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NOTES

A SECOND LOOK AT CLEARING FIRM LIABILITY*

INTRODUCTION

Within the securities industry, the notion of clearing firm¹ liability is an anathema.² Nevertheless, “[t]he role of [a] clearing broker [] is about to change[!]”³ In March 1998,

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¹ Serving a vital role within the securities industry, clearing firms provide necessary services and capital typically needed by small brokerage houses to complete a securities transaction. “Clearing” involves delivering securities to the purchasing broker-dealer and making money payments to the seller broker-dealer. Clearing services include: maintaining the books and records of customer accounts, sending confirmations and monthly statements to customers, and clearing and executing trades. NORMAN S. POSER, *BROKER-DEALER LAW & REGULATION* § 2.04[B] (3d ed. 2000); see *infra* Part II discussing the role and responsibilities of clearing firms.

² Some commentators have suggested that claims against clearing firms typically arise as a result of unsuccessful claims against introducing firms. Usually, suits against introducing firms are unsuccessful because the introducing firm is insolvent or investor funds have already been absconded, thereby affording no adequate remedy for the investor. In those circumstances where the introducing firm cannot provide an adequate remedy, the clearing firm is an investor’s only avenue for vindicating his or her claims. Ultimately, the financial burden will fall on either the investor or clearing firm. As a practical matter, the introducing firm is often out of the picture. See Comment, *The “Know Your Customer” Rule of the NYSE: Liability of Broker-Dealers Under the UCC and Federal Securities Laws*, 2 DUKE L.J. 489, 493-94 (1973) [hereinafter “*Know Your Customer*”]. Thus, “[b]ecause clearing firms are relatively well capitalized, they become ‘deep [] pocket’ litigation targets.” Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 BUS. LAW. 841 (1993).

³ Philip M. Adikoff et al., *Clearing Firm Liability: A Forward Looking Analysis*, 1062 PRACTISING LAW INSTITUTE: CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES [hereinafter PLI/CORP.] 113, 136 (1998) (“the trend is clear; turning a blind eye to securities violations will not be tolerated”). Cf. Michael G. Shannon, *Clearing Firm Liability—Has the Dam Really Cracked?*, 1196 PLI/CORP 677, 681 (2000).

former Chairman of the Securities and Exchange Commission ("SEC") Arthur Levitt forewarned that future SEC proposals may require clearing firms to oversee the activities of the introducing firm with whom they contract and even terminate those relationships where the introducing firm is engaging in fraudulent practices.⁴ Then, in 1999, the New York Stock Exchange ("NYSE") and National Association of Securities Dealers ("NASD") amended their rules requiring clearing firms to more closely monitor the acts of introducing firms with whom they contract. As a result, clearing firms may no longer maintain "complete immunity from liability"⁵ for investor losses.

Until recently, the regulation of clearing firms by the SEC, NYSE, NASD, and other regulatory agencies has been sparse. Such agencies have been reluctant to enact stricter regulations (which may impose liability when not properly carried out) because of the vital financial and administrative roles that clearing firms serve within the securities industry. The combination of a pro-business regulatory environment and the strong bargaining power of the clearing firm explains the reluctance of regulatory agencies to assign liability.⁶ Part I of this Note defines the clearing function and discusses the important role that clearing firms play within the securities industry.

When it comes to settling disputes between customers and their introducing broker-dealers, clearing firms have traditionally asserted an independent status. In fact, clearing firms such as Bear Stearns Securities Corp. ("Bear Stearns") have emphatically claimed "complete immunity" from any responsibility to entertain or investigate complaints, or to settle disputes involving the alleged fraudulent practices of an

⁴ Paul Beckett, *Levitt Wants SEC & Justice Agency to Work Together Against Bad Brokers*, WALL ST. J., Mar. 27, 1998, at A3.

⁵ POSER, *supra* note 1, at § 2.04[B].

⁶ Clearing services are performed by small number of firms. In 1993, there existed a ratio of approximately one clearing firm for every five introducing firms. See Audikoff et al., *supra* note 3, at 117; Gerald B. Kline & Raymond L. Moss, *Liability of Clearing Firms: Traditional and Developing Perspectives*, 1062 PLI/CORP. 139, 144 (1998) ("Recent industry statistics reflect that approximately one hundred twenty NYSE clearing firms serve the needs of more than four thousand introducing brokers."); Minnerop, *supra* note 2.

introducing firm.⁷ This claim of immunity stems primarily from the contractual allocation of responsibilities and corresponding liabilities within the clearing/carrying agreement⁸ and the lack of a fiduciary relationship between the clearing firms and the customer/investor. Part II of this Note outlines the legal frameworks for establishing clearing firm liability and reviews the traditional view of clearing firm liability for claims arising under Section 10(b) of the Securities Exchange Act of 1934.⁹

A recent shift in the attitude of the courts and self-regulatory organizations ("SROs") such as the NYSE and the NASD indicate that clearing firms do retain some responsibilities when performing clearing¹⁰ functions for the introducing firm and the customer/investor. In July of 1999, the SEC approved amendments to NYSE Rule 382 and NASD Rule 3230 which govern carrying agreements.¹¹ The purpose of these amendments is to allocate certain regulatory responsibilities between the clearing firm and the introducing firm. Although limited, these new regulatory responsibilities may evolve into new claims and theories of liability against a clearing firm.¹² New rules may give the courts the statutory flexibility needed to establish liability for a clearing firm's involvement in fraud originating at the introducing firm. Nevertheless, the extent of involvement required to establish liability remains unclear. Part II-D of this Note discusses the role self-regulatory organizations play in establishing liability

⁷ Introducing firms, typically small brokerages which lack sufficient capital, technology, and personnel to self clear, enter into relationships with clearing firms to outsource clearing services. See *infra* Part II for description of clearing services.

⁸ A carrying or clearing agreement is a contract between a clearing firm and introducing firm. Within the carrying agreement, the clearing firm agrees to perform certain enumerated services on behalf of the introducing firm and the investor. See discussion *infra* Part II.

⁹ Pub L. No. 107-48, 48 Stat. 881 (codified in 15 U.S.C. §§ 78 *et seq.*) [hereinafter Securities Exchange Act].

¹⁰ See *supra* note 1 and discussion *infra* Part II.

¹¹ See Self-Regulatory Organizations; New York Stock Exchange, Inc., Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change to Amend its Rule 382 Relating to Carrying Agreements, Exchange Act Release No. 41,469, 64 Fed. Reg. 31,338 (June 10, 1999) [hereinafter NYSE 1999 Amendments].

¹² See Kline & Moss, *supra* note 6, at 156.

and explains recent amendments to SRO rules governing the clearing relationship.

In the wake of the August 1999 settlement between Bear Stearns and the SEC, the responsibility and corresponding liability of clearing firms are being questioned anew.¹³ The settlement was precipitated by New York County District Attorney Morgenthau's successful prosecution of the introducing firm A.R. Baron & Co. ("Baron") and thirteen of its employees for securities fraud involving over \$75 million of investor funds.¹⁴ The SEC stated in a press release that Bear Stearns caused and aided and abetted securities fraud violations as well as violated Commission rules governing the clearing process.¹⁵ Part III of this Note discusses the August 1999 settlement between the SEC and Bear Stearns.

With the emergence of renewed interest in clearing firm liability, some commentators have speculated that clearing firms will be held responsible for "policing trading activities"¹⁶ at the introducing firm, a role they are not willing to or capable of undertaking. As the title of one *New York Times* article asks, "Should a clearing firm be its broker's keeper?"¹⁷ Opponents of increased responsibility on the part of a clearing firm claim that imposing stricter standards will increase a clearing firm's exposure to risk, resulting in an increase in the cost of services or even a clearing firm's decision not to perform clearing services at all.¹⁸ According to this view, a proposal aimed at increasing clearing firm liability may have a negative economic

¹³ Cf. Shannon, *supra* note 3, at 701 (suggesting that the effect of the Bear Stearns settlement on the future success of claims against clearing firms are minimal since there is no adjudicated result and since the facts were extremely unique).

¹⁴ Bear Stearns Securities Corp., Exchange Act Release No. 7,718, 70 SEC DOC. 537 (Aug. 5, 1999) [hereinafter *Bear Stearns Settlement*]; *Bear Stearns Securities Corporation to Pay \$35 Million to Settle SEC Charges that it Caused Fraud at A.R. Baron; Bear Stearns President Harrington Charged with Fraud*, at <http://www.sec.gov/news/press/99-94.txt> (last visited Aug. 27, 1999) [hereinafter *Bear Press Release*].

¹⁵ *Bear Press Release*, *supra* note 13, at 3.

¹⁶ Diana B. Henriques, *New Accusation in Investigation of Bear Stearns*, N.Y. TIMES, June 3, 1997, at D1.

¹⁷ Diana B. Henriques & Peter Truell, *Should a Clearinghouse Be Its Broker's Keeper?; Queries for Bear Stearns After a Firm Fails?*, N.Y. TIMES, Apr. 23, 1997, at D1.

¹⁸ See generally William J. Fitzpatrick & Ronald T. Carman, *An Analysis of the Business and Legal Relationship Between Introducing and Carrying Brokers*, 40 BUS. LAW. 47 (1984); Minnerop, *supra* note 2.

effect on Wall Street. Of course, advocates of stricter regulatory standards claim to hold the public interest in mind—with the ultimate goal of curbing securities fraud and ensuring the integrity of the securities market.

In general, this Note examines whether a clearing firm shall be held liable as a primary violator or an aider or abettor under Section 10b-5 of the Securities Exchange Act of 1934 for violations in connection with its actions pursuant to the clearing agreement. This Note examines questions that are at the heart of the issue of liability, namely: (1) whether a clearing firm has *knowledge* of fraud occurring at the introducing firm; (2) whether the clearing firm *assists or participates* in the fraud, and to what extent; and (3) whether a *fiduciary relationship* exists between the customer and the clearing firm. These limiting factors are the primary bar against investor relief for securities fraud violations.

This Note does not claim that clearing firms should be per se liable for the fraudulent acts of the introducing firms for whom they clear; nor does this Note claim that clearing firms should be per se immune from liability based on legal precedents which are outdated and inappropriate to the present situation. Instead, regulators and the courts must strive to find a middle ground that is equitable and efficient, and that preserves the economic and social community for all parties involved. Certainly, a clearing firm is held liable for causing or directly participating in securities violations with the introducing firm. Liability may also be imposed for certain involvement—including failure to investigate or reverse questionable trades, non-disclosure of fraudulent activity occurring at the introducing firm, and even failure to terminate contractual relations with fraudulent introducing brokers—which perpetuate securities violations originating at the introducing firm. In Part IV this Note proposes new theories of liability, even in the absence of regulatory change, that would hold clearing firms liable for these acts. In this section, the following traditional legal assumptions concerning clearing firm liability are questioned: (1) that “clearing” is an administrative function which is routine and neutral; (2) that the clearing firm’s knowledge of the fraud does not taint the clearing function; and (3) that the clearing firm owes no fiduciary duty to the investor.

I. THE ROLE OF THE CLEARING FIRM

At the center of the securities industry, clearing firms provide the necessary services and capital typically needed by small brokerage houses to complete a securities transaction, most importantly, the clearing function.¹⁹ For regulatory, as well as for technical reasons, clearing is capital intensive and requires significant technology as well as large numbers of personnel. Small brokerage firms, commonly referred to as "introducing firms," typically lack sufficient capital, back office technology and personnel²⁰ to "self-clear."²¹ As a result, they enter into "carrying agreements" with clearing firms to outsource clearing and other services. By contracting with clearing firms, introducing firms save considerable "costs associated with the initiation and maintenance of" these services.²² Even firms that have sufficient capital to self-clear find it more efficient to outsource clearing services.²³

A clearing firm *clears* trades, i.e., completes transactions by delivering securities to the purchasing broker-dealer and by making money payments to the selling broker-dealer.²⁴ Clearing responsibilities include: "receiving or delivering funds from or to the customer; maintaining records that reflect the transaction; and safeguarding the funds in the customer's account."²⁵ A clearing firm is also responsible for maintaining records of all trades made by the customer, including sending confirmations, monthly statements, and dividends to the customer/investor.²⁶ The courts have traditionally characterized these services as administrative, in that the clearing firm performs purely ministerial or "back office" functions.²⁷

¹⁹ See *infra* Part II, discussing the role of clearing firms.

²⁰ Minnerop, *supra* note 2, at 842.

²¹ See *infra* Part II for a brief description of "clearing."

²² Fitzpatrick & Carman, *supra* note 17, at 48.

²³ Minnerop, *supra* note 2, at 843 ("Clearing arrangements are classic examples of divisions of labor.").

²⁴ *Id.*

²⁵ *Id.* at 842.

²⁶ Fitzpatrick & Carman, *supra* note 18; Minnerop, *supra* note 2.

²⁷ See *Flickinger v. Brown & Co.*, 947 F.2d 595 (2d Cir. 1991); *Connolly v. Havens*, 763 F Supp. 6 (S.D.N.Y. 1991); *Dillon v. Militano*, 731 F Supp. 634 (S.D.N.Y. 1990); *Antinoph v. Laverell Reynolds Sec., Inc.*, 703 F Supp. 1185 (E.D. Pa.

Additional clearing services include the extension of credit for the purchase of securities on margin.²⁸ In a typical clearing arrangement, the clearing firm loans money to the introducing firm which is collateralized by securities owned by the introducing firm. If the value of the collateral falls below the minimum required, the clearing firm will issue a margin call—a demand to put additional money into the margin account to meet the minimum margin level.²⁹ In this capacity, the clearing firm acts as *creditor* to both the customer and the introducing firm.³⁰ It does so by committing to pay for customer trades, advancing the funds for those trades when the customer or introducing firm is delinquent, and then financing trades on margin.³¹ In its role as creditor, the clearing firm maintains daily records of the investor's accounts on margin including: the name and amount of shares of each stock held, its current selling price, the total market value, the equity on deposit, and the account's credit balance.³²

In addition to performing clearing functions, on occasion, the clearing firm executes transactions, thereby limiting the role of the introducing broker to simply soliciting investor sales.³³ The clearing firm also provides name recognition for the introducing firm, frequently inflating the image of a small, unknown introducing firm. The name Bear Stearns, for example, lends credibility, stability, business savvy, and expertise to unknown introducing firms.³⁴

1989); *Ross v. Bolton*, 639 F. Supp. 323 (S.D.N.Y. 1986).

²⁸ Minnerop, *supra* note 2.

²⁹ KENNETH M. MORRIS & ALAN M. SIEGAL, *THE WALL STREET JOURNAL GUIDE TO UNDERSTANDING MONEY & INVESTING* (1993).

³⁰ In the Matter of Symbolion Corp., Wells Submission of Bear Sterns Securities Corp., 3 (Oct. 23, 1998) [hereinafter *Wells Submission*] (on file with author).

³¹ *Id.*

³² *Id.*

³³ Minnerop, *supra* note 2.

³⁴ See Gretchen Morgenson, *Sleazy Doings on Wall Street*, FORBES, Feb 24, 1997, at 114. Such association leads many customers to believe that the clearing firm and introducing firm are intimately affiliated. In an effort to reduce this association, many clearing firms are not named by their parent, but are known under a different name.

The carrying agreement is a contract in which the clearing/carrying firm agrees to perform clearing services on behalf of the introducing firm and its clients.³⁵ Generally, the clearing firm agrees to perform certain enumerated services for the introducing firm according to the introducing firm's needs which, in turn, are based on the introducing firm's size and capitalization.³⁶

Within the clearing agreement, the introducing firm accepts "all sales practice and related compliance responsibilities."³⁷ According to the clearing department of Bear Stearns, the acceptance of these responsibilities eliminates any reason for the clearing firm to contact or communicate with the customer.³⁸ The customer agreement mandates that the clearing firm accepts all sales transactions from the introducing firm "*without inquiry or investigation*,"³⁹ and that it "will have *no responsibility* or liability [to the customer] for any acts or omissions of the [introducing firm], its officers, employees or agents."⁴⁰ Thus, when confronted with customer complaints of unauthorized trading by the introducing firm, in addition to refusing to reverse the trade, the clearing firm defers all customer correspondence to the introducing firm.⁴¹ It is the introducing firm's sole responsibility to maintain customer accounts.⁴² The

³⁵ Although the investor is typically not a party to the contract, the carrying agreement is binding on the customer. *Wells Submission*, *supra* note 30, at 7.

³⁶ Minnerop, *supra* note 2, at 843; Fitzpatrick & Carman, *supra* note 18. Two types of carrying agreements exist: fully disclosed agreements and omnibus agreements. As the name suggests, a fully disclosed agreement discloses to the carrying firm the identity of the introducing firm's customers and any relevant account information. In contrast, an omnibus agreement discloses only the name of the introducing firm with whom the carrying firm maintains an account. Notwithstanding the type of agreement, the customer deals solely with the introducing firm. Fitzpatrick & Carman, *supra* note 18.

³⁷ *Wells Submission*, *supra* note 30 (citing to the clearing agreement).

³⁸ *Id.* at 6.

³⁹ *Id.* at 5 (quoting from the customer agreement).

⁴⁰ *Id.*

⁴¹ Note that the 1997 amendments involving the handling of customer complaints speak to this. With NYSE Rule 382 and NASD Rule 3230, clearing firms are required to acknowledge to the customer, to the introducing firm, and to the proper self regulatory organizations, the receipt of all customer complaints.

⁴² Minnerop, *supra* note 2, at 843. By shifting all liability to the introducing firm, the clearing agent eliminates the need for customer contact. See discussion *infra* Part II. As such, it may be unreasonable to propose that clearing firms be held liable for investor losses due to inappropriate investment advice. "Knowing your customer" is

contractual allocation of responsibilities within the carrying agreement has been looked to by the courts to decide liability issues.⁴³

Although primarily a matter of contract between the parties, that allocation of responsibilities is also governed by rules promulgated by self-regulatory organizations.⁴⁴ Specifically, the 1982 amendments—to NYSE Rules 382 and 405 and NASD Rule 3220—allow both parties to agree on their respective functions and responsibilities as long as they are disclosed within the carrying agreement.⁴⁵ Additionally, “[u]nder [amended NYSE] Rule 382, all Rule 405 type responsibilities (e.g. “know your customer” rule) may be allocated exclusively to introducing firms.”⁴⁶

To the advantage of clearing firms, both the clearing and customer agreements have created substantial roadblocks for establishing liability. Additionally, the customer agreement also stipulates that a clearing firm may act on behalf of the

the sole domain of the introducing firm.

⁴³ See *Schwartz v. Bear Stearns & Co.*, 1998 WL 672708 (N.Y. Sup. Ct. Aug. 24, 1998) (The introducing firm may “accept orders [from the introducing firm] ‘without any inquiry or investigation’ and without any ‘responsibility or liability to [plaintiff] for any acts or omissions of [the introducing firm].’” See also POSER, *supra* note 1, at 81.

⁴⁴ As a matter of contract between the parties, the (contractual) allocation of responsibilities may be altered through rules promulgated by the self regulatory organizations. Two attempts at altering the responsibilities were made in 1982 and again in 1997.

⁴⁵ New York Stock Exchange, Inc., Order Approving Proposed Rule Change, Exchange Release No. 18,497, 47 Fed. Reg. 8284 (Feb. 19, 1982) [hereinafter NYSE Amends Rule 382]. NYSE Rule 382: “All clearing and carrying agreements shall specify the respective functions and responsibilities of each part to the agreement and shall, at a minimum, specify the responsibility of each party with respect to each of the following matters.” Except in regard to the handling of customer complaints, specific responsibilities are not relegated to either party under NYSE Rule 382. Under NYSE Rule 382, the clearing agreement must specify the party responsible for the following:

- (1) the opening, approving, and monitoring of accounts; (2) the extension of credit; (3) the maintenance of books and records; (4) the receipt and delivery of funds and securities; (5) the safeguarding of funds and securities; (6) the [sending of customer] confirmations and statements; and (7) the acceptance of orders and transactions.

Id., See also Self-Regulatory Org., Nat’l Assoc. of Securities Dealers, Inc., Order Granting Approval of Proposed Rule Change Concerning the Imposition of Substantive and Procedural Requirements on Members Entering Into Clearing Agreements, Exchange Release No. 33,517, 59 Fed. Reg. 4297 (Jan. 24, 1994) [hereinafter NASD Amends Clearing Rules].

⁴⁶ NYSE 1999 Amendments, *supra* note 11; see also Minnerop, *supra* note 2, at 849.

introducing firm, but safeguards against any liability to the investor.

II. THE TRADITIONAL VIEW OF A CLEARING FIRM'S LIABILITY

Private actors may bring claims for violations under the anti-fraud provisions of the Securities Exchange Act of 1934 (Section 10(b) and Rule 10b-5), state common law claims for fraud and for breach of fiduciary duty, and for violations of the rules of self-regulatory organizations. Traditionally, courts have accepted four possible liability theories: primary, controlling person, aiding and abetting, and contractual liability. But most claims have arisen under liability either as a primary violator or as an aider and abettor. Between these two theories, the courts have been more sympathetic to claims for aiding and abetting in as much as the theory does not require the clearing firm to have *actual control* over the actions of the introducing firm.⁴⁷ However, in the landmark case of *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court precluded private plaintiffs from bringing an action for aiding and abetting a Rule 10b-5 violation.⁴⁸ By restricting aiding and abetting liability claims, the *Central Bank* decision requires private plaintiffs to allege that the clearing firm is a primary violator, a more stringent standard to prove than secondary liability. Nevertheless, all secondary liability has not been eliminated by *Central Bank*.⁴⁹ Aiding and

⁴⁷ Minnerop, *supra* note 2, at 852.

⁴⁸ 511 U.S. 164 (1994). By restricting aiding and abetting liability claims by investors, the effects of the *Central Bank* decision will be increased attempts to expand the scope of primary liability. See *In re Blech Sec. Litig.*, 961 F. Supp. 569, 583 (S.D.N.Y. 1997) [hereinafter *Blech II*]. The courts have approached these attempts with caution. POSER, *supra* note 1, at § 6.02, 6-27; see *Sec. Inv. Prot. Corp. v. Holmes*, 76 F.3d 388 (9th Cir. 1996) (holding that the defendant is neither liable under aiding and abetting nor primary liability). Indeed, the effect of *Central Bank* is that it may be harder to find clearing firms liable.

⁴⁹ See POSER, *supra* note 1, at § 6.02, 6-28; "Know Your Customer," *supra* note 2, at 492; see also § 21(f) of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78t(f) (1995); *SEC v. Fehn*, 97 F.3d 1276, 1282-84 (9th Cir. 1996). See also Richard H. Walker & David M. Levine, *The Limits of Central Bank's Textualist Approach—Attempts to Overdraw the Bank Prove Unsuccessful*, 26 HOFSTRA L. REV. 1 (1997).

abetting claims may still be brought under SEC enforcement actions.

Primary liability under Rule 10b-5 is imposed for misstatements, omissions, and fraudulent schemes in connection with the purchase or sale of securities.⁵⁰ To find a viable primary liability claim, the plaintiff must allege that the clearing firm "intentionally or recklessly misrepresented or failed to disclose a material fact in connection with the purchase or sale of securities."⁵¹ For liability based on an omission, the clearing firm must show that it owed a direct duty to the customer and that this duty was breached.⁵² There is also a scienter requirement; any omission, misrepresentation, or fraudulent scheme must be made with an "actual intent to deceive."⁵³

Secondary liability claims for aiding and abetting require the claimant to allege: (1) a primary violation by someone other than the aider and abettor; (2) substantial knowledge of the violation (scienter); and (3) substantial assistance of the violation by the aider and/or abettor.⁵⁴ Therefore, a clearing firm's knowledgeable assistance or participation in the fraudulent acts of the introducing firm may give rise to aider and abettor liability.⁵⁵ Non-disclosure, however, may not be a basis for secondary liability unless there is an independent duty to disclose on the part of the clearing firm.

The issue of clearing firm liability is a paradox. In order to prove primary liability based on an omission, it must be shown that the clearing firm has a fiduciary relationship to the investor. However, by shifting (in the carrying contract) all authority to the introducing firm, the clearing agent eliminates the need for customer contact.⁵⁶ Then, as a matter of law, absent direct communications between the investor and the clearing firm, no fiduciary relationship is established. And absent a fiduciary relationship, a clearing firm that performs

⁵⁰ Securities Exchange Act § 10b.

⁵¹ *Antinoph*, 703 F. Supp. at 1187.

⁵² *Id.* at 1187-88.

⁵³ *Connolly*, 763 F. Supp. at 11.

⁵⁴ *Id.*

⁵⁵ *Faturik v. Woodmere Sec. Inc.*, 442 F. Supp. 943, 945 (S.D.N.Y. 1977).

⁵⁶ *Wells Submission*, *supra* note 30.

clearing services does not have a duty to investigate or disclose possible fraud at the introducing firm. In order to prove secondary liability, it must be shown that the clearing firm, with knowledge, substantially assisted in securities violations which originated at the introducing firm. However, the mere performance of clearing services does not constitute direct participation or substantial assistance.

The following subsections will explore in detail these possible barriers to liability: (1) the lack of a fiduciary relationship between the investor and the clearing firm;⁵⁷ (2) insufficient knowledge or insight into fraud occurring at the introducing firm by the clearing firm; and (3) the classification of services performed by the clearing firm as routine and administrative. This section will also discuss liability theories under the rules of self-regulatory organizations.

A. *Fiduciary Duties*

The lack of a fiduciary relationship between the clearing firm and the customer has been a boilerplate defense against all primary and most secondary liability claims.⁵⁸ Absent a fiduciary duty to the investor, mere knowledge of the fraud, without actual participation, is not actionable against the clearing firm,⁵⁹ and the clearing firm has no duty to disclose, or even investigate, suspicions of fraud occurring at the introducing firm. Therefore, unless the parties are in a fiduciary relationship, silence is not actionable. A duty to disclose arises only "when there is a fiduciary relationship or some relationship of confidence or trust."⁶⁰

A fiduciary has the "duty to act for the benefit of another."⁶¹ The fiduciary duty serves as an accountability mechanism over persons who are in control of actions that

⁵⁷ See POSER, *supra* note 1.

⁵⁸ *Id.*

⁵⁹ "Mere bystanders, even if aware of the fraud, cannot be held liable for inaction since they do not associate themselves with the venture or participate in it as something they wish to bring about." *Antinoph*, 703 F. Supp. at 1187.

⁶⁰ *Id.*

⁶¹ *Flickinger v. Harold Brown & Co.*, 947 F.2d 595, 599 (2d Cir. 1991) (citing *Mandelblatt v. Devon Stores, Inc.*, 132 A.D.2d 162, 168, 521 N.Y.S.2d 672, 676 (1st Dep't 1987) (quoting RESTATEMENT (SECOND) OF TORTS § 874, cmt. a (1977))).

benefit another.⁶² Moreover, fiduciary duties are pertinent to any liability scheme for omissions or inaction since the law is reluctant to impose liability for non-disclosure without a special duty to act. Underlying the necessity of a fiduciary relationship is the rationale that "[m]ere bystanders, even if aware of the fraud, cannot be held liable for inaction since they do not associate themselves with the venture or participate in it as something they wish to bring about."⁶³

Fiduciary duties arise from agency relationships.⁶⁴ "Agency is a legal relation created by contract, whereby one party, called the agent, is authorized to represent the other party, called the principal, in business dealings with third persons, and is usually empowered to bring the principal into contractual relations with such persons."⁶⁵ Essential to an agency relationship is the element of *control*; "there can be no agency relationship where the alleged principal holds no right of control over the [alleged] agent."⁶⁶ An agency relationship may result from the "manifestation of consent by one person to another that the other shall act on his behalf"⁶⁷ Even if the parties do not intend to create an agency relationship within the contract, it may be implied. However, mere trust and confidence in another may not, in itself, create a fiduciary duty.⁶⁸ The relationship must be consensual; the other party must accept, either implicitly or explicitly, the responsibilities associated with being a fiduciary.

An agency relationship exists between the introducing firm and the clearing firm as well as between the introducing firm and the investor. A clearing firm is an agent of an introducing firm but not vice versa; the introducing firm is not the agent of the clearing firm because the clearing broker acts on behalf of the introducing broker, which has control over the

⁶² J. C. SHEPARD, *THE LAW OF FIDUCIARIES* 97 (1981).

⁶³ *Antinoph*, 703 F. Supp. at 1187. (citing *Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980)).

⁶⁴ Fitzpatrick & Carman, *supra* note 18, at 53. See also RESTATEMENT (SECOND) OF AGENCY (1957) [hereinafter RESTATEMENT].

⁶⁵ *Sternaman v. Metro. Life Ins. Co.*, 170 N.Y. 13, 62 N.E. 763 (1902). See RESTATEMENT, *supra* note 64, at § 1.

⁶⁶ See *Kyung Sup Ahn v. Rooney, Pace, Inc.*, 624 F. Supp. 368, 370 (1985) (construing *Mazart v. State*, 109 Misc.2d 1092, 441 N.Y.S.2d 600 (Ct. Cl. 1981)).

⁶⁷ Fitzpatrick & Carman, *supra* note 18, at 53.

⁶⁸ *Id.* at 63.

actions of the clearing firm.⁶⁹ Under the clearing agreement, the introducing firm consents to and retains all control over the acts that the clearing broker performs on its behalf. In exchange, the clearing firm accepts all orders and instructions from the introducing firm "without inquiry or investigation."⁷⁰

If the introducing firm directs the clearing firm to "buy," the clearing firm buys. If the introducing broker directs the clearing firm to "sell," the clearing firm sells. If the clearing broker clears a purchase, it agrees to pay the counterparty to the transaction no matter what anybody says about the trade.⁷¹

In order for the "[clearing] system to work," states Bear Stearns, clearing firms must blindly accept the orders of the introducing firm.⁷²

Under the standard customer agreement, the introducing firm is the investor's agent.⁷³ As an agent, the introducing firm buys and sells securities for its customers on a commission basis. By virtue of the authorities outlined in the customer agreement, the customer grants the introducing broker ultimate power to act on its behalf, who then grants the clearing broker ultimate power to act on its behalf.⁷⁴

As agents, it is undisputed that introducing brokers owe special fiduciary duties to their customers.⁷⁵ At a minimum, it is the introducing broker who is responsible for providing investors with genuine investment advice and determining the suitability of investments. As a result, the introducing firm has certain disclosure obligations in addition to obligations of due care and loyalty.⁷⁶ These responsibilities remain exclusive to

⁶⁹ See *Katz v. Fin. Clearing Serv. Corp.*, 794 F. Supp. 88 (S.D.N.Y. 1992) (holding that an introducing firm is not an agent of the clearing broker.); *Kyung Sup Ahn*, 624 F. Supp. at 370 (no agency relationship existed because clearing firm held no right of control over introducing broker); *Fitzpatrick & Carman*, *supra* note 18.

⁷⁰ *Wells Submission*, *supra* note 30, at 5.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Antinoph v. Lavarell Reynolds Sec., Inc.*, 703 F. Supp. 1185 (E.D. Pa. 1989).

⁷⁶ According to the majority rule, a cause of action under the federal securities laws is not created unless the fiduciary violation is accompanied by fraud. Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599, 1602 (1999). See also *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 410 F.2d 135, 141-43 (7th Cir. 1969).

the introducing broker and are not deemed to be the responsibility of the clearing firm. That these obligations belong to the introducing firm is reinforced by NYSE Rule 405—the “know your customer” rule - requiring the introducing firm to use due diligence when opening and maintaining all customer accounts.⁷⁷ Absent a familiarization and acquaintance with the customer, the introducing firm has no ability to offer suitable advice.

In contrast, no court has found that the clearing firm is a fiduciary to the investor.⁷⁸ Underlying the courts’ reasoning is the lack of an agency relationship between the clearing firm and the investor. The standard rebuttal heralds that the clearing firm’s performance of routine “bookkeeping functions” does not create any “duty to investors whose contact and relationship was solely with the introducing broker.”⁷⁹ Clearing firms also argue that no trust relation exists with the customer because the clearing firm’s responsibilities are contractually limited to bookkeeping and other administrative duties.⁸⁰ Additionally, the clearing firm is relieved of the suitability obligations under the “know your customer” rule.⁸¹ In sum, the courts have concluded that the clearing firms’ contracted for responsibilities are wholly independent of the investor.

⁷⁷ NYSE Rule 405.

⁷⁸ *Carlson v. Bear Stearns & Co.*, 906 F.2d 315 (7th Cir. 1990) (clearing firm not liable for “aiding” or “participating” in introducing firm’s sale of unregistered securities under Illinois Security Statute); *In re Alder Coleman Clearing Corp.*, 198 B.R. 70 (Bankr. S.D.N.Y. 1996) (clearing broker not agent of introducing broker and owes no fiduciary duty to introducing broker’s customers); *Connolly*, 763 F. Supp. at 10-11 (clearing broker owes no fiduciary duty to client and not liable for aiding or abetting introductory broker’s fraud by providing normal services); *Faturik*, 442 F. Supp. at 946 (clearing broker liable for churning customer account under NYSE “know your customer” rule); *Mars v. Wedbush Morgan Sec., Inc.*, 283 Cal. Rptr. 238 (Cal Ct. App. 1991) (clearing broker owed customer no other duty than that it undertook to perform as clearing broker); *Stuart A. Smith Corp. v. Paine, Webber, Jackson & Curtis, Inc.*, No. 86-95-S (D. Mass. Nov. 12, 1986) (Paine Webber acting as clearing broker had no duty to investigate suitability of transactions directed by investment adviser); *Denson v. Bear Stearns Sec. Corp.*, 682 So. 2d 69 (Ala. 1996) (clearing broker duties are ministerial—not liable for actions of introducing broker or its agents), *Riggs v. Schappel*, 939 F. Supp. 321 (D.N.J. 1996) (clearing broker owes no duty to supervise introducing broker and is not liable under agency or negligence theory).

⁷⁹ *Dillon*, 731 F. Supp. at 639.

⁸⁰ *Wells Submission*, *supra* note 30, at 3.

⁸¹ NYSE Rule 405; *See also Fitzpatrick & Carman*, *supra* note 18; *Minnerop*, *supra* note 2.

B. *Scienter*

A second required element of both primary and secondary liability claims is scienter—knowing or intentional conduct. Absent a fiduciary duty between the clearing firm and the investor, the scienter requirement is heightened; it must be shown that the clearing broker acted with actual knowledge of the fraud or an intent to deceive.⁸² Thus, the claim that the clearing firm *should have known* of the fraud is not sufficient.⁸³ Because of this extremely high standard, many Rule 10b-5 claims are dismissed in their preliminary stages for failure to state a claim. If the clearing firm stands as a fiduciary to the investor, then a recklessness standard is sufficient to constitute scienter.⁸⁴ Recklessness is the “extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.”⁸⁵

The courts have held that a clearing broker, acting solely in its clearing capacity, may not have actual knowledge

⁸² *Connolly*, 763 F Supp. at 10.

⁸³ In *Ernst & Ernst v. Hochfelder*, the Supreme Court changed the law holding that an actual intent to deceive is a required element of a 10b-5 case. 425 U.S. 185, 193 (1976). See *Connolly*, 763 F Supp. at 9 (rejecting the claim that “in the exercise of reasonable diligence,” the clearing broker *should have known* of fraud at the introducing firm); *Stander v. Fin. Clearing & Serv. Corp.*, 730 F Supp. 1282 (S.D.N.Y. 1990) (dismissing aiding and abetting claim against clearing firm for reckless disregard of possible fraudulent activity at the introducing firm). In early liability cases prior to *Ernst & Ernst*, constructive knowledge was held to satisfy the scienter requirement of Rule 10b-5. See *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.); *SEC v. First Sec. Corp.*, 463 F.2d 981 (7th Cir. 1972). In *Buttrey*, it was found that the clearing broker should have known about illegal trading activities at the introducing firm because of his obligations under the “know your customer” rule, Rule 405 of the NYSE. In *First Securities*, the court held that “liability predicated on aiding and abetting may be founded on *less than* actual knowledge” of the illegal activity. 463 F.2d at 987 (emphasis added). Thus, these early cases demonstrate that if the activity of the primary violator is so “egregious or reckless,” knowledge of the violation will be imputed on the clearing broker. “*Know Your Customer*,” *supra* note 2, at 533. Therefore, under earlier case law, the scienter requirement was satisfied when the clearing firm had either actual knowledge of the fraud or was so reckless that knowledge was deemed imputed.

⁸⁴ *Ross v. Bolton*, 639 F Supp. 323, 326 (S.D.N.Y. 1986).

⁸⁵ *Id.* (citing the definition first announced in *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977).

of any illegal activities occurring at the introducing firm.⁸⁶ In other words, "clearing" alone does not provide the clearing firm with the necessary insight to reveal fraud at the introducing firm. Additional factors are necessary in order to prove scienter. For example, when the introducing and clearing firms enjoy a "close working relationship," it may be found that the clearing firm had sufficient knowledge of the underlying fraud to sustain a claim for aiding and abetting.⁸⁷ In the seminal case of *In re Blech Securities*⁸⁸ ("*Blech II*"), the plaintiff established that the clearing firm, Bear Stearns, had actual knowledge of the fraud because of: (1) daily contact with high ranking officers at the introducing firm; (2) an "intimate knowledge" of the securities held by the introducing firm and the "value and liquidity of those securities", (3) "information from daily analysis of key accounts" held by the introducing firm; and (4) past knowledge of sham trading at the introducing firm.⁸⁹ Under these facts, the plaintiffs alleged that Bear Stearns displayed an intent to deceive.

Many investors, albeit unsuccessfully, have claimed that certain clearing activities go beyond administrative and that a clearing firm may detect an "overall pattern" of securities violations through the performance of these activities.⁹⁰ Through its clearing responsibilities, including

⁸⁶ See *Connolly*, 763 F. Supp. at 9 (acting as clearing broker for the introducing firm does not establish that the clearing broker "knew, or in the exercise of reasonable diligence should have known" about illegal activities at the introducing firm) (citing the complaint, p. 164.). See *Stander*, 730 F. Supp. at 1286 (alleging that clearing firm, through its "clearing activities," knew or should have known of fraudulent activity by the introducing firm.).

⁸⁷ *Faturik*, 442 F. Supp. at 945 (holding that clearing firm had sufficient knowledge of underlying fraud where clearing firm had offices in the same building and on the same floor as the introducing firm).

⁸⁸ 961 F. Supp. 569 (S.D.N.Y. 1997).

⁸⁹ *Id.* at 583.

⁹⁰ *Aidikoff et al.*, *supra* note 3, at 132; *Antinoph v. Laverell Sec., Inc.*, 703 F. Supp. 1185 (E.D. Pa. 1989). Microcap stocks are low priced stocks issued by the smallest of companies. See <http://www.sec.gov/consumer/microbro.htm>. Microcap companies are typically thinly capitalized and maintain minimal filing requirements with the SEC. Within the Microcap securities industry, fraud is more prevalent since a small number of brokers control the market and public information is limited. See <http://www.sec.gov/news/extra/microcap.htm>. Fraud within the microcap securities industry usually involves a scheme called "*pump and dump*." Using high pressure sales tactics, customers are solicited to buy certain "preferred" stock in which the brokerage firm makes a market. As the "preferred" stock is promoted or "pumped" and market prices rise, company insiders sell stock realizing substantial profits at the

monitoring margin accounts and executing trades, customers have alleged that a clearing firm may identify "no net sale" policies, market price manipulation, undisclosed mark-ups, and excessive commissions,⁹¹ all of which are violations of the securities laws. Most courts, however, have rejected these claims.

In *Ross v. Bolton*, the plaintiff alleged that the clearing firm, by clearing transactions on margin, aided and abetted a market manipulation promulgated by the introducing firm.⁹² Plaintiff claimed that the clearing firm "cancelled a number of trades in which [the introducing firm] was purchasing securities but continued to execute transactions in which [the introducing firm] was the seller."⁹³ This tactic allegedly reduced the amount of money owed to the clearing firm, while increasing the amount of investor debt. Therefore, by holding a margin account, the plaintiff alleged that "Bear Stearns must have scrutinized the account more closely than it otherwise would have,"⁹⁴ and therefore knew that fraud was occurring at the introducing firm. The court held that when executing trades on margin, the clearing firm did not have actual or constructive knowledge of the fraud when it cleared a large number of transactions in a particular security and the price of that security was steadily rising, or when trades were selectively executed in order to reduce the amount owed.⁹⁵

Many investors have also brought claims alleging that the clearing firm *should have known* that trading done in their accounts was perpetuated by fraud. However, most courts have rejected these theories under the rationale that the customer's broker is the introducing firm and that no fiduciary relation exists between the clearing firm and the investor. In *Stander v.*

expense of public investors. Once large blocks of shares are sold, stock prices usually drop dramatically, leaving investors empty pocketed. As part of the "pump and dump" scheme, brokerage firms employ the following fraudulent business practices: "no net sales" policies, unauthorized trades, churning of accounts, and using "bait and switch" tactics. Under a "no net sale" policy, sales of stock are not permitted unless it is accompanied by a "crossing order—an order from another customer to purchase the same position." *Bear Stearns Settlement*, *supra* note 14.

⁹¹ Aidikoff et al., *supra* note 3, at 132.

⁹² *Ross*, 639 F Supp. at 325.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* at 327.

Financial Clearing & Services Corp. ("FiCS"), petitioners alleged that the clearing firm knew or should have known of fraudulent activity by the introducing firm through its clearing activities.⁹⁶ The court dismissed plaintiff's claim that NYSE Rule 405 imposed a fiduciary duty upon FiCS since the clearing agreement shifts any and all trading responsibilities to the introducing broker.⁹⁷ Indeed, clearing brokers (such as Bear Stearns) claim that due to the sheer volume of trades and their limited contact with customers, a clearing firm is not capable of overseeing the appropriateness of the investments and the trades that they clear. Finally, even if trades are risky or are inappropriate for a specific investor, the clearing firm, within the customer agreement, has full authority to accept trades from the introducing firm, limiting any affirmative duty to question the trades ordered. The *Stander* court held that even if trades made in a customer's account are "risky" or occur despite "unsatisfied margin calls," this is not sufficient to establish that the clearing firm had actual knowledge of fraudulent activity since all trading is done pursuant to a standard option agreement,⁹⁸ clearly authorizing the introducing firm to act as the customer's agent and to trade on the customer's account.⁹⁹ Within that context, all investment decisions are solely between the customer and the introducing firm and all investment advice and supervision of trading rests solely with the introducing firm. Unless FiCS "knew [the trading] authorization to be fraudulent or improper," the clearing broker could not be found to have actual knowledge of fraudulent trading in its customers' accounts.¹⁰⁰

These decisions suggest two things. First, the courts do not distinguish between a clearing firm's responsibilities when clearing trades on margin and those responsibilities required for traditional trading. Or, even if the responsibilities that evolve from each vary, neither meets the high threshold of the

⁹⁶ *Stander*, 730 F. Supp. at 1286.

⁹⁷ *Id.* at 1287.

⁹⁸ Prior to the initiation of any trading on the customer's account, he or she is required to sign a standard option agreement with the introducing firm and a customer agreement with the clearing firm. Both the standard option agreement and the customer agreement establish the legal relationships among the parties involved. *Antinoph*, 703 F. Supp. at 1186.

⁹⁹ *Stander*, 730 F. Supp. at 1286.

¹⁰⁰ *Id.* at 1287.

scienter requirement. In other words, even when executing trades on margin, the clearing firm may not gain greater insight into possible fraud by the introducing firm than when clearing traditional trades. Second, even if fraud is at the heart of the matter, the clearing firm will accept and process all trades ordered by the introducing firm, no matter how risky. Note that this reasoning seems to indicate that a clearing firm may look away (because of the authority granted to the clearing firm in the customer agreement, there is no reason to investigate), but it does not disprove that clearing may not provide insight into fraud at the introducing firm. A clearing firm may have knowledge of the fraud, but, as discussed above, the contractual arrangements among the parties allow the clearing firm to escape liability. And a "clearing broker cannot be held liable simply because it performed its contracted-for services."¹⁰¹ Viewed in a broader context, what appears to be intentional may not be.

C. *Direct Participation and Substantial Assistance*

Under both primary and secondary claims, liability ultimately turns on the clearing firm's involvement in the fraud and the extent of that involvement. Liability will not attach unless the clearing firm participated in the fraud (directly or indirectly), even if it is shown that the clearing firm knew or should have known of fraud occurring at the introducing firm.¹⁰² Under primary liability, it is alleged that the clearing firm participates directly in the fraud by either performing routine clearing services with knowledge of fraud, failing to disclose to the investor fraudulent behavior by the introducing firm, or even failing to prevent the fraud from continuing.¹⁰³ To find liability under aiding and abetting liability, the clearing firm must "substantially participate"¹⁰⁴ in the fraud. Substantial participation is also alleged through the

¹⁰¹ *Id.* at 1288.

¹⁰² *Blech II*, 961 F Supp. at 584.

¹⁰³ *Antinoph*, 703 F Supp. at 1187; *See Minnerop*, *supra* note 2, at 851.

¹⁰⁴ *See Minnerop*, *supra* note 2.

routine performance of clearing services with knowledge of fraud and non-disclosure of material facts.¹⁰⁵

A clear definition of what constitutes participation by the clearing firm does *not* emerge from the case law. Instead, courts have consistently and adamantly concluded what does not constitute participation: under either liability theory, the performance of routine clearing constitutes neither direct participation nor substantial assistance, even in the face of knowledge of fraudulent activity.¹⁰⁶ Thus, the "act of clearing sham trades is not equivalent to causing or directing sham trades."¹⁰⁷ Also, the courts do not distinguish between clearing trades on margin and traditional clearing; both do not constitute direct or substantial participation in the fraud by the clearing firm.¹⁰⁸

Absent a fiduciary relationship, any liability based on an omission will not qualify as direct participation or substantial assistance.¹⁰⁹ Even if the clearing firm has actual or constructive knowledge of the fraud, "awareness and approval, standing alone" will not create liability.¹¹⁰ In other words, mere knowledge of the fraud, absent *actual* participation, is not actionable against a clearing firm who is not in a fiduciary relationship to the investor. A clearing firm may be liable for inaction "only where there is a conscious or reckless violation of an independent duty to act."¹¹¹ Therefore, except in limited circumstances, the clearing firm has no duty

¹⁰⁵ *Id.*

¹⁰⁶ *Connolly*, 763 F. Supp. at 10 (stating that routine performance of clearing services does not constitute substantial assistance).

¹⁰⁷ *Blech II*, 961 F. Supp. at 584.

¹⁰⁸ In *Stander*, the court held that "continuing to execute and record trades in [plaintiffs] account despite [plaintiffs] failure to meet margin calls" does not constitute substantial assistance. 730 F. Supp. at 1287.

¹⁰⁹ *Connolly*, 763 F. Supp. at 11.

¹¹⁰ *Ross*, 639 F. Supp. at 327 (citing *Armstrong v. McAlpin*, 699 F.2d 79, 92 (2d Cir. 1983)).

¹¹¹ *Stander*, 703 F. Supp. at 1287 (citing *IIT v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980)); see *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith*, 410 F.2d 135 (7th Cir. 1969) (failing to use due diligence over customer accounts pursuant to NYSE Rule 405 constituted inactivity for which the clearing firm was held liable as an aider or abettor). *Buttrey*, however, is the minority view. See *infra* note 121. Moreover, the responsibilities under NYSE Rule 405 have been shifted from the clearing firm to the introducing firm.

to disclose or investigate possible fraud at the introducing firm under either primary or secondary liability¹¹²

In *Stander*, the court held that the only duty between the clearing firm and the customer under the clearing agreement was to "report on the activity of the [customer's] account."¹¹³ The complaint alleged that FiCS substantially assisted in the fraud "by continuing to execute and record trades in Stander's account despite Stander's failure to meet margin calls, and despite FiCS' alleged knowledge of Stander's initial conservative investment goals."¹¹⁴ The court held that to the extent the responsibilities of the parties are outlined in the carrying agreement, and the introducing firm was "acting under [the] actual authority" of the investor, and the clearing firm fulfilled its single duty of reporting account activity to the customer, the clearing firm had no duty to disclose or investigate risky trades.¹¹⁵ The *Stander* court stated the following to support its decision not to impose liability:

It would be an unfortunate stretch of liability to hold that a clearing broker, whose only privity-created obligation to an investor is a reporting one, must undertake the obligation of insuring that the investor, who has signed customer agreements outlining the broker's responsibilities, fully understand the reports provided, and that the investor acts on them in the most prudent manner. Such would be taking paternalism to an extreme.¹¹⁶

In the case of *Blech II*,¹¹⁷ a federal district court in the Second Circuit was the first court to decide what acts may expose a clearing firm to liability. The court held that a clearing firm may be held primarily liable only when it "directly and knowingly participate[s]" in the fraud.¹¹⁸

¹¹² *Stander*, 730 F Supp. at 1286-87.

¹¹³ *Id.* at 1287.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ 961 F Supp. 569 (S.D.N.Y. 1997). The initial complaint was denied with leave to amend. *In re Blech Sec. Litig.*, 928 F Supp. 1279 (S.D.N.Y. 1996) [hereinafter *Blech I*]. In *Blech I*, the court granted Bear Stearns' motion to dismiss even though the clearing firm "knew but failed to disclose" information pertaining to fraudulent conduct by the introducing firm because "as a matter of law, a clearing broker owes no duty of disclosure to the clients of an introducing broker." *Id.* at 1295-96.

¹¹⁸ *Blech II*, 961 F Supp. at 582.

Interpreted as the "*Blech* Exception,"¹¹⁹ the court held that allegations of pressure exerted by a clearing firm to reduce the introducing firm's debt balance, coupled with knowledge of "sham trading" (at the introducing firm) and the clearance of those trades, went beyond a clearing firm's routine clearing functions and were sufficient to survive a motion to dismiss.¹²⁰ Thus, even when participating in the sale of securities in its "traditional market role," a clearing firm may be held liable for "initiating," "directing," and "contriving" fraudulent trades.¹²¹ The court stated that this "case illustrates the fact-intensive battle between litigants in clearing firm cases and [ably] demonstrates that clearing firms are not always immune from liability exposure."¹²²

Because aiding and abetting claims under Section 10(b) of the Exchange Act are restricted in private suits, the court's discussion focused on whether the acts of the clearing firm, Bear Stearns, were "more than aiding and abetting" and therefore constituted primary liability.¹²³ Reiterating the prevailing standard, the court stated that even with knowledge of the fraud, "conduct that is no more than the performance of routine clearing functions" cannot constitute primary liability;¹²⁴ therefore, "the act of clearing sham trades is not equivalent to causing or directing sham trades."¹²⁵ Such conduct, stated the court, amounts to "no more than a non-existent claim of aiding and abetting" under *Central Bank*.¹²⁶

Nevertheless, the court held that plaintiffs alleged sufficient facts to establish the requisite elements of scienter and direct participation that are required to state a claim for primary liability against the defendant, Bear Stearns.¹²⁷ Through knowledgeable participation "at both the initiation and clearing stages" of several fraudulent transactions, Bear

¹¹⁹ *Scone Invs. v. Am. Third Mkt. Corp.*, No. 97 CIV 3802, 1998 WL 205338 (S.D.N.Y. Apr. 28, 1998).

¹²⁰ *Blech II*, 961 F. Supp. at 584.

¹²¹ See *Scone Invs.*, 1998 WL 205338, at *8.

¹²² *Kline & Moss*, *supra* note 6, at 145.

¹²³ *Blech II*, 961 F. Supp. at 583.

¹²⁴ *Id.* at 584.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

Stearns was held to be a direct participator in the fraud.¹²⁸ Recognizing a difference between clearing cash and margin trades, the court stated that Bear Stearns had the power to "deny or extend margin credit" to the introducing broker, and thereby used its power to influence fraudulent activity ¹²⁹ "[B]y demanding that Blech reduce its debit balance with knowledge of Blech's history of sham trading," Bear Stearns directed certain fraudulent transactions by Blech.¹³⁰

This course of conduct by Bear Stearns—the instigation of trading that Bear Stearns knew or should have known would result in fraudulent trades that would artificially inflate the price of Blech securities, and the subsequent clearing of the resultant fraudulent trades for its own pecuniary benefit—constitutes an attempt to affect the price of Blech securities. The pressure exerted by Bear Stearns on Blech to reduce his debit balance, when combined with Bear Stearns' knowledge of Blech's sham trading and its clearing of such trades, does not reflect the standard practice of [a] clearing broker.¹³¹

The court concluded the "complaint crosse[d] the line dividing secondary liability from primary liability when it claim[ed] that Bear Stearns 'directed' or 'contrived' certain allegedly fraudulent trades."¹³²

Presumably altering previous case law, the court distinguished the conduct of a normal clearing broker extending loans on margin with the conduct of a broker who, with knowledge of past sham trading, extends loans on margin.¹³³ Therefore, the court implies that clearing trades on margin, with knowledge of past sham trading at the introducing firm, will alter the characterization of the clearing function—causing it to become no longer routine.¹³⁴ As a financial lender, the clearing broker has a vested interest in the financial stability of the introducing firm, and in order to

¹²⁸ *Blech II*, 961 F Supp. at 585.

¹²⁹ *Id.* at 583.

¹³⁰ *Id.* at 584.

¹³¹ *Id.* at 584-85.

¹³² *Id.* at 584.

¹³³ *Blech II*, 961 F Supp. at 585 ("These allegations stand on grounds different from those presented in *Ross v. Bolton* [where] plaintiff's only alleg[ed] the conduct of a normal clearing broker that extends loans on margin to its clients.").

¹³⁴ *Id.* at 585.

decrease its own risk, Bear Stearns was motivated to maintain the price of Blech securities because those securities were collateral for margin loans extended to Blech.¹³⁵ It is this pressure exerted by the clearing firm, their instigation of trades, and their knowledge of sham trading which distinguishes fraudulent conduct from the normal functions of a clearing broker extending loans on margin.

In subsequent cases, *Blech II* has been interpreted narrowly. In *Scone Investments v. American Third Market Corp.*, plaintiff, Scone Investments, alleged that the defendant, Standard Bank Investment Corp. (Jersey) Ltd. ("Standard Bank" or "Bank"), directed a market manipulation scheme aimed at artificially inflating the price of securities.¹³⁶ Similar to the complaint in *Blech II*, the plaintiff alleged that Standard Bank directed the liquidation of certain securities in order to reduce the defendant's credit line and corresponding risk of default. Despite these similar allegations, the court failed to find Standard Bank primarily liable. Although it was alleged that Standard Bank directed the sale of securities, it was not alleged that the "sale be effectuated by way of fraudulent misrepresentation."¹³⁷ The court found that "[t]he Bank's liquidation demand is a far cry from the 'intimate' 'hands-on involvement' and participation in 'key decisions' about the details of the sale which would render it a primary violator."¹³⁸ The court held that Standard Bank's initial financing of the purchase of the securities at issue and the subsequent release of those securities from inventory for trading was indirect and "amount[ed] to nothing more than the routine functioning of a lending institution."¹³⁹ Although Standard Bank may have initiated the sale of securities by demanding that defendants reduce its credit line, the court held that it did not *directly* participate in the execution of the fraudulent transaction, and thus cannot be held primarily liable.¹⁴⁰ Standard Bank's

¹³⁵ *Id.* at 583.

¹³⁶ *Scone Invs.*, 1998 WL 205338, at *1.

¹³⁷ *Id.* at *8.

¹³⁸ *Id.* (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1460-61 (2d Cir. 1996)).

¹³⁹ *Id.* See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

¹⁴⁰ *Scone Invs.*, 1998 WL 205338, at *9.

alleged participation may be characterized as *indirect* and liability for such acts would constitute aiding and abetting liability, a claim which no longer exists for private plaintiffs after *Central Bank*.

In *Goldberger v. Bear Stearns & Co.*, a class action suit, the plaintiff class alleged that the clearing firm knowingly participated in the manipulation of the price of stocks.¹⁴¹ Distinguishing the allegations sustained in *Blech II*, the court dismissed the claims since there were no allegations that the clearing firm

instigated trading that it "knew or should have known would result in fraudulent trades that would artificially inflate the price" of manipulated securities. Nor are there allegations that Bear Stearns "asserted control over trading operations by placing Bear Stearns' employees at offices to observe trading activities, approving or declining to execute trades, imposing restrictions on inventory, and loaning funds."¹⁴²

Therefore, absent a clearing firm's knowledge that the securities involved were being manipulated and direct control over those securities, the "*Blech* exception" will not apply

D *Violations of the Rules of Self-Regulatory Organizations*

Through their rule making responsibilities, self-regulatory organizations play a fundamental role in the development of the law governing the clearing relationship. Most importantly, SRO rules dictate the terms of the carrying agreement between the introducing firm and clearing firm. A clearing firm could have supervisory responsibilities over the introducing firm if such terms were mandated by a SRO rule and inserted in the clearing arrangement. If the clearing firm did not fulfill those supervisory responsibilities in limited circumstances, a violation of a SRO rule could create a cause of action under the federal securities laws. Currently, there is a

¹⁴¹ *Goldberger v. Bear Stearns & Co.*, No. 98 CIV 8677, 2000 WL 1886605 (S.D.N.Y. Dec. 28, 2000).

¹⁴² *Id.* at *5.

split among the federal courts as to whether a violation of a SRO rule creates a federal cause of action.¹⁴³

In 1969, representing the minority view, *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith* was the first case to find a private federal cause of action for the violation of NYSE Rule 405—the “know your customer” rule¹⁴⁴—requiring “every member firm [to] [u]se due diligence to learn the essential facts relative to every customer, order, cash or margin account”¹⁴⁵ Defendants, who were acting in a manner typically

¹⁴³ Compare *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151, 156 (S.D. Tex. 1989) (holding that a private cause of action exists for violations of NYSE rule 405); *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977) (holding that a private cause of action exists for violations of the “know your customer” rule), *aff’d in part, remanded on other grounds*, 579 F.2d 38 (2d Cir. 1978); and *Faturik*, 442 F. Supp. at 946 (holding that a NYSE Rule 405 violation can create a private claim for relief in some circumstances); *with VeriFone Secs. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993) (holding that a private cause of action does not exist for a violation of the NYSE rule); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990) (holding that NYSE Rule 405 does not imply a private federal cause of action); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981) (holding that NYSE Rule 405 does not imply a private federal cause of action); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 680 (9th Cir. 1980) (holding that NYSE Rule 405 does not imply a private federal cause of action); *Birotte v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 468 F. Supp. 1172, 1180 (D.N.J. 1979) (holding that NYSE Rule 405 does not imply a private federal cause of action); and *Piper, Jaffray & Hopwood, Inc. v. Ladin*, 399 F. Supp. 292, 297 (S.D. Iowa 1975) (holding that NYSE Rule 405 does not imply a private federal cause of action).

¹⁴⁴ “Know Your Customer,” *supra* note 2, at 493; NYSE Rules 405 and 382 were amended in 1982 to allow clearing firms to shift the burden of the “know your customer” rule to the introducing broker. As a result of these amendments, clearing firms maintain that they are no longer liable for the failure to investigate or inquire into the acts of the introducing firm which may be fraudulent. *Ardikoff et al.*, *supra* note 3, at 122.

¹⁴⁵ New York Stock Exchange Rule 405 provides the following:

Every member organization is required through a general partner or an officer who is a holder of voting stock to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization. (2) Supervise diligently all accounts handled by registered representatives of the organization. (3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as

assigned to clearing brokers, and who knew or should have known that the brokers for whom they were executing trades were converting their customer's property, were held to have shown a "callous disregard" for the "know your customer" rule.¹⁴⁶ In determining whether to permit a suit for the violation of an Exchange rule, the court considered the "nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation."¹⁴⁷ The court held that violation of Rule 405 was actionable since the rule is integral to the SEC's regulation of Exchanges and was designed for the protection of investors.¹⁴⁸

Although *Buttrey* did not hold that a violation of Rule 405 was per se actionable, subsequent violations of the "know your customer" rule were "recognized judicially only in factual situations where a broker's failure to investigate a customer [was] tantamount to actual fraud or reckless indifference."¹⁴⁹ A second action for violation of NYSE Rule 405 was sustained in 1977 in *Faturik v. Woodmere*.¹⁵⁰ The court held that defendant Bear Stearns had a duty to inquire into their customers' situation under Rule 405 since the complaint alleged "irregularities or suspicious circumstances putting Bear Stearns on notice" of possible fraudulent activity.¹⁵¹ However, absent "irregularity or suspicious circumstances," the court held that a clearing broker had "no duty to look beyond its primary customer"¹⁵²

to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

Id.

¹⁴⁶ *Buttrey*, 410 F.2d at 141. See also *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 122-24 (W.D. Ark. 1949).

¹⁴⁷ *Buttrey*, 410 F.2d at 142 (citing *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir. 1966)).

¹⁴⁸ *Id.*

¹⁴⁹ "Know Your Customer," *supra* note 2, at 493.

¹⁵⁰ 442 F. Supp. 943 (S.D.N.Y. 1977).

¹⁵¹ *Id.*

¹⁵² *Id.* at 946.

Since the 1970s, the rules governing the clearing relationship have undergone two revisions. First, in 1982, the clearing industry lobbied for reform of regulatory rules governing carrying agreements and the NYSE amended Rules 382 and 405, both governing carrying agreements.¹⁵³ The 1982 amendments allow the clearing firm to shift any and all liability to the introducing firm and to "shift the burden of the 'know your customer rule' to their introducing counterpart."¹⁵⁴ The SEC noted that the proposed amendments are aimed to "clarify the relationship and responsibilities" between the clearing and introducing firms "while also recognizing the nature of the contractual relationship" between the parties.¹⁵⁵ Following the 1982 amendments, courts have used the contractual agreement as a shield against liability.¹⁵⁶

Since then, however, as the number of introducing firms have steadily increased, the resources needed to monitor and regulate those firms have "stretched thin."¹⁵⁷ Recent amendments have been aimed at improving the monitoring efforts at both introducing and clearing firms. These amendments were part of a reaction to a rise in questionable, and potentially fraudulent, activity on the part of introducing firms.¹⁵⁸

In 1999, the SEC approved amendments to NYSE Rule 382 and NASD Rule 3230.¹⁵⁹ The amendments address the handling of customer complaints,¹⁶⁰ specific procedures for issuing "exception-type reports,"¹⁶¹ and procedures involving an introducing firm's ability to issue negotiable documents (e.g.,

¹⁵³ The SEC approved amendments to NYSE Rules 382 and 405 on February 19, 1982. 47 Fed. Reg. at 18,497.

¹⁵⁴ Aidikoff et al., *supra* note 3, at 122.

¹⁵⁵ 59 Fed. Reg. 33,517.

¹⁵⁶ See *Stander v. Fin. Clearing & Serv.*, 730 F. Supp. 1282 (S.D.N.Y. 1990).

¹⁵⁷ See *Minnerop* *supra* note 2, at 850.

¹⁵⁸ See Self-Regulatory Org.; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the Nat'l Assoc. of Securities Dealers, Inc. to Amend its Rule 3230 Relating to Clearing Agreements, Exchange Release No. 39,349, 62 Fed. Reg. 63,589, 63,590 (Dec. 1, 1997) [hereinafter NASD Rule Amendments].

¹⁵⁹ NASD Rule Amendments, *supra* note 157; See also NYSE 1999 Amendments, *supra* note 11. The NYSE and NASD amendments mirror one another.

¹⁶⁰ NYSE Rule 382(d); NASD Rule 3230(b).

¹⁶¹ NYSE Rule 382(e); NASD Rule 3230(c). Exception reports help introducing firms maintain supervisory responsibilities. See NASD Rule Amendments, *supra* note 157, at 63,591.

checks) on their clearing firm's account.¹⁶² These amendments are intended to "enhance [an] introducing organization's ability to supervise activities relating to customer accounts" and to "enhance the ability of the Exchange and other securities self-regulatory organizations to monitor the activities of introducing organizations and their compliance with applicable regulatory requirements."¹⁶³

The change most relevant to liability issues involves an increase in monitoring and reporting of customer complaints.¹⁶⁴ NYSE Rule 382(d) and NASD Rule 3230(b) require the carrying firm to promptly furnish any *written* customer complaint to the introducing firm and to the introducing firm's Designated Examining Authority ("DEA").¹⁶⁵ Once complaints are collected, it is the DEA who processes the information and provides the introducing firm with information about a particular complaint or group of complaints.¹⁶⁶ Presumably, a clearing firm could be held liable for the failure to comply with this independent duty to act.

After a customer complaint is received, the amended rules require the clearing firm to provide acknowledgment to the customer of its receipt and to inform the customer that the complaint has been forwarded to the proper regulatory organization in addition to the introducing firm.¹⁶⁷ Written confirmation of the receipt of complaints serves to alert the customer that the clearing firm, introducing broker, and proper regulatory agency have all received and have been made aware

¹⁶² NYSE Rule 382(f); NASD Rule 3230(d).

¹⁶³ Information Memo Number 99-33, Salvatore Pallante, NYSE Senior Vice President, to all NYSE Members and Member Organizations, July 1, 1999, *available at* <http://www.nyse.com/content/memos/NT000392D6.html>. (last visited Feb. 12, 2002) [hereinafter NYSE Memo].

¹⁶⁴ *Id.* at 2.

¹⁶⁵ NYSE 1999 Amendments, *supra* note 11.

¹⁶⁶ See NASD Rule Amendments, *supra* note 157, at 63,591.

¹⁶⁷ Amendment to Rule 382(d). This amendment was in response to trends showing introducing firms' disregard for NASD Rule 3070, which requires introducing members to report to the NASD "any written customer complaints against it involving allegations of theft or misappropriation of funds or securities or of forgery." Recognizing the reality of most situations involving fraud, the NASD admits that it does not receive reports in a "timely manner" and is only aware of the customer complaint "long after the fact." See NASD Rule Amendments, *supra* note 157, at 63,590.

of the complaint.¹⁶⁸ Additionally, the early collection of complaints by a regulatory body may enhance an organization's regulatory potential for quick action by providing more information about possible fraudulent behavior, at an earlier time.¹⁶⁹ For example, large numbers of complaints regarding one introducing firm may be indicative of a problem requiring prompt regulatory action.¹⁷⁰

The amendments also require the clearing firm to provide the introducing firm with a comprehensive list of all exception-type reports offered as part of its clearing services¹⁷¹ and to retain and preserve copies of reports requested by the introducing organization.¹⁷² In a release, the SEC noted that exception reports allow for early detection of problems or suspicious activity within a firm's trading practices because exception reports may be used to reveal "unusual account activity or possible unauthorized trades."¹⁷³ The underlying premise of the rule is that the issuance of exception reports helps the introducing firm maintain its supervisory responsibilities.¹⁷⁴

Under the amended rules, the clearing firm must approve an introducing firm's "supervisory procedures" regarding the issuance of negotiable instruments.¹⁷⁵ Although the rule does not mandate what types of approval procedures the clearing firm should assume, it *implies* that some kind of contact with the customer may be necessary. In the NYSE's view the best supervisory practice would require all checks or wires to be accompanied by a notarized letter from the customer authorizing the money transfer.¹⁷⁶ The SEC believes that these new provisions will require the clearing firm to "reexamine its relationship with the introducing firm" if the introducing firm does not have adequate safeguards in place.¹⁷⁷

¹⁶⁸ *Id.* at 63,591.

¹⁶⁹ *Id.* at 63,590.

¹⁷⁰ *Id.*

¹⁷¹ NYSE Rule 382(e); NASD Rule 3230(c).

¹⁷² NYSE Rule 382(e)(i).

¹⁷³ NYSE 1999 Amendments, *supra* note 11, at 5.

¹⁷⁴ NASD Rule Amendments, *supra* note 157, at 63,591.

¹⁷⁵ NYSE Rule 382(f); NASD Rule 3230(d).

¹⁷⁶ NYSE Memo, *supra* note 163 (emphasis added).

¹⁷⁷ NYSE 1999 Amendments, *supra* note 11, at 5.

III. THE BEAR STEARNS SETTLEMENT

On August 5, 1999, the SEC settled with Bear Stearns in connection with the company's clearing relationship with the now defunct introducing firm A.R. Baron & Co. ("Baron"). The SEC found that Bear Stearns directly caused a fraud on Baron's customers and aided and abetted violations of the Commission's net capital rules, the rules governing the treatment of subscribers' funds in contingency offerings, and the rules governing credit extensions and record keeping.¹⁷⁸ According to the SEC, Bear Stearns' "conduct extended well beyond these routine clearing functions, and included approving and disapproving trades, providing working capital, and at times, preventing Baron from rescinding certain unauthorized trades."¹⁷⁹ Bear Stearns agreed to pay \$5 million in civil penalties as well as fund customer claims up to \$30 million.¹⁸⁰ This case marks the first time the Commission has found a clearing firm liable for fraud involving its introducing counterpart¹⁸¹ and shows that clearing firms are no longer absolutely immune from liability.

Until Baron's collapse, Bear Stearns continued to clear trades for Baron, knowing that Baron was engaged in securities violation, and offering significant assistance, that sometimes even causes those violations. From its inception, the value of Baron's house stock began to decline rapidly, which immediately caused the value of Baron's inventory account with Bear Stearns to decline—threatening its ability to meet industry wide net capital requirements, as well as Bear Stearn's own individual requirements for Baron.¹⁸² In order to maintain the price of its house stocks, Baron engaged in high

¹⁷⁸ *Bear Stearns Settlement*, *supra* note 14. Bear Stearns neither admitted nor denied the findings of the order but consented to them solely for the purposes of the SEC proceedings. *Id.* The settlement was precipitated by New York County District Attorney Morgenthau's successful prosecution of the introducing firm. *Bear Press Release*, *supra* note 14.

¹⁷⁹ *Bear Stearns Settlement*, *supra* note 14, at 8.

¹⁸⁰ *Id.*

¹⁸¹ *Antifraud: Bear Stearns to Pay Another \$3.5 Million to Reimburse Cheated A.R. Baron Customers*, SECURITIES LAW DAILY (BNA) (Oct. 21, 1999).

¹⁸² Adler Coleman, Baron's prior clearing agent, began selling significant shares of Baron's house stock, exerting downward pressure on the price of these thinly traded stocks. *Id.*

pressure sales; readily recognizable were

classic indications of unauthorized trading [such as] a high incidence of failures to pay for trades, excessive trade cancellations, corrections and credit extensions, numerous customer complaints against Baron and a pattern of stock being sold to customers from Baron's inventory and then purchased back into the inventory by Baron close to the settlement at a loss.¹⁸³

As a result of these tactics, certain customers refused to pay for unauthorized trades. Not surprisingly, additional Bear Stearns staff was needed in order to handle the influx of customer complaints. Also, not surprisingly, Bear Stearns continued to defer all customer complaints back to Baron.

Beginning in September 1995, Bear Stearns initiated several supervisory procedures to ensure the protection of its credit position. Bear Stearns employees were assigned to closely monitor Baron's daily trading activities, including keeping a detailed log of trading patterns and determining whether Baron complied with Bear Stearns's equity requirements.¹⁸⁴ All inside trades were to be *individually* approved by Bear Stearns representatives who were present on Baron's premises. Approval was conditioned on "whether the trade increased Bear Stearns's credit exposure by making Baron a net buyer of its house stocks on that day"¹⁸⁵ If the trade was approved, Bear Stearns still required that Baron gain customer telephone verification through the use of a script provided by Bear Stearns, with Bear Stearns employees monitoring the conversation.¹⁸⁶

Although anticipated, Bear Stearns never officially terminated its relationship with Baron. In October 1995, Bear Stearns informed Baron that it planned to terminate their clearing relationship "because the relationship had become too expensive and risky for Bear Stearns."¹⁸⁷ Nevertheless, plans to terminate fell through with Bear Stearns agreeing to loan Baron additional funds in order to comply with NASD net

¹⁸³ *Bear Stearns Settlement*, *supra* note 14, at 9.

¹⁸⁴ *Bear Stearns Settlement*, *supra* note 14, at 9.

¹⁸⁵ *Bear Stearns Settlement*, *supra* note 14, at 14.

¹⁸⁶ *Bear Stearns Settlement*, *supra* note 14, at 14.

¹⁸⁷ *Bear Stearns Settlement*, *supra* note 14, at 14.

capital requirements.¹⁸⁸ Again in December 1995, Bear Stearns notified Baron of its plan to terminate their clearing relationship only to revoke its threat of termination on March 16, 1996. On May 29, 1996, the SEC issued a temporary cease and desist order against Baron. Yet, on June 14, 1996, Bear Stearns again loaned Baron \$1.5 million in funds in order to meet NASD net capital requirements. On July 3, 1996, in an effort to evade SEC orders, Baron filed for bankruptcy. Finally on August 5, 1999, the SEC settled with Bear Stearns, collecting \$5 million in civil penalties and \$30 million to fund customer complaints.

The impact of the settlement on the future success of claims against clearing firms is debatable. One commentator has suggested that since the case was a SEC settlement, with no adjudicated result, it holds little, if any precedential value.¹⁸⁹ In addition, the facts represent an atypical case in which a high ranking executive at the clearing firm personally benefitted and was intimately involved in the fraud.¹⁹⁰

It is not a case centered on a theme that the clearing firm turned a blind eye to the known misconduct of one of its correspondents. Nor is it a case where the clearing firm, as a corporate entity, "knew or should have known" of the correspondents' misdeeds simply through the firm's computer data and records.¹⁹¹

However, these shortcomings may not prove dispositive. It is high level executives who, acting on behalf of the corporate entity, customarily expose the corporation to criminal and civil liabilities. Moreover, the well publicized settlement sparked renewed interest in the case for finding clearing firms liable for investor losses, and, most importantly, spurred regulatory attention to the issue of clearing firm liability

IV THEORIES OF LIABILITY

Over the past three decades, the courts and self-regulatory organizations have struggled with the issue of

¹⁸⁸ *Bear Stearns Settlement*, *supra* note 14, at 15.

¹⁸⁹ Shannon, *supra* note 3, at 702.

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

clearing firm liability, leaning toward liability in the early 1970s and away from that position beginning in 1982. As they have done in the past, self-regulatory organizations may change the rules governing the clearing arrangement, making it easier or harder for the clearing firm to escape liability.¹⁹² Note, here there is an opportunity for change; as a matter of contract between the parties, the (contractual) allocation of responsibilities may be altered through rules promulgated by the self-regulatory organizations.¹⁹³ The 1999 amendments were an attempt, although meager, to reassess and reformulate existing liabilities. The interpretation of these amendments by the courts and their affect on reducing securities fraud is yet to be seen.

Nevertheless, as the presence of clearing firms within the market strengthens, their lobbying efforts to curb any expansion of the law will continue. As illustrated by the 1982 amendments to NYSE Rule 405, self-regulatory organizations are "reluctant to promulgate rules for the protection of investors if there will be a presumption of civil liability in the event of their breach."¹⁹⁴ Therefore, it is unlikely that self-regulatory organizations will impose affirmative responsibilities on clearing firms within the carrying agreement absent external pressures. Future efforts to influence the imposition of clearing firm liability may include pressure from the SEC on self-regulatory organizations, such as the NYSE and NASD, to amend their own rules governing carrying agreements. Those organizations may also have their own incentives to adopt stricter regulations which may contribute to and improve the organizations' overall institutional integrity. In addition, the SEC may promulgate its own rules. Finally, it is also up to the courts to reformulate and restructure their thinking about the basic tenets of the clearing process and the relationship that exists among the introducing firm, clearing firm, and customer. As long as the courts refuse to recognize any legal relationship between the clearing firm and investor, the clearing firm will always escape

¹⁹² The SEC can require self-regulatory organizations to adopt such rules. See Securities and Exchange Act, §19(c).

¹⁹³ See POSER, *supra* note 1, at 81.

¹⁹⁴ "Know Your Customer," *supra* note 2, at 561.

liability under the premise that there exists no fiduciary duty between the two parties.

A. *Establishing a Fiduciary Relationship Under Agency Law*

The fiduciary duty is fundamental when it comes to protecting investors; it should be regulated, not contracted away. The fiduciary duty is necessary to ensure the accountability of those who are in control. The need for establishing fiduciary duties among business partners is magnified, especially in clearing situations, where one party, the investor, has no real bargaining power over the terms of the contract.

Nevertheless, in the clearing context, the implications of finding a fiduciary duty should be limited. Liability should not be imposed for the performance of routine clearing functions, absent a clearing firm's knowledge of the fraud. Otherwise, similar to respondeat superior liabilities under tort law, liability would be imposed automatically upon the clearing firm. That standard is too high. Under such high standards, the clearing firm's role would be to "police" the actions of the introducing firm, a position most parties do not want to invoke.

Overwhelmingly, courts have rejected the notion that there is any fiduciary relationship between a clearing firm and an investor.¹⁹⁵ As such, the lack of a fiduciary duty has created substantial roadblocks for imposing even minimal liability upon the clearing firm. Absent a fiduciary duty, the clearing firm has no duty to disclose knowledge of potential fraud. Courts have recognized that the clearing firm acts as an agent of the introducing firm, and that the introducing firm is the agent of the customer, with both relationships invoking fiduciary obligations.¹⁹⁶ But the analysis has stopped there. Therefore, this analysis implies that no, or at most a minimal,

¹⁹⁵ Absent any fiduciary duty, the scienter requirement under § 10(b) is heightened. Therefore, in the absence of any fiduciary duty, the clearing firm would not be liable even if it knew of fraudulent activity on the part of the introducing firm. In the absence of any fiduciary relationship, there is also no duty on the part of the clearing firm to inquire into or disclose the actions of the introducing firm.

¹⁹⁶ See Fitzpatrick & Carman, *supra* note 18.

relationship exists between the clearing firm and the customer.¹⁹⁷

One reason that the courts have failed to find clearing firms liable for investor losses is that they have confused the relationship among the introducing firm, clearing firm, and investor. The clearing firm not only maintains a relationship with the introducing firm, it also maintains a relationship with the customer. As such, under agency law, the clearing firm is an agent to the introducing firm *as well as* a "subagent" to the customer.¹⁹⁸ The subagent (clearing firm) is both the agent of the principal (investor) and an agent of the appointing agent (introducing firm). Therefore, a clearing broker's disavowal of any responsibility (to the customer) or liability for the acts of the introducing firm does not preclude an agency relationship.

A subagent is "a person appointed by an agent . . . to perform functions undertaken by the agent for the principal, but for whose conduct the agent agrees with the principal to be primarily responsible."¹⁹⁹ The prefix "sub" is meant to indicate that the party appointed to perform functions for the agent is itself an agent of the appointing party; e.g., a clearing firm (subagent), appointed to perform functions undertaken by an introducing firm on behalf of a customer, is an agent of the introducing firm (appointed party).²⁰⁰ Stated alternatively, the subagent is the agent of the one from whom he derived his authority.²⁰¹

In addition, the subagent is an agent of the principal.²⁰² Accordingly, the clearing firm is the agent of the investor. Recognizing that the "purpose of the entire arrangement is to carry out the purpose of the first principal" (the customer), the *Restatement on Agency* establishes the relationship as follows. The appointed party is the "agent of two principals, one of whom is subordinate to another."²⁰³ Thus, the clearing firm is

¹⁹⁷ *Id.* at 63.

¹⁹⁸ See RESTATEMENT, *supra* note 64, § 5.

¹⁹⁹ *Id.* § 5, ch. 26.

²⁰⁰ Fitzpatrick & Carman, *supra* note 18, at 53.

²⁰¹ RESTATEMENT, *supra* note 64, § 5, ch. 1.

²⁰² *Id.* § 5, chs. 1, 24.

²⁰³ Note the following illustration: A person employs a real estate broker to sell a tract of land, with the understanding that the real estate broker is to use his own instrumentalities, including subordinates who are to be responsible to the real estate broker for what they do and who are to receive their compensation from him. The

the agent of both the introducing firm as well as the investor, with the introducing firm subordinate to the investor. Moreover, the clearing firm must be the agent of the investor because the clearing firm binds the investor while acting on his or her behalf.²⁰⁴ Finally, as an agent of the principal, the clearing firm stands in a fiduciary relationship to the principal.²⁰⁵

It is well established that agents owe fiduciary duties to their principals. The same is true with subagents. Although the subagent is not contractually liable to the principal because the principal generally has a contract only with the agent, the subagent shall be responsible for any violation of a fiduciary duty.²⁰⁶ As the *Restatement of Agency* explains:

The subagent is subject to a duty, as is the agent, not to act contrary to what he knows to be the principal's orders. Although he has a duty of loyalty and obedience to the agent who is his immediate principal, the subagent is subject to liability to the ultimate principal for participating in a breach of duty by the agent to the principal if he has notice that the agent's conduct constitutes a breach of duty.²⁰⁷

Therefore, under agency law, the subagent (clearing firm) owes fiduciary duties to the principal (customer) as well as the agent (introducing firm).

Under the above analysis, as a fiduciary, a clearing firm is subject to liability for participating in any breach of duty by the introducing firm. If the clearing firm is on notice of fraudulent activity by the introducing firm, then the clearing firm will be subject to liability to the investor for participating in the fraud. Presumably, any activity by the clearing firm after having notice of fraud—e.g., continuing to clear trades or

broker's salesman is employed to execute a contract for the principal and is liable to the broker for any failure of performance. Notwithstanding, the salesman thus employed to sell Blackacre does so on behalf of the owner. If this were not true he could not bind the seller. "With reference to the owner, [the salesman] is as much an agent in the transaction as if he had been employed directly." *Id.* § 5, ch.1 & § 428, ch. 13.

²⁰⁴ *Id.* § 5, ch. 1.

²⁰⁵ *Id.* § 5, cmt. d.

²⁰⁶ RESTATEMENT, *supra* note 64, § 5, cmt. d; see also *Licari v Blackwelder*, 539 A.2d 609, 613 (Conn. App. Ct. 1988) (secondary broker "under the same duty as the primary broker to act in the utmost of good faith").

²⁰⁷ RESTATEMENT, *supra* note 64, § 428, ch. 13.

offering additional credit—would be a breach of the clearing firm's fiduciary duties. Additionally, as a fiduciary, a clearing firm is subject to a duty to not act contrary to what he knows to be the principal's orders. Therefore, a clearing firm would be held to violate its fiduciary duties if it refused to accept or recognize customer demands to stop or cancel unauthorized trades.

The ramifications of finding a fiduciary relationship between the clearing firm and investor are great. As a fiduciary, a clearing firm would have a duty to disclose possible fraud at the introducing firm. Moreover, if a fiduciary relationship between the clearing firm and investor is found, a recklessness standard will be enough to establish scienter. Therefore, finding a fiduciary relationship would make it easier for investors to bring complaints against clearing firms, especially as primary violators.²⁰⁸

B. *Knowledge of the Fraud*

The 1999 amendments to NYSE and NASD rules and recent legal decisions, namely *Blech II*, may make it more difficult for clearing firms to claim ignorance of securities fraud violations occurring at the introducing firm. The 1999 amendments require the clearing firm to acknowledge receipt of customer complaints.²⁰⁹ Customer complaints made directly to the clearing firm regarding unauthorized trades may alert a clearing firm to fraudulent activities occurring at the introducing firm. Presumably, a clearing firm who receives written customer complaints cannot deny actual notice.²¹⁰ Even if the clearing firm does not have actual knowledge of fraud,

²⁰⁸ Presumably, liability based on agency principles has not been singled out by *Central Bank*. See *Pollack v. Laidlaw Holdings, Inc.*, No. 90 CIV 5788, 1995 WL 261518 (S.D.N.Y. May 3, 1995) (holding that liability based on agency principles is not limited by *Central Bank*). See also *AT&T v. Winback & Conserve Program, Inc.*, 42 F.3d 1421, 1432 (3d Cir. 1994) (holding that "*Central Bank's* discussion of aiding and abetting should not be transplanted into the more settled realm of agency law"); *Seolas v. Bilzerian*, 951 F. Supp. 978, 983 (D. Utah 1997) (holding that even though Rule 10b-5 "does not specifically mention agency or respondeat superior," these claims are not precluded under *Central Bank*).

²⁰⁹ *Aidikoff et al.*, *supra* note 3, at 132.

²¹⁰ *Id.*

adequate suspicion that the introducing firm is partaking in manipulative schemes to defraud investors may be inferred.

When monitoring margin trading, a clearing firm may also have sufficient insight and knowledge into possible fraudulent schemes originating at the introducing firm. When monitoring margin accounts, the clearing firm focuses on the amount of equity in the clearing firm's account.²¹¹ "[T]he carrying firm is particularly concerned with the credit worthiness of the introducing firm and its customers and will monitor closely potential credit exposure for its own protection."²¹² It is these safeguards which may lead the clearing firm to uncover fraudulent practices at the introducing firm.

C. *Participation*

Liability is not imposed for performing *routine* clearing functions.²¹³ The traditional legal standard has been that a clearing firm will not be held liable for the fraudulent acts of the introducing firm unless it actively and knowingly participates in the fraud. Therefore, neither the inadvertent, nor purposeful clearing of fraudulent trades are actionable against the clearing firm. The underlying rationales are that *clearing* is purely an administrative, routine, and neutral activity and that knowledge of the fraud does not taint the action. Moreover, this theory assumes that when clearing sham transactions, the actions of a clearing broker are no different than when the broker clears legitimate transactions.

²¹¹ Minnerop, *supra* note 2, at 845.

²¹² Fitzpatrick & Carman, *supra* note 18, at 49.

²¹³ *Blech II*, 961 F Supp. at 584

When plaintiffs allege mere clearing conduct against Bear Stearns, such allegations amount to no more than a non-existent claim of aiding and abetting because, at most, they allege only that Bear Stearns knowingly and substantially assisted Blech by clearing the fraudulent trades. However, the complaint crosses the line dividing secondary liability from primary liability when it claims that Bear Stearns "directed" or "contrived" certain allegedly fraudulent trades.

Id.

Moreover, even if a fiduciary relationship exists between the clearing firm and the investor, routine clearing, without knowledge of the fraud, should not be actionable against the clearing firm.²¹⁴ Imposing liability for the performance of routine clearing functions would mean that clearing firms would always be exposed to liability by virtue of their relationship with a defunct broker dealer. Such a standard would be too high; clearing firms would be required to police the functions of the introducing firm.

Until *Blech II*, the court had not defined what actions extend *beyond* mere clearing services. In *Blech II*, the court held that pressure exerted by a clearing firm to reduce the introducing firm's debt balance, coupled with knowledge of sham transactions (at the introducing firm) and the clearance of those trades, went beyond routine clearing functions.²¹⁵ It is suggested by the *Blech II* court that when a clearing firm has *knowledge* of fraud, its services extend beyond mere clearing. Therefore, future theories of liability will depend on the characterization of knowledge as a taint.

Clearing functions, that provide the clearing firm with insight into suspicious or fraudulent activity at the introducing firm should be considered participation. Inaction (including a lack of inquiry or disclosure of possible fraud at the introducing firm) in the face of knowledge should also be considered participation. The assumption underlying this theory of interdependence is that the inadvertent clearing of fraudulent trades is no different than the purposeful clearing of fraudulent trades. The axiom that the clearance of sham transactions plays no part in the furtherance of fraud is false and should be dismantled.

When performing clearing services with knowledge of fraudulent activity, especially when clearing trades on margin, the actions of the clearing firm should be distinguished from those actions needed to clear legitimate trades. When acting as a creditor, the clearing firm obligates itself to pay for all executed trades regardless of any default on the part of the

²¹⁴ *Id.* ("Even assuming that Bear Stearns had knowledge of the Blech scheme, primary liability cannot attach when the fraudulent conduct that is alleged is no more than the performance of routine clearing functions.").

²¹⁵ *Id.*

customer.²¹⁶ Although, pursuant to the clearing agreement, the introducing firm agrees to indemnify the clearing firm against any loss due to a customer lack of funds, that is not always the case. When the introducing firm can no longer carry the burden or becomes insolvent, it is the clearing firm that ultimately absorbs most, if not all, of the financial loss.²¹⁷ Therefore, the clearing firm is on high alert for any activity by the introducing firm that will expose the clearing firm financially.²¹⁸ As evidenced by the A.R. Baron case, the clearing firm knows that it cannot rely on the introducing broker to be financially responsible or solvent.

As affirmed in *Blech II*, when acting as *creditor* to the introducing firm, clearing calls for the close monitoring of introducing firms.²¹⁹ "[C]learing firms monitor the introducing firm's proprietary margin accounts, focusing on the market value of those accounts and the liquidity and concentration of securities in such accounts."²²⁰ To protect against such risk, clearing firms have veto power over the execution of any trade and may reject the introduction of new accounts.²²¹ In the past, some clearing firms have even terminated agreements with an introducing firm because of suspicious activity.

When clearing margin trades with knowledge of fraudulent trading at the introducing firm, the clearing broker cannot be said to be a neutral or disinterested party and any inaction on the part of the clearing broker should be actionable by the aggrieved customer. In the face of knowledge of fraudulent activity occurring at the introducing firm, the clearing firm may be seen as an active participator in the fraud. Clearing firms should have the affirmative duty to react to customer complaints, to disclose possible fraudulent activity at the introducing firm, to investigate or reverse questionable trades, and even to terminate relations with fraudulent introducing brokers.

²¹⁶ Minnerop, *supra* note 2, at 844.

²¹⁷ Fitzpatrick & Carman, *supra* note 18, at n.15 ("[C]onsidering [the introducing firm's] small net capital there was a substantial likelihood that the clearing brokers would themselves have to bear all or part of any potential losses.").

²¹⁸ *Id.*

²¹⁹ Minnerop, *supra* note 2, at 844.

²²⁰ *Id.* at 845.

²²¹ *Id.*

D. *Critique of Regulatory Changes*

The 1999 amendments to the rules of self-regulatory organizations attempt to address sales practice related problems. The rules are pro-active and are meant to reveal "red flags" prior to the time when full-blown fraud becomes apparent. They may even cause clearing firms to act with a greater degree of care when entering into clearing relationships. The amendments are not, however, meant to "alter the fundamental clearing relationship"²²² and do not "change or otherwise affect rights, responsibilities, or liabilities of the introducing or clearing firm under law or contract."²²³ Instead, they are simply meant to "clarify the relationship and responsibilities" between the introducing and clearing firms as outlined in the carrying agreement.²²⁴ The amended rules reinforce well-established legal precedent that all regulatory responsibility and corresponding liability lies with the introducing firm rather than the carrying firm—with the carrying firm acting as a blind intermediary

A fundamental effect of the amendments is that they impose on the clearing firm an independent duty to act. As such, investors may bring novel claims for violations of the amended rules, e.g., failure by a clearing firm to alert the proper SRO of a written customer complaint, or disregard of its responsibilities for ensuring adequate supervisory procedures at the introducing firm.²²⁵ It is too early to know how the courts will interpret these new amendments or whether they will echo early cases in which clearing firms were held liable for violations of NYSE Rule 405, the "know your customer" rule.

Admittedly, the rules will increase the potential of self-regulatory organizations to inhibit securities fraud, albeit in a untimely and inefficient manner. The introducing broker is probably the first person to whom a customer directs a complaint. After receiving from an introducing firm an unsatisfactory response, or no response, the customer's next

²²² NYSE Memo, *supra* note 163, at 4; NASD Rule Amendments, *supra* note 158, at 63,590.

²²³ NASD Rule Amendments, *supra* note 158, at 63,590.

²²⁴ NYSE Memo, *supra* note 163, at 4.

²²⁵ Kline & Moss, *supra* note 6, at 156.

alternative is to contact the clearing firm. But the clearing firm, pursuant to its interpretation of its responsibilities under the carrying agreement, defers all complaints back to the introducing firm! Thus, it may be said that the customer gets the "run around."

The new amendments also require the clearing firm to send all written complaints to the proper DEA and SRO. However, reaction by self-regulatory agencies may occur long after the completion of questionable trades. The reactions of self-regulatory agencies usually occur on a large scale, ultimately identifying magnificent fraud occurring over a long period of time at a particular introducing firm. For the disgruntled investor, *re-action* by the self regulatory agency comes too late; investor funds have already been lost, fraudulently transferred, or absconded to offshore entities—ever to be found or retrieved.

Finally, the amendments do little more than *facilitate* the retrieval and collection of customer complaints. Ironically, the clearing firm is not required to act substantively, rather only to act administratively; the rule does not require any action on the part of the clearing firm to prevent fraudulent transactions. The clearing firm is neither required to inquire into nor examine customer complaints. At least one commentator has hypothesized that "the amendments have arguably provided the clearing firm with a more secure safe harbor against many of the claims typically asserted against them by customers of their introducing firms"²²⁶ by allowing clearing firms to wipe their hands clean of any responsibilities early on in the regulatory process.

It is the clearing firm that has the best ability to curb the fraud. By refusing either to clear—or by canceling—a fraudulent trade, the clearing firm has the potential to stop fraud prior to or quickly after a trade is executed. Clearing firms should have the affirmative duty to react to customer complaints, to disclose possible fraudulent activity at the introducing firm, and even to investigate or reverse

²²⁶ Shannon, *supra* note 3, at 682. The author argues that the new amendments are "hardly a lip service to the problem. Rather, they are a well-balanced and focused solution to the troublesome core questions of the responsibilities of clearing firms and the need for action against misbehaving or fraudulent introducing brokers." *Id.* at 709.

questionable trades. Instead, read in conjunction with amendments to NYSE Rule 405 ("know your customer" rule), the new amendments can be interpreted as serving the resolve of clearing firms to avoid any liability pertaining to fraudulent transactions in association with the introducing firm.

CONCLUSION

The idea of holding a clearing firm liable for the acts of an introducing firm with whom it contracts goes against the grain of traditional practice within the securities industry. Clearing firms argue that requiring them to monitor the acts of introducing brokers would result in increased compliance and cost burdens. Ultimately, it is argued that the imposition of liability will discourage clearing firms from entering into clearing relationships, or even from renewing existing relationships, with smaller introducing brokers. Some commentators have even claimed that "the system [would] not work if clearing firms are held liable for the sales practice violations of introducing firms."²²⁷ Commentators argue that liability for "basic housekeeping functions" will expose the clearing brokers to even greater risks.²²⁸ From the perspective of the clearing firm, the risk may simply be too high: "Well-capitalized clearing firms like Bear Stearns would be very reluctant, indeed probably unwilling, to enter into clearing agreements with relatively low-capitalized introducing firms; that's the way the economics of the business work."²²⁹

These can all be seen as self-serving statements by the clearing front. It is this increased responsibility and corresponding risk that would cause clearing brokers to be more discriminating when choosing to contract with small, thinly capitalized introducing firms. If liability is imposed, the degree of care taken by the clearing firm would be substantially heightened—both when clearing for an introducing firm with whom it has already contracted and

²²⁷ *Wells Submission*, *supra* note 30, at 17.

²²⁸ *Henriques & Truell*, *supra* note 17, at D1.

²²⁹ *Id.* (quoting General Counsel and Executive Vice President for Bear Stearns, Mark Lehman: "If they make the clearing firms liable for the sales-practice activities of the introducing firms, they can't pay clearing broker's enough to accept that risk.").

when deciding to enter into new clearing relationships. In addition, the higher the risk the introducing firm poses to the clearing firm, the more expensive it will be for the introducing firm to contract for services, thereby reducing the number of small introducing firms who may be more susceptible to engaging in fraudulent practices.

When clearing for introducing firms that have prior reported dealings involving fraud, clearing firms impose higher risks on themselves. Although clearing firms are aware of the increased risk, they reject the duty and liability that flow from it; they contract that duty away, and with it, accountability. It is the clearing firm that *agrees* to contract with and perform clearing services for an introducing firm that may not adhere to industry standards. It logically follows that with increased risk comes increased responsibility. When contracting with an introducing firm that has repeatedly failed to meet margin requirements, or has been known to be associated with past fraudulent persons or practices, or has been repeatedly reported by customer complaints, the pattern is all too clear. The clearing firm should certainly be held responsible, and, therefore, liable for directing, causing, or perpetuating fraudulent activity *and* for failing to disclose or investigate activity which has the potential to be fraudulent.

A clearing firm is one of the limited number of parties who are privy to information about the financial situation of the introducing firm. It is simply not true, as some commentators argue, that the clearing of sham transactions is no different than the clearing of legitimate transactions when the clearing firm is aware of or suspects potential fraud at the introducing firm. Moreover, because the clearing firm is exposed to high risk, it is naive to claim that the clearing firm is a detached and disinterested party. Although it is sometimes economically beneficial to turn a blind eye to short term market manipulation, it is inappropriate not to require affirmative action by the clearing firm to react to customer complaints, investigate or reverse questionable trades, disclose possible fraudulent activity at the introducing firm, and even terminate contractual relations with fraudulent introducing brokers.

In the past, the courts have improperly analyzed the role of clearing firms when performing these functions.

Clearing firms have the capacity to know when alleged fraudulent practices are occurring at the introducing firm. And knowledge of the fraud, coupled with a special duty to the customer, imposes on the clearing firm liability for any lack of disclosure. Therefore, non-neutral acts may impose on clearing firms heightened levels of responsibility and, ultimately, yield clearing firm liability.

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