. This means that they keep track of who owns what and record the transfer of money and securities.

These are corporations, not government entities. They [write their own rules, procedures, and bylaws](https://www.dtcc.com/legal/rules-and-procedures) and enforce them amongst their members with contract law. They are regulated by the SEC in their role as clearing agencies, but members have a lot of freedom to use the system how they want until a member raises a dispute or a regulatory agency intervenes.

* The [CNS](https://www.dtcc.com/clearing-services/equities-clearing-services/cns) system is the process used to settle most trades. The buyer and the seller execute their trades with the NSCC as the middleman/guaranteed counterparty, then a couple of days later (T+2) the NSCC tells the buyer and the seller their new balances and sends the result to the DTC.

* The next day (T+3) the DTC credit/debits the appropriate accounts and notifies everyone that the transactions are complete.

If the NSCC doesn't receive the stock from the seller on T+2, it's a fail to deliver for the seller. If the buyer doesn't get the stock from the NSCC on T+2, it's a fail to receive for the buyer. The buyer *could* submit a request for a forced buy-in but this doesn't happen often. Instead the buyer can set aside the money they got from their retail customer in the Fully Paid For Account and the seller's debt gets documented and stacked up in the ["Obligation Warehouse"](https://www.dtcc.com/clearing-services/equities-clearing-services/ow) service. Then the DTCC's algorithm can sort through all the buys and sells every day to clear out the oldes failures and keep all the money and stocks moving where they need to go with a minimum of disruptions.

The Obligation Warehouse is a separate can of worms, for now let's dive into the Fully Paid For Account and see if we can collect a few wrinkles along the way.

The biggest red flags for the Fully Paid For Account are the "benefits" listed on the DTCCs information page:

> * Enables Members to deliver securities to institutional clients on settlement day using customer fully-paid-for securities.
>

> * Reduces the number of institutional fails.
>
> * Allows Member to maintain good relationships with institutional customers.
>
> * The Fully-Paid-for-Account is a good control location for compliance with the requirements under Section 15c3-3 of the Exchange Act.

What are the odds that a program designed for brokers to maintain good relationships with institutional customers and reduce the number of institutional fails is a Good Thing for retail? And what exactly is ["Section 15c3-3 of the Exchange Act"](https://www.sec.gov/rules/final/34-47480.htm)? 15c3-3 is the broker-dealer customer protection rule, which 'ensures' that brokers don't put customer assets at risk when they loan them out or use them as collateral. The cash, treasury bills, or a letter of credit from a bank original act specified that

> The rule requires broker-dealers to take steps to protect the securities that customers leave in their custody. These steps include the requirement that broker-dealers promptly obtain and thereafter maintain possession or control of all "fully paid" and "excess-margin" securities carried for the accounts of customers. The possession or control requirement is designed to ensure that broker-dealers do not put customers at risk by borrowing their securities to expand or otherwise further the broker-dealer's proprietary activities.
>
> Paragraph (b)(3) of Rule 15c3-3 sets forth conditions under which broker-dealers may borrow fully paid or excess margin securities from customers for their own use without violating the rule's possession or control requirement. These conditions include the requirement that broker-dealers and their lending customers enter into written agreements that (1) set forth the basis of compensation for the loans as well as the rights and liabilities of the parties in the borrowed securities, (2) require the broker-dealers to provide the lenders with schedules of the securities actually borrowed, (3) require the broker-dealers to provide the lenders with, at least, 100% collateral consisting exclusively of cash, United States Treasury bills and notes, or an irrevocable letter of credit issued by a bank, and (4) contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the lenders with respect to the securities loan transactions. Moreover, the loaned securities and pledged collateral must be marked to market daily, and additional collateral posted if necessary to maintain the 100% collateralization requirement. These requirements are designed so that borrowings of customer securities remain fully collateralized for the term of the loan.

So, the SEC lays out rules about how brokers can use their customers assets in margin accounts or with a [signed lending agreement](https://www.fidelity.com/trading/fully-paid-lending) that compensates the customer and warns them of the risks. Sounds good so far... but what happens if a customer gives money to the brokerage, the brokerage gets a fail to receive, and they just let it ride instead of forcing a buy-in? No stock is being loaned but there's a fully collateralized chunk of money that gets 'marked to market' daily to track the price of the stock. You have a stock-shaped asset on the books that satisfies the CNS process for settling accounts just like a stock would, but no shares have actually changed hands and customer assets aren't being "loaned". If my reading of the situation is accurate, this also means that each brokerage decided to receive the IOUs from the NSCC rather than the counterfeit shares just showing up in the system as a result of the market maker's shenanigans.

> **Members instruct NSCC to move their expected long allocations** from the general CNS “A” subaccount into a fully-paid-for location (the “E” subaccount) and are then permitted to use customer fully-paid-for positions to complete institutional deliveries in DTC.
>
> As Members instruct NSCC to move expected long allocations to the fully-paid-for location, NSCC reclassifies the relevant long allocations as a fully-paid-for long allocation and debits the Member the market value of the relevant securities in the NSCC settlement system. These long allocation reclassifications and corresponding settlement debits are posted intraday by NSCC. The funds associated with the fully-paid-for process are collected via NSCC’s end-of-day settlement process and are held by NSCC and used to ensure the customer fully-paid-for positions can be replaced should the Member become insolvent. Upon completion of a fully-paid-for long allocation, the relevant funds are used to pay for the securities received from CNS via NSCC’s end-of-day settlement process.

One more nifty little detail, apparently the NSCC doesn't need to document the difference between shares and Fully Paid For Account entries on their books, so when they open their books to a regulatory agency it just shows that all the numbers match up. I'm not too sure about this one, I'd it if anyone with a compliance/accounting/actuarial background could chime in. From NSCC Rule 12.2:

> (c) any action taken by the Corporation pursuant to an instruction given to the Corporation by a Member to move a position to its Fully-Paid-For Subaccount shall not constitute an appropriate entry on the Corporation’s books so as to constitute such movement

TL;DR - Your brokerage can **choose** to receive an IOU instead of an actual share and keep your cash on the books in a special sub-account. The CNS system makes this look just like a share and since all the brokerages in the NSCC share liabilities as the guaranteed counterparty, they're incentivized to keep looking the other way and prevent the MOASS.