TRENDS IN SUPERVISORY AND CLEARING FIRM LIABILITY

By: Timothy J. O'Connor and Paul C. Carroll

SECURITIES ARBITRATION
AND MEDIATION 2017:
THE COURAGE TO SIMPLIFY,
DAVID E. ROBBINS, ESQ. AND JAMES D. YELLEN, ESQ., CO-CHAIRS
New York Bar Association
Continuing Legal Education Series
New York City, April 6, 2017

SECURITIES ARBITRATION AND MEDIATION 2017: THE COURAGE TO SIMPLIFY, DAVID E. ROBBINS, ESQ. AND JAMES D. YELLEN, ESQ., CO-CHAIRS
New York Bar Association Continuing Legal Education Series,
New York City, April 6, 2017

TRENDS IN SUPERVISORY AND CLEARING FIRM LIABILITY

By: Timothy J. O'Connor and Paul C. Carroll

TABLE OF CONTENTS

Page

INTRODUCTION 1

THE EQUITABLE AUTHORITY OF FINRA ARBITRATION PANELS 2

A. SUPERVISORY LIABILITY 2

SUPERVISION 2

FINRA RULE 3110 (SUPERVISION) 2

FINRA RULE 3120 (SUPERVISORY CONTROL SYSTEM) 2

FINRA RULE 3130 (ANNUAL CERTIFICATION OF COMPLIANCE AND SUPERVISORY PROCESSES) 3

FINRA RULE 2090 AND 2111 – THE KNOW YOUR CUSTOMER RULE AND THE SUITABILITY RULE 4

FINRA RULE 2210 – COMMUNICATON WITH THE PUBLIC 4

FINRA RULE 3270 – OUTSIDE BUSINESS ACTIVITIES 5

SUPERVISION OF BROKERS WITH A HISTORY OF PRIOR COMPLAINTS 5

B. CLEARING FIRM LIABILITY TRENDS 5

WHAT IS A CLEARING FIRM? 6

CLEARING FIRMS EXTEND MARGIN LEVERAGE 7

CLEARING FIRM DUTIES UNDER FINRA RULE 4210(f)(8)(B) 7

CLEARING FIRM'S CHANGING RULES WITH BROKER MIGRATION 8

CLEARING FIRMS AND THE BANKING INTERFACE 8

FINRA RULE 4311(h)(2) CLEAERING FIRM REPORTING REQUIREMENTS 9

SEC REGULATION SHO 9

NEW TECHNOLOGIES HEIGHTENING CLEARING FIRM RESPONSIBILITY 10

EMERGING PROBLEM AREAS FOR CLEARING FIRMS... 11

CLEARING FIRM RESPONSIBILITY FOR AFFORDING WRONDOERS MARKET ACCESS 12

FINRA RULES RELATING TO MARKET ACCESS AND SEC RULE 15.3-5 13

DUTY TO MONITOR THE NET CAPITAL AND COMPLIANCE CULURE OF INTRODUCING BROKERS 14

THE EROSION OF CLEARING FIRM CLAIMS OF IMMUNITY FROM CIVIL LIABILITY.. 15

FINRA REGULATION AND ENFORCEMENT.. 18

APPLICABILITY OF THE ANTI-WAIVER PROVISIONS OF THE FEDERAL SECURITIES LAWS.. 19

COUNSEL FOR INVESTORS SHOULD THOROUGHLY REVIEW THEIR CLIENTS' POTENTIAL CLEARIN FIRM CLAIMS 19

CLEARING FIRMS AND THE NEW FIDUCIARY RULE... 20

CLEARING FIRMS AND THE NEW PARADIGM.. 20

HIGH STANDARDS OF COMMERCIAL HONOR AND JUST AND EQUITABLE PRINCIPLES OF TRADE – THE GUIDING PRINCIPLE FOR INTRODUCING AND CLEARING BROKERS.. 22

THE EQUITABLE RELIEF STANDARD 23

PUBLIC STATEMENT BY LINDA D. FIENBERG 23

THE OVERRIDING CONCEPT OF EQUITY.. 23

WILL ARBITRATION BECOME OBSOLETE?... 24

SECURITIES ARBITRATION AND MEDIATION 2017: THE COURAGE TO SIMPLIFY, DAVID E. ROBBINS, ESQ. AND JAMES D. YELLEN, ESQ., CO-CHAIRS
New York Bar Association Continuing Legal Education Series,
New York City, April 6, 2017

TRENDS IN SUPERVISORY AND CLEARING FIRM LIABILITY

By: Timothy J. O'Connor and Paul C. Carroll

INTRODUCTION

As suggested in the agenda for this program "wrongdoing rarely takes place without the assistance or acquiescence of others". This pertains to both liability claims in the supervisory context of major wirehouses, brokerage firms, introducing firms and independent broker dealers, as well as in the case of clearing firm liability. With the emergence of mandatory customer arbitration in the case of Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), virtually all retail customer claims are currently resolved under the auspices of the Office of Dispute Resolution of Financial Industry Regulatory Authority (FINRA). With this change of 30 years ago, there is very little controlling court precedent in this arena. Rather arbitrators are afforded considerable leeway and discretion to make decisions in accordance with the guidelines of the authority granted to them pursuant to the directives of the FINRA Arbitrator's Manual, as well as any statutory and common law the arbitrators deem applicable.

The Equitable Authority of FINRA Arbitration Panels

The guiding principal of equity espoused by the FINRA Arbitrator's Manual and other pronouncements of FINRA afford arbitrators latitude to make decisions without being wholly bound to any particular court decisions involving clearing firm liability which may have issued from one of the various state or federal courts:

> "Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas

> the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail." – Domke on Aristotle, from the FINRA Dispute Resolution Arbitrator's Guide, at page 8 (July 2013 Edition).

In addition to those FINRA rules applicable to all FINRA members, this article will also touch upon certain court related precedent, particularly in the context of clearing firm related claims.

A. Supervisory Liability

Supervision

FINRA Rule 3110 (Supervision)

FINRA Rule 3110 mandates that brokerage firms must establish and maintain an organizational structure to assure the supervision of the activities of its associated persons in such a manner to assure compliance with the securities laws, regulations and FINRA rules. The hallmark of Rule 3110 is the requirement that firms have written supervisory procedures including those involving its supervisory personnel – in other words, how are the supervisors going to be supervised?[1] These supervisory rules include the firm's investment banking and securities businesses, as well as correspondence, internal communications, customer complaints, etc. The rule also requires the implementation of hierarchical structure to achieve these ends with specificity to include all supervisory activities of individuals working in the supervisory hierarchy, how supervisory reviews are conducted and in-house supervisory.[2]

FINRA Rule 3120 (Supervisory Control System)

This rule requires firms to have in place supervisory control policies (SCP's) and procedures. This includes a requirement for testing and verification of these procedures,

[1] FINRA Regulatory Notice 14-10 "Consolidated Supervision Rules – SEC Approves New Supervision Rules", March, 2014.

[2] Rule 3110 also defines the concept of branch offices and Offices of Supervisory Jurisdiction (OSJ's), setting forth the respective designation and registration aspects of these offices, as well as provisions requiring office inspections and transaction reviews.

differentiating these requirements from those requirements of written supervisory procedures required by FINRA Rule 3110. Supervisory control policies and procedures are required to test and verify the written supervisory procedures of Rule 3110 at least annually. This rule also requires the designation of principals, positions which include a heightened level of securities industry licensure within the FINRA examination scheme, and these principals are required to establish, maintain and enforce supervisory control policies.[3]

FINRA Rule 3130 (Annual Certification of Compliance and Supervisory Processes)

In addition to the principal designation procedures required by FINRA Rule 3120 (above), Rule 3130 requires firms to formally designate, identify and make filings to identify the principal(s) who will be serving as Chief Compliance Officers (CCO). The rule also requires that the firm's Chief Executive Officers certify that the firm has in place sufficient processes to establish, maintain, review, test and modify policies and procedures to assure compliance of applicable laws and regulations.[4] In turn, these processes are required to be reported to a firm's board of directors and audit committee on an annual basis.

Under the rule, CEO's are required to certify that they have met with their Chief Compliance Officers within the past 12 months and have engaged in a meaningful in person exchange regarding the compliance and supervisory processes, including those required by Rule 3110 and 3120. In other words, the executive officers of the firm and the firm's compliance officers are required to engage in a meaningful and effective course of interaction in a face-to-face context and not merely rely on paper flows and signatures.

---

[3] These principals are also required to report annually, particularizing their firm's supervisory control systems in a report known as a Rule 3120 Report.

[4] See FINRA Regulatory Notice 14-10 "Consolidated Supervision Rules – SEC Approves New Supervision Rules" March 2010

FINRA Rules 2090 and 2111 – The Know Your Customer Rule and The Suitability Rule

FINRA Rule 2090, the latest version of FINRA's Know Your Customer Rule, states that "every member shall use reasonable diligence in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer…".[5] This Rule dovetails with FINRA Rule 2111, the Suitability Rule, which states that "a member or associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer…". As FINRA Regulatory Notice 11-02 indicates, these two rules work hand-in-hand.

FINRA Rule 2210 – Communications with the Public

In this day and age of cell phones (texting), e-mails,[6] chat rooms, PDF document scans, cloud stored information, blogging, Google alerts, photocopying/scanning, a comprehensive review of a brokerage communications with the public requires hands-on day-to-day vigilance. In addition to the obvious easily detectable modes of communication, other means of assessment includes a periodic review of office photocopier for documents photocopied, to detect the copying of contraband/unauthorized materials relating to securities, unauthorized correspondence or even cut and paste bogus account statements misrepresenting account valuations. Photocopier storage conventions and protocols have included embedded storage capabilities of all documents copied and scanned on photocopiers. Transfers between accounts, as well as transfers outside of a firm's account structure would beg for periodic review and confirmation of third party withdrawals requests.

---

[5] FINRA Regulatory Notice 11-02 "Know Your Customer and Suitability – SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations" January 2011.

[6] FINRA Regulatory Notice 07-59, as well as follow-up guidance, addresses the need for thorough review of electronic correspondence.

FINRA Rule 3270 – Outside Business Activities

FINRA Rule 3270 requires that associated persons of member firms make full disclosure of their outside business activities to their FINRA member firms prior to participating in such activities. Hundreds of customer claims have been filed over the years against firms whose brokers have operated side businesses involving prohibited selling away activity involving pitching of interests in these separate business enterprises to firm customers. FINRA Rule 3270 requires that firms supervise these activities with an eye on detecting improper conduct.

These FINRA Rules form the bulwark of the supervisory and compliance obligations of introducing brokerage firms relative to the activities of their brokers.[7] In this context, FINRA arbitration panels have the equitable authority, as well as the common-law authority, to render decisions and fashion awards, where merited, in furtherance of their equitable powers.

Supervision of Brokers with a History of Prior Complaints

Supervision of brokers with a history of customer complaints statistics show that approximately one percent (1%) of associated persons have had more than one complaint lodged by a customer within the preceding five years.[8] Given this, it is clear in this day and age of technological capabilities, heightened supervisory review of accounts under management of this small percentage of brokers is essential.[9]

B. Clearing Firm Liability Trends

The majority of all stock and bond transactions in the New York securities markets are cleared through clearing brokers, with trades often initially entered by introducing brokers or their

---

[7] FINRA Rules 3110, 3120, 3130, 2090, 2111, 2210, 3270

[8] See NASD Notice to Members 97-19 "NASD Regulation and New York Stock Exchange Memorandum discusses sweep report and provides guidance on heightened supervision recommendations".

[9] See also FINRA 2017 Annual Regulatory and Examination Priorities Letter, January 2017, page 2 addressing "High-risk and Recidivist Brokers".

customers. What's the difference between introducing brokers and clearing brokers and why do we need clearing brokers? There are over 3,900 brokerage firms licensed with the Financial Industry Regulatory Authority.[10] Over ninety percent (90%) of them have no trade clearing facilities of their own given the logistics, as well as the regulatory and infrastructural costs of maintaining securities trade clearing and custody facilities.[11] Large, household name brokerage firms (also known as wirehouses) still remain self-clearing, that is to say they have their own facilities for clearing trades and overseeing any purchases of sale of stocks and bonds through their own facilities. Further, with respect to clearing firms in the context of supervision and FINRA rules encompassing supervisory responsibilities, no distinction is made in these rules which would serve to expressly immunize clearing firms from liability to customers.[12]

What is a Clearing Firm?

At the outset, the definition of what constitutes a clearing broker, including the variants of financial services related firms providing clearing services is essential. Traditionally, clearing firms performed services limited primarily to effectuating the purchase and sale of securities for introducing brokers and generally having no direct in-person exchanges with retail customers. Just as there are a number of large, self-clearing, major brand name brokerage firms who are self-clearing, there are likewise several large clearing firms which oversee, facilitate and finalize securities trades, while also maintaining the back office, operational infrastructure for the issuance of monthly account statements, trade confirmation reports, cash and custodian account

---

[10] Finra.org/newsroom/statistics

[11] Top clearing firms include Apex Clearing Corp, COR Clearing, First Clearing, Goldman Sachs Execution and Clearing, LPL Financial, Merrill Lynch Professional Clearing Corp and Broad Court, National Financial Services Fidelity Clearing and Custody Source, Pershing, Raymond James & Associates, Inc., RBC Correspondent Services, Sterne Agee Clearing, Inc., Southwest Securities Inc. and Wedbush Securities Inc.

[12] The Securities Investor Protection Act has defined the term "broker" to include clearing brokers (see 15 U.S.C. Section 78(c)(a)(2).

coordination and the issuance of tax reporting statements. Further, recent guidance suggests an emerging responsibility to monitor certain transactions for red flag issues.[13]

Clearing firms are compensated in a number of ways for their involvement with trading activity directed in the first instance by introducing brokers. For example, payment for order flow, transaction fees, margin interest spreads and custody float are modes of compensation which brings millions of dollars in revenues to clearing firms. In return, clearing brokers are also assisting in the provision of best price executions for its clients.[14]

Clearing Firms Extend Margin Leverage

In all instances the carrying clearing firm as creditor extending margin leverage has the obligation to ensure compliance with the margin rules and the overall management of the attendant risk to the carrying firm represented by a customer's portfolio. Clearing brokers may allocate to an introducing broker, the role of communicating the existence of a margin call to the client and require the IB (introducing broker) to take an active role in monitoring the actions taken to meet the call. However, FRB Regulation-T and FINRA Rule 4210 do not permit the abdication of the creditors compliance responsibility to an introducing broker or investment advisor regardless of any written agreement between the parties to the contrary. This prohibition also applies to the Day Trading provisions under FINRA 4210(f)(8)(B).

Clearing Firm Duties Under FINRA Rule 4210(f)(8)(B)

Under 4210(f)(8)(B), clearing brokers are required to monitor all accounts for intra-day exposure in instances when a position is acquired during the trading day and close out prior to

[13] FINRA Regulatory Notice 09-05 "Unregistered Resales of Restricted Securities – FINRA Reminds Firms of Their Obligations to Determine Whether Securities are Eligible for Public Sale", including an enumeration of compliance red flags. P. 3-4.

[14] See FINRA Regulatory Notice 08-80 "Best Execution – FINRA Requests Comment on Proposed FINRA Rule Addressing Best Execution" December 2008.

the close of business of the same day. Since Reg-T and FINRA 4210 calculate margin as of the close of business each day, the day trading rule was designed to capture the market risk which is no longer present at the close. In effect, it prevents an account from trading on the creditor's dime without ever having to put up a nickel.

Clearing Firms The Changing Role of with Broker Migration

The past decade has seen the migration of thousands of FINRA licensed brokers from self-clearing, household name, wirehouse firms to small independent FINRA member brokerage firms, for more reliant upon the services of clearing brokers to perform various tasks. The past decade has also seen an explosion in the number of brokers leaving large brokerage firms, transferring their business platforms to non-FINRA licensed Registered Investment Advisory model.[15] With these two trends, clearing brokers have also taken on additional tasks given their emerging interface with private banking business models, investment advisory platforms, money management relationships, ancillary credit and lending services, and the check writing and credit card interface with banks.

Clearing Firms and the Banking Interface

Clearing brokers now interface with and perform a considerable number of additional tasks and functions that they did not perform a generation ago.[16] With the integration of bank products linked directly with brokerage accounts, clearing firms have added a layer of complexity when calculating the availability of client assets held and how the assets are captured

[15] Top custodians for Registered Investment Advisory custody clients include Folio Institutional, Interactive Brokers, LPL Financial, National Advisors Trust Co., National Financial Services Fidelity Clearing and Custody, Pershing Advisors Solutions, RBC Advisor Services, Schwab Advisors Services, Scottrade Advisor Services, Shareholder Services Group, Trade-PMR Inc., TD Ameritrade Institutional, U.S. Bank Trust Company of America, ("Custodian and Clearing Firms Ranked by Number of Clients", Investment News, as of June 30, 2015).

[16] See NASD Notice to Members 97-89 "SEC Approves Bank Broker/Dealer Rule; Effective February 15, 1998". The emergence of bank broker/dealers located in banking institutions and offering their services to customers is also referenced in FINRA Rule 3160.

and treated under the Net Capital rules, segregation calculations and funds available for margin trading. Clearing firms are now performing a steadily increasing percentage of the trade clearing in the American securities markets, commensurate with the levels previously performed by self-clearing wirehouses and broker dealers.

FINRA Rule 4311(h)(2) Clearing Firm Reporting Requirements

FINRA Rule 4311(h)(2) requires a clearing member to notify the introducing broker and FINRA of the reports offered to the introducing member firm. These reports include exception and surveillance focused information related to the transactions in and performance of the accounts cleared on their behalf. Clearing firms cannot turn a blind eye to patterns of suspicious or improper activity captured by these reports and occurring in the introduced accounts i.e. late trade bookings, cherry picking, unusual banking activity or order routing abnormalities.[17]

SEC Regulation SHO

Compliance with Regulation SHO went into effect in January, 2005. A significant concern which drove the adoption of this rule was the persistence of fail to deliver and potentially abusive short selling practices.[18] Regulation SHO Rule 204 contains provisions which require broker dealers to take action to close out failure to deliver positions within prescribed timeframes. Although some of the responsibility for compliance can be shared with introducing brokers, clearing brokers must have robust monitoring and close-out procedures in place to make every reasonable effort to prevent the aging of fail to deliver positions.

Under certain circumstances, failure to resolve an ongoing fail to deliver can prevent the broker from effecting additional short sales in the same security on behalf of any customer carried on the books of the clearing broker until such time as the aged fails have been satisfied.

[17] See SEA Rule 15c3-5, Exchange Act Rule 10b-5, FINRA 2020, U.S. Patriots Act & AML Regulations.

[18] See 17 CFR § 242.200 – 204; 17 CFR § 240.15c3-5 and 17 CFR § 242.600 – 613.

Naked short selling by introducing brokers can result in liability for the clearing broker and affect the clearing broker's ability to service other introducing brokers and their clients. Clearing brokers can also be a party to lawsuits involving issuing companies and shareholders alleging illegal short selling violations.

New Technologies Heightening Clearing Firm Responsibility

Clearing firms now employ various types of software, scanning technology, forensic capabilities and other systems and methodologies designed to detect aberrant trading activity including defalcation, unauthorized withdrawals, unauthorized transfers, suspicious trading volumes, factoring, and criminal activity.[19] With suspicious day trading and margin related strategies becoming all the more prevalent in these days of algorithmic and computerized trading, it is important to keep in mind that the primary creditor is the clearing firm.[20] With these extensions of credit to suspicious or known wrongful actors clearing firms can clearly be involved with not only facilitating but aiding and abetting of civil, common law, regulatory and criminal wrongdoing.

Pattern recognition procedures, software and computer processes, algorithms, Anti-Money Laundering Regulations, Suspicious Activity Reports SARS and the interface of clearing firms with the Financial Crimes Enforcement (FinCEN), all come to the fore, making it very

[19] See SEA Rule 15c3-5, Exchange Act Rule 10b-5, FINRA 2020, U.S. Patriots Act & AML Regulations.

[20] FINRA Regulatory Notice 16-21, "Qualification and Registration of Associated Persons Relating to Algorithmic Trading" address the SEC approval of an amendment to NASD Rule 1032(f) expanding the scope of persons required to register as a Securities Trader to include individuals who are "responsible for the day-to-day supervision or direction" of "algorithmic trading strategy relating to an equity, preferred or convertible debt securities".

difficult for clearing firms to turn a blind eye to the clear indication of wrongdoing and customer victimization.[21]

Emerging Problem Areas for Clearing Firms

Consider the emerging trend involving an increase in non-FINRA licensed Registered Investment Advisors, working alone or in small independent offices, without any meaningful compliance or supervisory review or oversight. Given their lack of FINRA licensure and registration, it will be invariably argued that they are not subject to the aforementioned FINRA rules set forth earlier in this article. Clearing firms who custody and transfer the beneficial account owner's assets, however, must insure that the activity which they facilitate is in accordance with FINRA rules.

In addition to the increase in non-FINRA licensed RIA's is the trend involving smaller introducing brokerage firms specializing in boutique and niche services including speculative, low-priced and illiquid securities, high yield bonds, options and margin trading strategies and private placements; present trading scenarios exposing investors to considerable losses if not properly executed, monitored and supervised.[22] Examples of types of transactions which can involve a more hands-on/intertwining relationship between an introducing firm and a clearing broker include the following:

1. Outsized trades by in or dollar amount or number of shares versus the equity on deposit.

---

[21] See also FINRA Regulatory Notice 16-21 "Qualification and Registration of Associated Persons Relating to Algorithmic Trading" and 15-09 "Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies".

[22] Top independent broker-dealer firms include LPL Financial, AIG Advisor Group, ING Advisors Network, NFP Securities, Inc., AXA Advisors, LLC, National Planning Holdings, Inc., Securities America Inc., Commonwealth Financial Network, Northwestern Mutual Investment Services and MML Investor Services, with LPL Financial and Primevest Financial Services, Inc., a subsidiary of ING Advisors Network, Inc.

2. Accumulation of large positions and positions involving an outsized percentage of the public float of a public company.

3. Thinly traded and/or illiquid securities

4. Cross-selling transactions involving the sale of securities from one customer's account to another customer's account within the same firm.

5. Regulation T or Portfolio margin violations and non-marginable securities

6. Discrepancies involving client account information on new account forms, margin trading forms, trading authorization forms and cash and securities transfer authorization forms.

7. Embezzlement schemes.

8. Direct Market Access – clearing brokers which provide direct access to external parties using a trading acronym or Market Participant Identification Number (MPH) assigned to the clearing member are required to surveil all trading activity for compliance with exchange based rules and SEC 15c3-5.

9. Improper trading strategies engaged in by non-FINRA licensed Registered Investment Advisors.

Clearing Firm Responsibility for Affording Wrongdoers Market Access

One of the central concepts when considering a case of clearing firm liability is the extent to which the clearing firm has afforded market access to wrongdoers. By merit of the contractual relationship between clearing broker and introducing broker or registered investment advisor utilizing the market access afforded by the clearing broker with all the intended possibilities to engage in wrongdoing, the regulatory responsibilities of the clearing broker for what is going on because of this access can't be overlooked.

Clearing brokers have developed a potpourri of digital services offered to allow introducing brokers and their clients immediate access to market data, sophisticated trade routing tools and complex derivative securities. While introducing brokers may hold the primary responsibility for suitability, clearing brokers can be held responsible to unintended consequences which result from the systems lack of proper controls covering order violations, suspicious trading activity or ineffective risk management. These tools may end up in the hands of neophyte investors or bad actors intent on gaming the system.

The clearing broker is the entity accountable for regulatory compliance of the rules of the exchanges and clearing organizations for all activities effectuated over these systems. Since introducing brokers are often thinly capitalized, clearing brokers cannot rely on the introducing broker to manage the capital or regulatory risk to the clearing broker or to have in place sophisticated tools to monitor compliance.[23]

FINRA Rules Relating to Market Access and SEC Rule 15.3-5

The interplay of the FINRA, Rules SEC Rule 15c3-5 and other federal securities regulations, serve to highlight the regulatory responsibility of clearing firms and highlight the requirement of clearing firms to monitor the activities of introduced customers and to take action once they discovery regulatory violations and illicit conduct being engaged in by their contractual partners.[24] Clearing firms affording nanosecond access to trading capabilities providing the opportunity for all sorts of gamesmanship including spoofing, intraday trading access and trading in excess of an introducing firm's or Registered Investment Advisor's capacity, away trading and gaming of share price and share price bid/ask spread discrepancies

[23] FINRA Regulatory Notice 15-33 "Liquidity Risk, Guidance on Liquidity Risk Management Practices".

[24] For example, see FINRA Rules 5210 and 6410 and 17 CFR § 242.200 – 204; 17 CFR § 240.15c3-5 and 17 CFR § 242.600 – 613.

resulting in investment victimization, are all examples of conduct that can be facilitated by clearing brokers.[25] The blue-chip name recognition and street credibility which establish clearing firms afford introducing brokers and registered investment advisors is something which these firms routinely tout in their marketing materials.

Duty to Monitor the Net Capital and Compliance Culture of Introducing Brokers

Clearing brokers must also have procedures in place which monitor the introducing broker's net capital, compliance culture and the potential impact on the clearing broker's capital, funding needs and associated reputational and operational risk of partnering with what could be an unsophisticated broker with no more than rudimentary tools to manage its customer.[26] The transparency afforded through the publicly accessible FINRA BrokerCheck[27] website or directly to clearing firm members or their registered users only, through the more detailed Web CRD (Central Registration Depository) website[28] affords clearing firms access to detailed information relating to the compliance, disciplinary and complaint histories of the firms and individual brokers they interface with. As the tools marketed to introducing brokers continue to expand to a one-stop-shop model designed to provide a comprehensive array of financial products, trading tools and cash management solutions to all clients, clearing brokers open themselves up to liability should they fail to monitor the effectiveness of the products and the ability of the introducing brokers and their clients to utilize them in a responsible manner.

---

[25] "As indicated in FINRA's 2017 Annual Regulatory and Examination Priorities Letter. At footnote 6, page 11 "spoofing involves a trading pattern in which multiple, non-*bona fide* limit orders are entered generally inside the existing NBBO, with the intention of briefly triggering some type of market movement or response from another market participant, followed by cancellation of the non-bona fide orders, and the entry of an order on the opposite side of the market."

[26] The SEC noted the need for continued focus regarding the review of the compliance reviews of clearing firms with the Dodd-Frank Act in SEC Office of Compliance Inspections and Examinations, Examination Priorities for 2016", 2 (January 11, 2016).

[27] https://brokercheck.finra.org/

[28] https://crd.finra.org

The Erosion of Clearing Firm Claims of Immunity from Civil Liability

Up until the past decade, clearing firms have cited case law going back several decades to claim immunity from civil liability in customer claims, from trading activity or conduct directed, in the first instance, by introducing brokers. Claiming that they perform solely administrative tasks for their introducing brokerage firms, clearing firms have contended they are not liable for the wrongful conduct of introducing firms which clear through them. These statements are often gratuitous misstatements in instances when the introducing broker is solely reliant on the clearing broker to provide market access, margin funding, stock borrowing, equity research, advanced trading tools, IB (introducing broker) Focus calculations and a myriad of exception reports to identify trade allocation issues, suspicious order routing practices, AML surveillance, income and expense analytics and asset movement irregularity pattern recognition.[29] In many instances, the clearing broker cannot simply ignore red flag information known to them, as well as their introducing broker, without requiring a reasonable explanation from the introducing broker regarding any potential questionable activity identified.

Clearing firms have been held liable in varying degrees for facilitating the fraudulent activity of the introducing brokerage firms which clear through them.[30] Examples of clearing

---

[29] One need only look at the recent initiatives with its **SEC and Market Data Capabilities** web based resource (SEC.gov/data) to see how billions of bits of data can be organized to help discover possible fraud involving trading and possible fraud, and possible regulatory violations, improper trading and fraud.

[30] See *Levitt v. Bear Stearns & Co.*, 340 F.3d 94, 97 (2d Cir. 2003); *Koruga v. Fiserv Correspondent Services, Inc.*, 40 Fed. Appx. 364 (9th Cir. 2002); *McDaniel v. Bear Stearns & Co.*, 196 F. Supp. 2d 343 (S.D.N.Y. 2002); *Berwecky v. Bear Stearns & Co.*, 197 F.R.D. 65 (S.D.N.Y. 2000); see also *McDaniel v. Michael Davis, Bear, Stearns & Co.*, NASD Case No. 97-00497, 2001 NASD Arb. LEXIS 668 (July 31, 2001) Klein v. Oppenheimer, 130 P. 3d 569; 218 Kan. 330 (Kan. 2006) (NASD arbitration panel award against clearing firm; *In re Arbitration Between Peers v. Saydein*, NASD Case No. 00-00027, 2001 NASD Arb. LEXIS 1347 (Nov. 21, 2001) (NASD panel award against clearing firm, including attorney fees); *In re Arbitration Between Hamszeh v. Bear Stearns Secs. Corp.*, NASD Case No. 99-00959, 2001 NASD Arb. LEXIS 253 (Jan. 29, 2001) (breach of fiduciary and failure to supervise, and unsuitability against Respondent clearing firm. NASD awarded claimants $127, 511 in compensatory damages); *Kostoff v. Fleet Secs., Inc.*, 2007 U.S. Dist. LEXIS 25444 (M.D. Fl. 2007) (Clearing firm was liable, as "a conduit that provided the introducing firms the ability to engage in the proscribed activity which damaged [the customer's] account."

firm liability include arbitration claims including allegations of fraud, aiding and abetting, constructive fraud, breach of fiduciary duty, conversion, misrepresentation and equitable claims. A number of decisions have issued out of the various State and Federal Courts of New York over the past decade, including the following:

1. Goldman Sachs Execution & Clearing LP v. The Official Unsecured Creditors Comm. of Bayou Group, LLC, et al. 491 Fed Appx. 201 (2nd Cir. 2012). The Second Circuit refused to vacate a $20.6 million arbitration award against Goldman Sachs Execution & Clearing, LP where it argued that it was a "mere conduit", in a claim in which the firm was an initial transferee of fraudulently transferred property.

2. In Bear Stearns Securities Corp v. Gredd, 397 B.R. 1 (SDNY 2007) District Court, noting the control which Bear Stearns exercised by merit of its clearing contract, held that Bear Stearns was liable to the victimized customers there as an "initial transferee" of Ponzi Scheme proceeds.

3. McDaniel v. Bear Stearns & Co., Inc., 196 F. Supp. 2d 343 (SDNY 2002). This case contains a comprehensive review of the then extant law in the area of clearing firm liability with underlying claims including aiding and abetting liability claims as against Bear Stearns as well as claims also alleging primary securities fraud by the introducing broker dealer. The court noted that where a clearing firm "…moves beyond performing mere ministerial or routine clearing functions and becomes actively and directly involved in the introductory broker's actions, it may expose itself to liability with respect to the introductory broker's misdeeds." (Citing, *inter alia* Berwecky v. Bear Stearns & Co., 197 FRD 65 (S.D.N.Y. 2000), Koruga v. Fiserv Correspondent Services, 183 F. Supp. 2d 1245, 1247 (D.Or. 2001) *interalia* and In Re Blech Securities Litigation, 961 F. Supp. 569, 584 (S.D.N.Y. 1997) and Michael G. Shannon "Clearing Firm Liability Has the Dam Really Cracked?", 1196 PLI/Corp 677, 690-697.

The FINRA Office of Dispute Resolution maintains a public online repository of the decisional history of all arbitration awards, including decisions involving clearing firms. A mere sampling of these recent cases includes the following:

- Aimes v. RedRidge Securities, Inc., et al., FINRA Case No. 15-02212 (diversion of funds by investment advisor involving wire transfers of funds).

- Schroeder v. Wells Fargo Advisors, LLC, et al, FINRA Case No. 15-00074 (claim involving unauthorized change of address of record, forged signatures and unauthorized cash withdrawals – award for clearing firm).
- Pershing, LLC v. Rochdale Securities, LLC, N.Y. Sup. Ct. Index No. 651604/2016 per Honorable S. Scarpulla (lengthy decision containing detailed analysis of interrelationship between introducing broker and clearing broker, motion to vacate award against clearing broker denied, also including analysis of indemnification provision, attorney's fees).
- John Carris Investments, LLC v. Cor Clearing, LLC, FINRA Case No. 14-03457 (dispute between introducing broker and clearing broker with allegations of breach of contract, conversion, theft and breach of fiduciary duty, award for claimant introducing firm).
- Richard G.A. Forde, Jr., et al. v. TD Ameritrade Clearing, Inc., et al., FINRA Case No. 15-00598 (case involving claims of negligence, negligent supervision, breach of contract, etc. Award in favor of claimant customer).
- Grace Financial Group, LLC v. Penson Financial Services, Inc., FINRA Case No. 12-020002 (industry case in favor of member firm against clearing broker in claims involving breach of clearing agreement).

Additionally, a number of securities arbitration support vendors have published articles regarding trends associated with causes of action asserted and the types of firms against which such claims have been filed (i.e., wirehouses, introducing broker dealers, clearing firms, platform firms, registered investment advisors and individual FINRA associated person brokers), and other emerging trends.[31]

[31] The award/decisional history of the FINRA Office of Dispute Resolution has also been addressed by several vendors and publications, vendors and legal support service providers offering varying degrees of a editorialization, summaries, search capacities and arbitrator vetting services (i.e., The Securities Arbitration Commentator). Dana Pescosolido of Pescosolido, Florida has authored a number of articles, including annual summaries of arbitration

FINRA Regulation and Enforcement

FINRA Regulation and Enforcement have addressed the various emerging problems facing clearing firms in these times of rapidly increasing technological capacities and the emergence of trading entities formed solely for the purpose to qualify for preferred treatment of margin rule and for risk treatment considerations.[32] Introducing firms have used the market access afforded to them by clearing firms to configure portfolios presenting with risk exposure perhaps beyond the capabilities and tolerances of individual or separate parties or partners to these trading entities.[33] Recent FINRA pronouncements suggest that clearing firms may have an ongoing obligation to monitor and calculate the risk of these portfolios and trading activity of these entities in furtherance of their regulatory responsibilities and also highlight the need for clearing firms who maintain supervisory procedures to address these concerns and scenarios including the issuance of exception reports and to their contractual partners and communicating their concerns about possible violations seeking feedback from these partners of these concerns.[34]

---

awards rendered by the FINRA Office of Dispute Resolution, including commentary regarding trends, patterns, pitfalls, practical advice and statistics.

[32] Regulatory Notice 16-17 "Options Positions Reporting – FINRA Reminds Firms of Their Obligations When Reporting Large Options Positions". For example, noted that "the clearing firm must establish a reasonable system or process to collect in concert information from its introducing firms, if reporting on their behalf, and notify their introducing firm of accounts with potential in concert relationships identified in their review for potential inclusion" (page 8) referring to the aggregation of options contracts of 200 or more under common control or involving individuals or entities acting in concert.

[33] FINRA's 2017 Regulatory and Examination Priorities Letter noted that "…[w]e will also review how correspondent clearing firms incorporate funding needs for large introducing firms and market participants in their contingency plans, where such entities rely on their clearing brokers for funding during a stress event, including coverage for intraday risk. We urge firms to consider the effect of practices discussed in Regulatory Notice 15-33 as they evaluate their liquidity management plans".

[34] In circumstances involving fraudulent wire transfers of customer funds facilitated by weak supervisory systems clearing firms have also been held responsible. In one such matter, Brad Bennett, FINRA Executive Vice President and Chief of Enforcement noted: "Ameriprise and its affiliated clearing firm missed numerous supervisory red flags, including the fact that two of the wired transfers went to accounts in Guelinas' (the brokers) in Maine. Firms must have robust supervisory systems to monitor and protect the movement of customer funds." ("FINRA Fines

Applicability of the Anti-Waiver Provisions of the Federal Securities Laws

Investors having an account with an introducing broker utilize the services of clearing brokers to clear their trading, initiate their account relationships by signing new account forms forming contractual relationships with both the introducing broker and the clearing broker. These agreements oftentimes contain various hold-harmless, as well as indemnification provisions with which clearing brokers have been known to raise as defenses to investor claims – but are they enforceable? The Anti-Waiver provisions of the Federal securities laws may tend to militate against such defenses.[35]

Counsel for Investors Should Thoroughly Review Their Clients' Potential Clearing Firm Claims

Far too often, counsel for victimized investors assume that clearing firms are one and the same with the introducing brokers and registered investment advisors that they serve. While they are oftentimes named as respondents in FINRA arbitration claims, establishing a case of liability against a clearing firm requires a detailed assessment of the underlying facts and circumstances of the case of alleged victimization. An understanding of the relationship between clearing brokers and introducing brokers, as well as an understanding of the relationship between registered investment advisors and/or registered representative/stockbrokers on the one side and clearing firms on the other side is essential to assessing a case of possible clearing firm liability. Clearing firms have successfully defended many claims brought against them and an assessment with an experienced securities professional and expert witness can be crucial in making a

---

Ameriprise and Clearing Firm $750,000 for Failing to Supervise Transmittal of Customer Funds to Third Party Accounts", FINRA Press Release March 4, 2013).

[35] The Anti-Waiver Provisions of the Federal Securities Laws render void any clause or contract purporting to constitute a waiver of compliance with the Federal Securities Laws (see Section 29(a) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78cc(a) "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.")

determination as to whether or not a clearing broker should be a named party in a customer claim.

Clearing Firms and the New Fiduciary Rule

As of this writing, it is not known whether or not the Fiduciary Rule will become effective relative to the obligation of broker dealers carrying IRA and other retirement type accounts.[36] With the looming onset of the Fiduciary Rule, however, a number of large self-clearing brokerage firms have made known that they will be moving various retirement-type accounts to mandatory wrap-fee arrangements. With customers who only transact one or two purchase or sale transactions in any given year in their retirement accounts be willing to pay wrap fees? Probably not. If fully implemented and enacted, the Fiduciary Rule could well see a favorable business opportunity for clearing firms serving smaller independent broker dealers who will continue with the transactional fees as opposed to mandatory wrap fees. In this environment, clearing brokers may well be positioned to afford these small investors cost effective access to the financial markets.

Clearing Firms and the New Paradigm

What is the future of clearing firms given their increasing interaction with the independent broker model brokers, registered investment advisors and trading partnerships, balanced against emerging technologies such as high frequency and block trading technology, blockchain encryption, and newly emerging trading platforms and nascent competing entities?[37]

---

[36] The Department of Labor Fiduciary Rule was originally scheduled to be phased in April 10, 2017 through January 1, 2018, expanding the definition "Investment Advice Fiduciary" as set forth under the Employee Retirement Income Security Act of 1974 (ERISA) to include Individual Retirement Accounts (IRA's). On February 3, 2017, President Trump signed an Executive Order delaying the implementation of this rule for 180 days.

[37] "Distributed Ledger Technology: Implications of Blockchain for the Securities Industry. A Report from the Financial Industry Regulatory Authority", January 2017. Distributed ledger technology, also known as blockchain and/or distributed database technology is currently being explored by Financial Services Industry as a way to bring

Some have suggested that blockchain encryption technology will revolutionize the definition of a clearing broker.[38] Trends in technology and transactions, including high-frequency trading, have served to commoditize the services provided by clearing firms, particularly in light of the cutthroat competition for trading and credit associated fees, charges and expenses and narrowing profit margins.[39]

Clearing firms are also facing competition from emerging trading modalities and platforms including Alternate Trading Systems, Electronic Communications Networks and dark pools.[40] These emerging economic and financial considerations notwithstanding, they do nothing to alter the role of the human element and the ongoing responsibility of clearing firms and their compliance and supervisory professionals to monitor the activities of their trading partners (introducing brokers) to whom they provide trading and credit access.[41]

One could argue that the accelerating pace of change requiring greater sophistication and expense in developing and maintaining order routing software, integrated bank and security accounts, the growing list of alternate trading facilities and the full complement of central

---

additional transparency and deficiencies and has the carrying to the prospect of a sea change for clearing firms, clearing arrangements and record keeping associated with securities transactions.

[38] Entities engaging in transactions involving securities in a digital ledger technology format may constitute a clearing agency for purposes of the registration requirements under Section 17A of the Exchange Act. See also FINRA Rule 4311.

[39] "A Day in the Quiet Life of an NYSE Floor Trader" D.M. Levine, **Fortune**, May 29, 2013. Suggesting that automated trading systems comprising 75% of all trades on the NASDAQ and New York Stock Exchange as of 2014. "84% of All Sock Trades are By High-Frequency Computers…Only 16% Are Done By Human Traders. George Washington, zerohedge.com April 26, 2012.

[40] Electronic Communication Networks fall under the general category of alternative trading systems and are required to register as broker dealers by the SEC. See also FINRA Regulatory Notice 15-51 (Alternative Trading Systems).

[41] For example, NASDAQ utilizes SMARTS, a sophisticated natural language processing and machine intelligence-based technology to monitor and surveil communications with an eye monitoring electronic communications to detect potential market manipulation and risky conduct. See "NASDAQ and Digital Reasoning Establish Exclusive Alliance to Deliver Holistic Next Generation Surveillance and Monitoring Technology". NASDAQ Press Release, February 23, 2016.

clearing counterparties to clear and custody the cash and securities will continue the consolidation of specialized clearing brokers. This allows the introducing brokers to utilize their intellectual and capital resources to focus on profit making opportunities, while leaving the bookkeeping details to someone else. These developments, however, do not permit clearing firms to abdicate their supervisory and compliance responsibilities.

The clearing business has and continues to evolve into a complex matrix of seemingly routine steps. Clearing brokers cannot rely on the traditional view that they just issue monthly statements and provide bookkeeping. They have become an integral part of and partner with the introducing brokers they service. The intertwining and bundling of these additional, emerging services open up new areas of exposure to clearing brokers requiring increased vigilance and potential liability to the actions of an introducing broker and by extension the potential harm caused to a public customer. All of these considerations aside, clearing firms are still required to exhaust their supervisory and compliance obligations pursuant to FINRA guidelines and SEC rules and regulations.

High Standards of Commercial Honor and Just and Equitable Principles of Trade – The Guiding Principle For Introducing and Clearing Brokers

The overriding guiding principle for FINRA member firms as set forth in the Duties and Conflicts chapter of the FINRA Manual is stated in Rule 2010 entitled Standards of Commercial Honor and Principles of Trade, this one sentence rule states:

> "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade".

Within this same chapter is Rule 2020 entitled "Use of Manipulative, Deceptive or Other Fraudulent Devices" which states:

> "No member shall affect any transaction, or induce the purchase or sale of, any security by means of any manipulation, deceptive or other fraudulent device or contrivance.

These rules, in addition to the aforementioned FINRA rules regarding supervisory and compliance obligations of all FINRA member firms, as well as the additional provisions specific to clearing firms, provide guidance to FINRA arbitration panels in fashioning a just and proper equitable award in claims of retail customers.

THE EQUITABLE RELIEF STANDARD

As noted by FINRA President Linda D. Fienberg:

PUBLIC STATEMENT BY LINDA D. FIENBERG
President of NASD (now FINRA) Dispute Resolution July 20, 2004

> "In SRO NASD arbitration, unlike in court, you get an equitable result. ***You do not have to have a claim that is cognizable under state or federal law; it can be cognizable under NASD rules***…So, for example, there is only one cause of acton under federal securities laws, that's for 10b, its very limited, it has a very short statute of limitations. The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law."[42]

Towards this end, FINRA arbitration panels are exhorted to pursue an equitable result in the claims they are presented with.

THE OVERRIDING CONCEPT OF EQUITY

FINRA arbitration panels are not wholly bound by law or rules formalistic evidence (Lentine v. Fundaro, 29 N.Y.2d 382, 328 N.Y.S.2d 418, 278 N.E.2d 633). Panels may apply these concepts, as well as the concept of equity, to the cases they decide (Matter of Sprinzen [Nomberg], 46 N.Y.2d 623, 631, 415 N.Y.S.2d 974, 389 N.E.2d 456; Gilmer v. Interstate/Johnson Lane Corp., 500 U.S.20, 111 S. Ct. 1647, 1655 (1991); See also Reliastar Life Ins. Co. of NY v. EMC National Life Co., 564 F. 3d 81 (2nd Cir. 2009); Matter of Port

[42] Speech by Linda D. Fienberg presented to the North American Securities Administrators Association Arbitration Forum (NASAA) on July 20, 2004 in Washington, D.C. www.connectlive.com/events/nasaa. President Fienberg retired as President of FINRA Dispute Resolution in November, 2014

Washington Union Free School Dist. v. Port Washington Teachers Assn., 45 N.Y.2d 411, 418, 408 N.Y.S.2d 453, 380 N.E.2d 280; Matter of Raisler Corp. [New York City Housing Auth.], 32 N.Y.2d 274, 283, 34 N.Y.S.2d 917, 298 N.E.2d 91).

WILL ARBITRATION BECOME OBSOLETE?

Probably not, but this era of commoditization of information and big data has served to only enhance the opportunity for the human element to engage in meaningful and protective supervisory and compliance reviews in the financial markets. Given the emerging trends in involving technology, transactions and job titles in the securities industry, both introducing firms and clearing firms can no longer turn a blind eye to wrongful conduct which they facilitate. These innovations will surely afford the securities industry and the customers they serve a more transparent and mutually beneficial and protective relationship.