Clearer Skies for Investors: Clearing Firm Liability Under the Uniform Securities Act*

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I. INTRODUCTION

Securities fraud poses a major threat to the financial security of millions of investors. Stock fraud and the brokerage firms perpetrating it thrive, bilking investors out of millions of dollars annually. The North American Securities Administrators Association (NASAA), an association comprised of state and regional securities regulators, estimates that investors lose $6 billion a year to investment fraud, including micro-cap stock fraud.[1] In 2000, Bradley Skolnick, the Indiana Securities Commissioner and former head of the NASAA, stated that boiler rooms were "the single greatest source of investment scams."[2] Yet defrauded investors are unlikely to recover funds lost to fraud, because these firms rarely operate with adequate reserves to pay settlements or awards.[3] Furthermore, the firms, their principals, and their brokers typically declare bankruptcy to avoid liability.[4]

Under these circumstances, it comes as no surprise that investors attempt to recover from the larger clearing firms that process trades for these smaller broker-dealers; often there is no one else to go to. In addition, the clearing firms play an important role in the fraud. The New

1. California Department of Corporations, *Micro-Cap Fraud*, *at* http://www.corp.ca.gov/pub/microcap.htm (last visited Oct. 21, 2002). Micro-cap stocks are typically shares of companies that are not well established and have only a small amount of shares in public hands. *Id.* Firms perpetrating micro-cap stock fraud are often referred to as "boiler rooms" or "bucket shops." JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 58 (5th ed. 1998).

2. Ken Berzof, *Unscrupulous 'Boiler Rooms' Aim to Burn the Investor*, COURIER-J. (Louisville), Feb. 28, 2000, at C1.

3. *See* N.Y. STATE ATT'Y GEN. BUREAU OF INVESTOR PROT. & SEC., REPORT ON MICRO-CAP STOCK FRAUD 15–16 (1997) [hereinafter REPORT ON MICRO-CAP STOCK FRAUD].

4. *See id.*

> Problem brokers have been likened to cockroaches, because when the lights are turned on by regulators, the brokers scatter and regroup somewhere else. . . .
>
> . . . [E]ven if . . . an award is made against a broker, the broker often gets the award discharged by filing for personally (sic) bankruptcy. Even if the award remains unpaid it is not a debarring circumstance for NASD licensure.

Id. Securities Investor Protection Corporation (SIPC) insurance coverage does not provide very much, if any, protection for investors. *See* Albert B. Crenshaw, *Group Assails Insurer of Investors*, WASH. POST, July 21, 1999, at E1; Gretchen Morgenson, *U.S. Report Faults Agency that Oversees Investor Claims*, N.Y. TIMES, June 22, 2001, at C1. Note that this problem has been ameliorated by the passage of the Corporate and Criminal Fraud Accountability Act of 2002, which makes debts incurred in violation of securities laws nondischargeable in bankruptcy. Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, § 803, 116 Stat. 745 (to be codified at 11 U.S.C. § 523(a)(19)).

York Attorney General's Office stated:

> Many of these firms use big-name clearing houses to carry out their activities. The clearing firms' policies and procedures regarding these smaller firms' practices frequently amount to a blind eye, or worse. . . .
>
> Micro-cap brokerage firms can only exist by processing their transactions through the road provided by the clearing firms. Existing regulatory "speed bumps" to prevent fraud have proven ineffective. It is time to re-examine the responsibilities and obligations of clearing firms in light of the widespread fraud involved in the telemarketing of low-priced stocks.[5]

In the past, investors typically lost these cases. Clearing firms argued successfully that even had they had actual knowledge of the fraud being perpetrated by the brokerage firm, they had no duty to do anything about it.[6] Recently, however, the tides have started to turn for investors attempting to hold clearing firms liable for the fraud of an introducing firm. A recent National Association of Securities Dealers (NASD) arbitration award has provoked controversy by finding secondary liability for the clearing firm Hanifen, Imhoff Clearing Corporation (now known as Fiserv Correspondent Services) for the fraud of the brokerage firm Duke & Company, under the state securities laws of California and Washington.[7] A federal district court in Oregon upheld the award, and the Ninth Circuit affirmed on appeal.[8] The antifraud section of the Washington statute is modeled on the Uniform Securities Act of 1956 (Uniform Act),[9] currently adopted in thirty-four states.[10] This Comment

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5. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 3.

6. The Securities and Exchange Commission (SEC) has brought successful enforcement actions against clearing firms; most notably, against Bear, Stearns in 1999, related to Bear, Stearns's clearing activities for A.R. Baron. *See generally* Bear, Stearns Sec. Corp., Exchange Act Release No. 41,707, 70 SEC No. 710 (Aug. 5, 1999). A.R. Baron engaged in widespread micro-cap stock fraud from 1992 to 1996. *Id*. at 712–14. The firm declared bankruptcy in 1996, shortly after the SEC issued a cease and desist order. *Id*. at 711 & n.2. The firm and many of its officers and employees were indicted for fraud, and most pled guilty to grand larceny and enterprise corruption. *Id*. at 712.

7. *See* Koruga v. Wang, No. 98-04276, 2000 WL 33534559 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.). For a discussion of the controversy, see John A. Byrne, *Another Regulatory Landmine for Traders*, TRADERS MAG., March 1, 2001, 2001 WL 9059572; and Gretchen Morgenson, *Striking a Blow for the Little Guy*, N.Y. TIMES, Feb. 11, 2001, § 3, at 1.

8. Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001), *aff'd*, No. 01-35295, 2002 WL 530548 (9th Cir. Apr. 5, 2002) (unpublished opinion).

9. *See* I LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 42 n.39, 74 n.114 (3d ed. 1998).

10. *Id*. at 42. A number of the states that have not adopted the Uniform Act have adopted antifraud provisions that are either similar to or broader than those portions of the Uniform Act. *Id.* at 73–76 & nn.114–16. Although California securities laws are not

argues that secondary liability under state blue sky laws that are modeled on the Uniform Act provides a viable theory under which clearing firms may be liable to investors for the fraud of an introducing firm.[11]

Part II of this Comment defines and describes the relationship between introducing and clearing firms, outlines the role of the clearing firm in the perpetuation of micro-cap stock fraud, and identifies arguments in favor of extending liability to clearing firms under some circumstances. Part III explains the impact of arbitration on securities fraud claims and illustrates the effect of recent arbitration awards holding clearing firms liable for the fraud of introducing firms. Part IV discusses existing federal law regarding secondary liability for clearing firms. Part V presents an analysis of the secondary liability provisions of the Uniform Act as they may be applied to clearing firms.

II. The Relationship Between Introducing Firms and Clearing Firms

A. Definitions and Roles

An "introducing firm" or "introducing broker" is a brokerage firm that deals directly with the public and originates customer accounts.[12] The introducing firm is engaged in the business of soliciting or receiving orders for transactions from customers and is the primary point of contact for the customer. Many introducing firms are small, with little in the way of capital.[13] Smaller firms are usually unable to process their own transactions from beginning to end due to the high costs involved.[14] They may not possess the expertise or technology necessary to process every aspect of a transaction.[15] As a result, introducing firms contract with clearing firms to do this work for them.

A "clearing firm" (also known as a "carrying broker" or "carrying firm")[16] is usually a large, well-capitalized brokerage firm that provides

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based on the Uniform Act, many of the fraud provisions are similar. *Id.* at 83–86.

11. This Comment will refer to the Uniform Securities Act of 1956, because the 1985 Act has not been adopted by many states. *Id.* at 42. The antifraud provisions of the 1985 Act are nearly identical, however. *Id.* at 71 n.108.

12. *See* Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 Bus. Law. 841, 841–43 (1993); *see also* William J. Fitzpatrick & Ronald T. Carman, *An Analysis of the Business and Legal Relationship Between Introducing and Carrying Brokers*, 40 Bus. Law. 47, 47 n.2 (1984) (providing a discussion of these terms, which are not explicitly defined in the regulations).

13. *See* Minnerop, *supra* note 12, at 842–43.

14. *Id.*

15. *Id.*

16. Clearing firms "carry" the accounts of introducing firms. *See* Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1 (2002).

a wide variety of services to the introducing firm.[17] These services can include:

> the maintenance of books and records; the receipt, custody, and delivery of customer securities and funds; the extension of credit to finance customer transactions in margin accounts; and . . . the execution of transactions on exchanges or on the over-the-counter markets. Most important, clearing firms "clear" transactions—paying for securities purchased and delivering securities sold in the accounts introduced to them . . . .[18]

The relationship between clearing firms and introducing firms is governed by contract, within the parameters set by the regulatory agencies.[19] The most common type of clearing agreement is the "fully disclosed" agreement.[20] In this type of agreement, the clearing firm sends out trade confirmation slips and statements directly to customers, whose names and addresses are disclosed to the clearing firm.[21] Customers are informed of the existence of the clearing firm, the clearing agreement, and the relative roles and responsibilities of the clearing and introducing firms.[22]

One of the most important functions played by clearing firms relates to the extension of credit. In most cases, the clearing firm commits to pay for purchases and to deliver securities for the introducing firm. If a customer does not pay for securities by the settlement date of the transaction, the clearing firm must provide the funds to pay for the trades.[23] The clearing agreement generally makes payment the responsibility of the introducing firm.[24] As a result, the clearing firm often extends credit to the introducing firm, which consequently "becomes a debtor of the clearing firm."[25] The clearing firm must gain

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17. *See* Minnerop, *supra* note 12, at 841, 844.
18. *Id.* at 841.
19. For a discussion of clearing agreements, see Fitzpatrick & Carman, *supra* note 12, at 47–52.
20. Minnerop, *supra* note 12, at 843. Other types of clearing agreements include "omnibus" agreements, where the clearing firm and the customers of the introducing firms have no knowledge of each others' identities, and "professional" clearing agreements, which do not involve public customers. *Id.* at 843 & n.7.
21. *Id.* at 843.
22. *See id*. These responsibilities are identified in NYSE Rule 382(b). NYSE CONSTITUTION AND RULES, 2 N.Y.S.E. Guide (CCH) ¶ 2382 (Aug. 31, 1999).
23. *See* NAT'L SEC. CLEARING CORP., RULES AND PROCEDURES, Rule 2, § 1, at 13 (Aug. 1, 2002), http://www.nscc.com/legal/nsccrules.pdf; *see also* Minnerop, *supra* note 12, at 844–45.
24. *See* Minnerop, *supra* note 12, at 845.
25. Bear, Stearns Sec. Corp., Exchange Act Release No. 41,707, 70 SEC No. 710, 715 (Aug. 5, 1999).

the approval of the New York Stock Exchange (NYSE) or NASD to extend credit,[26] and must keep records regarding the extension of credit. This includes, in the case of the NYSE, sending monthly reports of introducing firms whose requested settlement extensions exceed two percent of those firms' monthly transactions.[27]

B. The Growth of Clearing as a Business

The growth of clearing has its basis in a few significant rule changes.[28] In 1982, the SEC approved the NYSE rule changes that allowed clearing firms to allocate supervisory functions to introducing firms in the clearing agreement.[29] This rule change allowed clearing firms to assign supervisory responsibility to the introducing firms regarding compliance of their representatives with securities regulations.[30] The clearing agreement delineating the responsibilities of each of the parties must be filed with and approved by the NYSE.[31] The growth of the clearing business since 1982 has been attributed in large part to this rule change; clearing became easier and cheaper, because it now involved less risk to the clearing broker.[32]

Another development that impacted the growth of the clearing business was the introduction in 1975 of a lenient uniform net capital rule.[33] The net capital rule specified the amount of cash reserves a firm

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26. The NYSE and NASD are self-regulatory organizations (SROs) that govern their member firms. The Securities and Exchange Commission (SEC) must approve all NYSE and NASD rule changes and can suggest additional rule changes to the SROs. Securities Exchange Act of 1934 § 19(b)–(c), 15 U.S.C. § 78s(b)–(c) (2000). *See generally* VI LOSS & SELIGMAN, *supra* note 9, at 2715–32 (3d ed., rev. 2002) (discussing the rulemaking relationships between these organizations).

27. *See* NYSE Info. Memo No. 94–22, at 2 (June 10, 1994), *available at* 1994 NYSE Info. Memo LEXIS 51; NYSE Interp. Memo No. 97-4 (Aug. 28, 1997), 1997 NYSE Interp. Memo LEXIS 7, at *133.

28. See Minnerop, *supra* note 12, at 846–51, for a discussion of this issue.

29. Order Approving NYSE Proposed Rule Change, Exchange Act Release No. 18,497, 47 Fed. Reg. 8284 (Feb. 25, 1982). For a discussion of the 1982 changes to NYSE Rules 382 and 405, see also NYSE Info. Memo No. 82–18 (Mar. 5, 1982), *available at* 1982 NYSE Info. Memo LEXIS 57; and Minnerop, *supra* note 12, at 848–50.

30. *See* Order Approving NYSE Proposed Rule Change, Exchange Act Release No. 18,497, 47 Fed. Reg. at 8284. This rule change does not eliminate all liability from clearing firms, however. *See* Bear, Stearns Sec. Corp., 710 SEC at 715 (Aug. 5, 1999) ("[N]o contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under the federal securities laws and applicable SRO rules." (quoting Order Approving Proposed Rule Change, Exchange Act Release No. 18,497, 42 Fed. Reg. at 8284 n.2)).

31. NYSE CONSTITUTION AND RULES, Rule 382(a), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (Aug. 31, 1999).

32. Minnerop, *supra* note 12, at 846.

33. Net Capital Requirements for Brokers and Dealers, 17 C.F.R. § 240.15c3-1 (2002).

must have in order to engage in the securities business. Before the 1975 rule, each exchange set its own requirements, which were comparatively quite high. These exchange rules posed a substantial barrier to entry into securities markets. In 1975, the SEC set new net capital requirements at only $5000 for introducing firms that cleared through clearing firms with adequate capital on a fully disclosed basis.[34] Net capital requirements have since been increased to $100,000 for most introducing firms,[35] but even with these increases, the minimums are not difficult to meet. As a result of these lenient requirements, smaller firms are able to participate in the securities business as long as they clear their trades through an adequately capitalized clearing firm. The growth of the clearing business has been attributed to the easy entry into the market provided by lenient net capital requirements.[36]

Clearing has become a serious business. The number of introducing firms utilizing a clearing firm has grown from 564 in 1975 to 5030 in 2000,[37] and that number is expected to increase.[38] It is estimated that eighty-five percent of brokerage firms are introducing firms that utilize the services of a clearing firm.[39] Smaller, thinly capitalized firms are able to enter the market, utilizing the services of larger, well-capitalized clearing firms.

C. Clearing Firms and Micro-Cap Stock Fraud

1. Financial Responsibility

One sign of stock fraud that is readily apparent to clearing firms is the illegal behavior that introducing firms undertake in order to meet net capital requirements. As discussed above, the net capital requirement is $100,000 for most introducing firms of the type involved in micro-cap

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34. *Id.*; *see also* Minnerop, *supra* note 12, at 847–48.
35. 17 C.F.R. § 240.15c3-1(a)(2). The exact amount varies depending on the type of firm. The $100,000 requirement is for firms that clear customer transactions through another dealer (a clearing firm) but engage in market making activities of over-the-counter (OTC) stocks; this applies to most introducing firms engaging in this type of micro-cap stock fraud. *Id.*
36. Minnerop, *supra* note 12, at 846–48.
37. Brief of Amicus Curiae Securities Industry Association, Inc. at 5–6, Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001) (No. 00-1415 MA) (citing Henry F. Minnerop, *Recent Developments in the Regulation of Clearing Brokers*, 1 J. INVESTMENT COMPLIANCE 27, 32 (2000)).
38. *Id.*
39. *Id.*

stock fraud,[40] and includes limits on the amount any particular security can count toward meeting the requirements.[41] If a firm has a substantial concentration of a few securities, which is commonly the case with firms involved in micro-cap stock fraud, it must heavily discount the value of those securities when calculating its net capital.[42]

Introducing firms engaging in fraud utilize a number of strategies designed to work around the over-concentration requirements. The strategies generally involve temporarily converting securities to cash for the purpose of meeting the requirements. For example, introducing firms utilize a practice known as "parking."[43] To reduce the net capital requirements it would otherwise be subject to, the introducing firm executes a number of transactions every night, usually just before the markets close. The firm parks the securities in a third party's accounts, then moves the shares back to the firm's proprietary account the next morning. Another strategy is to execute unauthorized sales in customer accounts.[44] When the customer complains, the firm may buy the shares back, keep them in the customer's account despite the complaint, or sell them to another customer—with or without authorization.[45]

In addition, clearing firms often become aware of fraud through activities connected with the extension of credit.[46] As noted above, clearing firms are responsible for paying for purchases and delivering securities for the introducing firm. Customers often refuse to pay for these unauthorized trades.[47] The clearing firm must then either get approval from the introducing firm to cancel the trade or request a credit extension from the NYSE or the NASD.[48]

Clearing firms are required to keep records documenting credit extension

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40. 17 C.F.R. § 240.15c3-1(a)(2)(iii); *see supra* note 35.
41. 17 C.F.R. § 240.15c3-1(c)(2)(vi)(M).
42. *Id.*
43. The SEC described parking as follows:

> "Parking" refers to the practice of concealing stock ownership by placing the stock in the account of a third party, while secretly retaining the obligation to repurchase that stock at a future date. While persons may park stock for a variety of reasons[,] Baron parked stock to maintain the appearance of compliance with the Commission's net capital rules. . . . Because the securities in its proprietary accounts were exclusively house stocks, for which, in calculating net capital, a substantial haircut was required[,] Baron had a strong incentive to park those stocks before calculating net capital.

Bear, Stearns Sec. Corp., Exchange Act Release No. 41,707, 70 SEC No. 710, 714 n.6 (Aug. 5, 1999).

44. REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 39–40.
45. *Id.*
46. *Id.* at 82–85.
47. *Id*. at 82.
48. NYSE Info. Memo No. 94–22, at 2 (June 10, 1994), *available at* 1994 NYSE Info. Memo LEXIS 51; NYSE Interp. Memo No. 97-4 (Aug. 28, 1997), 1997 NYSE Interp. Memo LEXIS 7, at *133.

requests.[49] Repeated problems with unpaid purchases and canceled transactions suggest underlying fraud.[50] If the introducing firm goes under, the clearing firm is still obligated to make good on transactions and can incur substantial liability for trades for which the introducing firm has failed to pay.[51] As a result, the clearing firm has an interest in obtaining approval for extensions and prohibiting unauthorized trades.

Clearing firms often become aware of an introducing firm's fraud in connection with activities related to these financial responsibility standards.[52] Clearing firms that continue to allow introducing firms to operate after becoming aware of this behavior are important components of the fraudulent activity.[53] In the case of A.R. Baron, for example, the SEC found that Bear, Stearns had knowingly aided the introducing firm in its violation of the net capital requirements.[54] The SEC determined that Bear, Stearns knew, or was reckless in not knowing, that A.R. Baron engaged in unauthorized trading and parking of securities.[55] By continuing to clear trades for A.R. Baron, Bear, Stearns aided and abetted the violation of these requirements.[56]

2. Customer Complaints

Clearing firms may also become aware of the introducing firm's fraud through customer complaints. Customers often send complaints directly to clearing firms, especially after calls to their broker and the introducing

49. *Id.*
50. REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 85.
51. *See* NAT'L SEC. CLEARING CORP., *supra* note 23, Rule 2, § 1, at 13.
52. *See, e.g.*, Bear, Stearns Sec. Corp., Exchange Act Release No. 41,707, 70 SEC No. 710, 718 (Aug. 5, 1999) ("[C]lassic indications" of unauthorized trading and parking include "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 settlement at a loss."); s*ee also* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 84–85.
53. REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 74 ("In the world of levitating house stocks a clearing broker that will extend credit and execute trades when a micro-cap brokerage firm has no capital is a great ally.").
54. Bear, Stearns Sec. Corp., 710 SEC at 726–27.
55. *Id.*
56. There is no private right of action for aiding and abetting under federal securities laws. *See* discussion *infra* Part III. The SEC can bring these actions, however, as a result of 1995 legislation amending section 20 of the Securities Exchange Act of 1934. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, §104, 109 Stat. 757 (1995) (codified as amended at 15 U.S.C. § 78t(e) (2000)).

firm prove ineffective.[57] In 1999, the SEC approved amendments to NYSE Rule 382 and NASD Rule 3230 that increase the responsibilities of clearing firms regarding the reporting of customer complaints.[58] Prior to the amendments, the clearing firm often ignored customer complaints, referring the customer back to the introducing firm.[59] Clearing firms even ignored customer requests to halt all trading in their accounts as a result of unauthorized trading.[60] The new rules require the clearing firm to send customer complaints both to the introducing firm and to the appropriate self-regulatory organization (SRO) as well as notify the customer in writing that the complaint has been submitted to these parties.[61]

3. *History of Illegal or Suspicious Activity*

Many clearing firms have reason to believe that an introducing firm may perpetrate micro-cap stock fraud before the firm even opens its doors; performing due diligence on an introducing firm before beginning a clearing relationship, a common industry practice, can uncover a history of illegal activity by the principals or brokers.[62] Firms like Merrill Lynch regularly look into the prior practices, disciplinary history, and regulatory actions of a firm and its principals and brokers prior to entering into a clearing agreement.[63] This type of due diligence often uncovers indications that a firm may engage in fraudulent behavior.[64] For example, an Oregon arbitration panel found that the clearing firm Hanifen, Imhoff Clearing Corporation (Hanifen) had actual knowledge that the principals and salespeople of Duke & Company had been involved in fraudulent activities while at the firm Stratton Oakmont.[65]

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57. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 71–72.

58. *See* Clearing Agreements, Exchange Act Release No. 34-41468, 64 Fed. Reg. 31,024, at 31,025 (June 2, 1999) (approving NASD rule changes); Carrying Agreements, Exchange Act Release No. 34-41464, 64 Fed. Reg. 31,338 (June 2, 1999) (approving NYSE rule changes).

59. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 71–72.

60. *See id.*

61. NYSE CONSTITUTION AND RULES, Rule 382(a), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (Aug. 31, 1999). NYSE member firms are subject to the guidelines provided by the NYSE. NASD member firms are subject to NASD rules.

62. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 78–80.

63. *See id.* at 78.

64. *See id.* at 79.

65. Koruga v. Wang, No. 98-04276, 2000 WL 33534559, at *9 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.). Stratton Oakmont was permanently expelled from the securities industry in 1996 after engaging in widespread micro-cap stock fraud for many years. Dist. Bus. Conduct Comm. for Dist. No. 10 v. Stratton Oakmont, Inc., Complaint No. C10950081, 1996 NASD Discip. LEXIS 52, at *55 (N.A.S.D. Dec. 5, 1996).

D. Why Clearing Firms Should Be Liable for Fraud

Micro-cap stock fraud follows a familiar pattern—the introducing firm engages in market manipulation, unauthorized trading, parking of securities, excessive trading, or refusing to execute sell orders.[66] The clearing firm ignores customer complaints, often referring the investors back to the introducing firm, who generally has already failed to respond to that same complaint.[67] The clearing firm is well aware that the broker's activities look fraudulent.[68] It continues to extend credit and facilitate transactions that assist the introducing firm in meeting its net capital requirements, knowing that if it fails to do so, the introducing firm will go under and will be unable to pay money owed to the clearing firm. The clearing firm does these things, apparently secure in the belief that it will not be held liable for the securities fraud perpetrated by the introducing firm—even if it knows of the fraud, and even if it assists the introducing firm in its commission.[69]

The signs of securities fraud are apparent to clearing firms.[70] Protecting investors is a primary goal of securities laws.[71] Allowing clearing firms to continue to process transactions for an introducing firm under these circumstances runs counter to the need to protect investors. In fact, the current industry-wide belief that clearing firms will not be held liable for knowingly assisting an introducing firm's fraud has encouraged clearing firms to turn a blind eye to fraud.[72] Imposing liability on clearing firms that have reason to know of securities fraud serves a powerful deterrent function.

Clearing firms should be liable for the fraud of introducing firms because most victims of securities fraud have no other recourse. A

66. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 33–44.
67. *See id.*
68. *See id.*
69. *Koruga*, 2000 WL 33534559, at *9.
70. REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 72–73, 85; *see also* Gary Weiss, *How the SEC Is Passing the Buck on Microcaps*, BUS. WK., May 18, 1998, at 150 (stating that clearing firms "often are the first to see the 'red flags' of stock fraud").
71. *See* Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 296 (1993).
72. *See, e.g.*, Koruga v. Wang, No. 98-04276, 2000 WL 33534559, at *22 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.) (noting that clearing firm Hanifen's position was that it would be unfair to impose liability, because the clearing firm believed that the law insulated them from liability).

recent article in *Barron's*, recounting a conversation with Barry Goldsmith, executive vice president of enforcement for the NASD, stated: "Most victims of securities fraud never see a dime in restitution . . . because firms go out of business or 'morph into something else.'"[73] Individual brokers and control persons typically declare bankruptcy.[74] A select few are criminally prosecuted. Most firms have no assets once the fraud is uncovered.[75] Firms withdraw from registration as broker-dealers, often reopening under different names.[76] One 1998 analysis of the SEC penalty collection rate showed that the SEC "collects only about half of the financial penalties it imposes on securities-law violators, leaving $2.5 billion uncollected over the past 13 years."[77] The article goes on to add that "[a]mong the biggest nonpayers are some major alleged purveyors of small-stock fraud."[78] Firms often declare bankruptcy after being hit with a judgment.[79] This 1998 report focused on the SEC collection rate for its own financial penalties, but the same issues are exacerbated in the collection of civil judgments.

Industry members argue that if liability is imposed on clearing firms, the costs of clearing will go up dramatically.[80] These costs will be passed on to introducing firms and customers, driving up the cost of doing business, and putting smaller firms out of business.[81] However, it is unclear whether the types of activities necessary to avoid liability under an aiding and abetting theory would prove unduly costly. In fact, many clearing firms already have internal processes in place that are likely to satisfy any additional requirements.[82] In any case, rather than viewing additional costs as a burden on individual investors and small firms, it is important to realize that clearing firms are in an ideal position to spread the costs of due diligence to their customers—which may be preferable to imposing the cost of noncompliance on the individual victims of securities fraud. It is not at all clear that the individual costs to defrauded investors are lower than the costs of due diligence by clearing firms.[83]

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73. Jim McTague, *Naughty, Naughty*, BARRON'S, Sept. 3, 2001, at 31.
74. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 2–3.
75. *See id*.
76. *See id*. at 2–3, 66–69.
77. Michael Schroeder, *SEC Collects Only Half Its Financial Penalties*, WALL ST. J., Aug. 26, 1998, at A3.
78. *Id.*
79. *Id.*
80. *See* Brief of Amicus Curiae Securities Industry Association, Inc. at 16–17, Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001) (No. 00-1415 MA).
81. *See id.*
82. *See* REPORT ON MICRO-CAP STOCK FRAUD, *supra* note 3, at 78–79.
83. *See generally* John M. Bellwoar, Note, *Bar* Baron *at the Gate: An Argument*

Finally, clearing firms benefit financially from the fraud by continuing to process trades for broker-dealers engaged in fraudulent activity. Clearing is an extremely profitable business for large broker-dealers.[84] Clearing firms that continue to extend credit, or fail to report introducing firms after becoming aware that they are not satisfying their net capital requirements legitimately, help those firms stay in business in violation of securities laws. The introducing firms are then able to perpetrate more violations. By keeping the introducing firm in business, the clearing firm is attempting to salvage its own financial position relative to the introducing firms at the expense of the broker's customers. Under these types of circumstances, it seems reasonable to extend liability to clearing firms.

III. THE *KORUGA* ARBITRATION AWARD

In the past few years, there has been a quiet revolution in arbitration awards—arbitration panels have been finding clearing firms liable for the fraud of their introducing firms. Arbitration panels rarely, if ever, provide explanations for their awards, so the legal grounds for such awards are often unclear. However, in October 2000, an arbitration panel in Oregon cleared the air by finding the clearing firm Hanifen, Imhoff Clearing Corporation (now known as Fiserv Correspondent Services) secondarily liable for the fraud of the boiler room Duke & Company, and perhaps more importantly, by issuing a lengthy arbitration award identifying what the panel viewed as the successful legal theories of liability based on the securities laws of Washington and California.[85] A U.S. district court upheld the award, and the Ninth Circuit Court of Appeals affirmed.[86]

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for Expanding the Liability of Securities Clearing Brokers for the Fraud of Introducing Brokers, 74 N.Y.U. L. REV. 1014 (1999) (arguing in favor of imposing liability based on economic efficiency).

84. As one journalist aptly stated: "For large brokerages, the clearing business is a cash cow." Gary Weiss, *Clearing Firm, Clear Thyself*, BUS. WK., July 7, 1997, at 120.

85. Koruga v. Wang, No. 98-04276, 2000 WL 33534559, at *1 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.).

86. Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245, 1248 (D. Or. 2001), *aff'd*, No. 01-35295, 2002 WL 530548 (9th Cir. Apr. 5, 2002) (unpublished opinion). Due to the liberal standard of review given to arbitration awards, a district court is unlikely to vacate an award, and an appeals court is unlikely to overturn a district court decision. A district court may vacate an award if it is completely irrational, procured by fraud or corruption, or if the panel was aware of the applicable law and yet completely ignored it. Federal Arbitration Act, 9 U.S.C. § 10 (2000); *see also* United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 40 (1987); Decker v. Merrill

Although arbitration awards have no precedential value[87]—they are not produced by courts of law—the *Koruga* award has generated a considerable amount of controversy.[88] Arbitration panels often look to the decisions of other panels for guidance. In fact, the *Koruga* panel stated: "We hope our willingness to take on this task will encourage future NASD panels to be more forthcoming, so that a body of meaningful precedents, interpreting the securities laws of various states, may become available . . . ."[89] Indeed, the Securities Industry Association (SIA), an industry trade group, has gone so far as to request that the explanation of the award be struck.[90] This suggests a general awareness by industry members that other panels may be more likely to issue similar awards if attorneys and arbitrators are able to use the *Koruga* explanation to support their positions.

Historically, securities fraud cases have been brought under section 10(b) of the Exchange Act of 1934 (section 10(b))[91] and SEC Rule 10b-5 (Rule 10b-5)[92] (implementing section 10(b)). In 1994, the Supreme Court eliminated what had been an implied private right of action for aiding and abetting under section 10(b) with its decision in *Central Bank of Denver v. First Interstate Bank of Denver*.[93] Prior to 1994, plaintiffs and claimants were able to argue that clearing firms had aided and abetted the fraud of introducing firms, although satisfying the elements of the cause of action was difficult. Now that there is no federal civil liability for aiding and abetting, the *Koruga* award presents us with new ways to think about clearing firm liability.

IV. LIABILITY FOR SECURITIES FRAUD UNDER THE SECURITIES EXCHANGE ACT OF 1934

A. Primary Liability

In 1933 and 1934, Congress enacted two major pieces of securities legislation: the Securities Act of 1933 (1933 Act)[94] and the Securities

Lynch, Pierce, Fenner & Smith, Inc., 205 F.3d 906, 909 (6th Cir. 2000); Todd Shipyards Corp. v. Cunard Line Ltd., 943 F.2d 1056, 1060 (9th Cir. 1991).

87. *See* DAVID ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL 589 (3d ed. 1998).

88. *See, e.g.*, Byrne, *supra* note 7 (discussing the controversy); Morgenson, *supra* note 7, at § 3, at 1.

89. *Koruga*, 2000 WL 33534559, at *12.

90. Brief of Amicus Curiae Securities Industry Association, Inc. at 1, *Koruga*, 183 F. Supp. 2d at 1245 (No. 00-1415 MA).

91. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)).

92. 17 C.F.R. § 240.10b-5 (2001).

93. 511 U.S. 164 (1994).

94. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77bbbb (2000)).

Exchange Act of 1934 (1934 Act).[95] The 1933 Act regulates the primary market (the initial distribution of securities), whereas the 1934 Act regulates the secondary markets and the postdistribution trading of securities.[96]

There are a number of different provisions in both Acts relating to securities fraud, but the majority of fraud claims against broker-dealers are brought under section 10(b) of the 1934 Act. Section 10(b) states, in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . .[97]

This section is not self-operative; the "manipulative or deceptive device or contrivance" must be in violation of some other rule or regulation established by the SEC. The SEC has established a number of such rules under section 10(b), including Rule 10b-5.

Rule 10b-5 identifies the specific practices that constitute a violation of section 10(b):[98]

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any facility of any national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[99]

Although section 10(b) does not expressly contain a private right of action whereby private plaintiffs can sue for damages, courts have been

95. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)).
96. The 1934 Act was designed "to deter fraud and manipulative practices in the securities markets." Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 296 (1993) (quoting Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986)).
97. 15 U.S.C. § 78j.
98. 17 C.F.R. § 240.10b-5 (2001). For an account of the adoption of Rule 10b-5 in 1942, see IX LOSS & SELIGMAN, *supra* note 9, at 4383–84 (3d ed. 1992).
99. 17 C.F.R. § 240.10b-5 (2001).

implying civil liability for violations of the statute for many years.[100]

As a result of the broad language of section 10(b) and Rule 10b-5, a large body of federal common law has developed to limit section 10(b) and bring it in line with common law fraud claims.[101] In order to prevail in a section 10(b) action, the plaintiff must prove the following: that (1) the defendant made an untrue statement of material fact, (2) the conduct occurred in connection with the purchase or sale of a security, (3) the defendant made the statement or omission with scienter,[102] (4) the plaintiff relied on the misrepresentation or omission,[103] and (5) the plaintiff suffered damage as a result.[104]

It is difficult to establish a clearing broker's primary liability for securities fraud under section 10(b). Primarily liability requires that the plaintiff establish the direct participation of the clearing firm in the scheme to defraud and that the clearing firm "directly and knowingly participated in the deceptive or manipulative conduct that caused damage to the Plaintiffs."[105] If a plaintiff can establish that a clearing firm is "itself engaged in the kind of manipulative conduct that Section 10(b) prohibits,"[106] primary liability to the plaintiff can also be established. However, in most cases of securities fraud, clearing firms only participate in the fraud by not preventing the introducing firm from perpetrating it, not informing the customers of the introducing firm of the fraud, or benefiting from the ongoing business of the introducing firm.[107]

In order for an omission to constitute a primary violation, the plaintiff must establish that the clearing firm had a fiduciary duty to the customer of the introducing firm.[108] Failure to inform customers of the fraud, or failure to prevent the introducing firm from engaging in fraudulent activities, is not by itself sufficient to establish direct participation in the absence of a fiduciary duty.[109]

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100. For a discussion, see *Central Bank*, 511 U.S. at 171; and IX LOSS & SELIGMAN, *supra* note 9, at 4383 n.434 (3d ed. 1992). Note that a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." *Central Bank*, 511 U.S. at 173.

101. *See* VII LOSS & SELIGMAN, *supra* note 9, at 3488–89 (3d ed. 1991).

102. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (stating that the standard cannot be negligence); *In re* Blech Sec. Litig., 961 F. Supp. 569, 582 (S.D.N.Y. 1997).

103. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 243 (1988).

104. *See* Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992); *In re Blech Sec. Litig.*, 961 F. Supp. at 582; Connolly v. Havens, 763 F. Supp. 6, 10 (S.D.N.Y. 1991) (citing Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1015 (2d Cir. 1989)).

105. *In re Blech Sec. Litig.*, 961 F. Supp. at 582.

106. *Id.* at 583.

107. *See* discussion *supra* Part II.C.

108. Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990).

109. *Id.*

The fiduciary duty requirement is a major hurdle to finding a clearing firm primarily liable for an introducing firm's fraud. In *Connolly v. Havens*,[110] a New York district court held that even if the plaintiffs could establish the clearing firm's direct participation in the fraud, the primary liability claim would still fail because "[i]t is well-established that a clearing firm . . . does not have a fiduciary relationship with the customers . . . of the introducing broker with which it has contracted to perform clearing services."[111] As a result of this failure to establish a fiduciary duty, the primary liability claim did not survive the clearing firm's motion for summary judgment.[112]

B. Control Person Liability

Control person liability is a form of secondary liability for securities fraud. Section 20(a) of the 1934 Act establishes joint and several liability for those persons who control the persons committing the fraud:

> Every person who, directly or indirectly, controls a person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[113]

Rule 12b-2 clarifies that control person liability may exist where the person has "the power to direct or cause the direction of the management and policies of a person."[114] Courts have regularly held that control person liability does not apply to clearing firms.

There is a circuit split regarding the proper test for control person liability.[115] Under any test, however, the nature of the post-1982 relationship between clearing firms and introducing firms makes it difficult to establish that the clearing firm had the power or ability to control the introducing firm.[116] For example, the ability to refuse to

110. 763 F. Supp 6 (S.D.N.Y. 1991).
111. *Id.* at 10.
112. *Id*. at 11.
113. 15 U.S.C. § 78t(a) (2000).
114. 17 C.F.R. § 240.12b-2 (2001).
115. *See* Gerald B. Kline & Raymond L. Moss, *Liability of Clearing Firms: Traditional and Developing Perspectives*, *in* 2 SECURITIES ARBITRATION 1998: REDEFINING PRACTICES AND TECHNIQUES 147–49 (PLI Corporate & Practice Course, Handbook Series No. B-1062, 1998).
116. *See generally* Dillon v. Militano, 731 F. Supp 634 (S.D.N.Y. 1990). *See also*

process trades has not been sufficient to establish control person liability.[117]

Prior to 1982, the NYSE allocated supervisory responsibilities to clearing firms. In 1982, NYSE Rules 382 and 405 were changed so as to eliminate the clearing firm's supervisory responsibilities over the agents of the introducing firm,[118] effectively eliminating the clearing firm's exposure to control person liability. Since 1982, clearing firms have continually argued that they perform no supervisory or oversight functions.[119]

A few courts have found clearing firms liable under section 20(a), but these tend to be older decisions.[120] Though this type of argument is out of favor today, some plaintiffs' attorneys argue that under the current NYSE Rule 382, clearing firms have to provide regulators with information regarding the introducing firm, including customer complaints. Accordingly, they argue, clearing firms have an implied duty to monitor the behavior of introducing firms.[121] However, the NYSE explicitly states that current reporting obligations "further clarify the relationship and responsibilities between introducing and carrying organizations without altering the fundamental carrying/clearing contractual relationship."[122] Because the duty under section 20(a) did not exist before the rule changes, a new duty will not be established under the new rule.

C. Aiding and Abetting Liability

In 1994, the United States Supreme Court changed the face of securities litigation with its decision in *Central Bank of Denver v. First Interstate Bank of Denver*.[123] In a five-to-four decision, the Supreme Court held that "a private plaintiff may not maintain an aiding and

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In re Blech Sec. Litig., 961 F. Supp. 569, 586–87 (S.D.N.Y. 1997) (stating that affecting the actions of an introducing firm is not sufficient to establish that the clearing firm directed them).

117. *See* Carlson v. Bear, Stearns & Co., 906 F.2d 315, 318–19 (7th Cir. 1990); Damato v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 878 F. Supp. 1156, 1160 (N.D. Ill.1995).

118. *See* Minnerop, *supra* note 12, at 848–50.

119. *See, e.g.*, Neiman v. Clayton Brokerage Co. of St. Louis, Inc., 683 F. Supp. 196, 201–02 (1988).

120. *See, e.g.*, Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104, 122–23 (W.D. Ark. 1949) (holding that the clearing firm controlled the introducing firm by way of the clearing agreement, because the clearing firm identified policies regarding the way business was to be conducted); *see* Philip M. Aidikoff et al., *Clearing Firm Liability: A Forward Looking Analysis*, *in* SECURITIES ARBITRATION 1998: REDEFINING PRACTICES AND TECHNIQUES, *supra* note 115, at 118–24 (discussing older cases finding liability under control person theory), WL 1062 PLI/Corp 113.

121. *See* Aidikoff et al., *supra* note 120, at 135.

122. NYSE Info. Memo No. 99–33, at 4 (July 1, 1999), *available at* 1999 NYSE Info. Memo LEXIS 28.

123. 511 U.S. 164 (1994).

abetting suit under § 10(b)."[124] Prior to the *Central Bank* decision, every circuit had recognized a private cause of action against aiders and abettors under section 10(b).[125] Although this decision eliminated federal aiding and abetting liability for securities fraud, the test for liability—and its application to clearing firms—is still very important, because some states have interpreted their own secondary liability provisions by reference to the federal standard.[126]

Though the interpretation of the test varied by circuit,[127] the three-part test required that the plaintiff establish: (1) a primary violation of section 10(b), (2) actual knowledge or recklessness as to the existence of the primary violation,[128] and (3) "substantial assistance" of the violation.[129] Substantial assistance required a "substantial causal connection between the culpable conduct of the alleged aider and abettor and the harm to the plaintiff . . . ."[130] The elements of knowledge and substantial assistance were analyzed in reference to one another.[131] Both elements posed problems with regard to clearing firm liability for securities fraud.

The scienter requirement presented a high hurdle for plaintiffs attempting to impose liability on clearing firms. Most courts required that the aider have knowledge of the primary violation,[132] although there

124. *Id.* at 191.

125. *Id.* at 192. Legislation enacted in 1995 gave the SEC the ability to bring aiding and abetting actions, but Congress decided not to extend this ability to private litigants. *See supra* note 56.

126. *See, e.g.*, Foley v. Allard, 427 N.W.2d 647, 650 (Minn. 1988).

127. Most of the circuits based their version of the test on the *Restatement (Second) of Torts* formulation. *Central Bank*, 511 U.S. at 194. The Tenth Circuit formulation was followed by the lower court in *Central Bank*. *Id*. at 168.

128. At the time *Central Bank* was decided, there was a circuit split as to whether the standard was knowledge, recklessness, awareness of, or intent to further the primary violation. Generally, the more substantial the assistance, the lower the applicable scienter standard. *See* Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 727–39 (1997–1988). Because of the *Central Bank* decision, this issue was never resolved.

129. *Central Bank*, 511 U.S. at 168; *see also* First Interstate Bank of Denver v. Pring, 969 F.2d 891, 898 (10th Cir. 1992).

130. Metge v. Baehler, 762 F.2d 621, 624 (8th Cir. 1985) (quoting Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1084 (N.D. Cal. 1979)).

131. *See* Bromberg & Lowenfels, *supra* note 128, at 729. As one court stated, these two elements should not "be considered in isolation, but rather should be considered relative to one another." *Metge*, 762 F.2d at 624 (citing Stokes v. Lokken, 644 F.2d 779, 784 (8th Cir. 1981)).

132. *See* Bromberg & Lowenfels, *supra* note 128, at 670–71; *see also* Connolly v. Havens, 763 F. Supp. 6, 10–11 (S.D.N.Y. 1991).

were significant differences in the interpretation of this requirement.[133] In the absence of a fiduciary duty, most courts required at least actual knowledge of the fraud and, more frequently, intent to defraud.[134] This requirement led to unsuccessful results for plaintiffs who argued that a clearing firm aided the fraud by failing to stop clearing trades or failing to notify the plaintiff of the fraud. As with primary liability claims, clearing firms were able to argue that they had no independent duty to the customer.[135] In the absence of a fiduciary duty, courts required more than actual knowledge of the primary violation—something closer to conscious intent to participate in the fraud.[136] In effect, this type of requirement blurred the distinction between primary and secondary liability.

In order to establish the substantial assistance element of aiding and abetting, the plaintiff had to show that the clearing firm went beyond its normal clearing duties or that the clearing firm had a fiduciary duty to the customer of the introducing firm, which it violated by its inaction, omission, or silence.[137] Neither of these was easy to establish. District courts interpreting this section typically treated performance of standard clearing firm responsibilities as ministerial or clerical in nature and not sufficient to establish substantial assistance.[138] For example, in *Ross v. Bolton*,[139] a district court held that clearing trades and loaning money to the alleged primary violator were not sufficient to establish substantial assistance because "[a]wareness and approval, standing alone, do not constitute substantial assistance."[140] Instead, courts required that something more than "ordinary business activity" be present.[141] Under this definition of substantial assistance, it was easy for a clearing firm to argue successfully that even if it had actual knowledge of the fraud, continuing to clear trades and extend credit constituted only normal business activity. The difficulty of establishing a fiduciary duty to customers has already been discussed; the same issues arise in this context as well.

Prior to the 1982 changes to NYSE Rules 382 and 405, plaintiffs could establish the duty element with less difficulty and, as a result, could demonstrate aiding and abetting liability more easily. In the 1970

133. *See* Bromberg & Lowenfels, *supra* note 128, at 670–700.

134. *Id* at 671.

135. Stander v. Fin. Clearing & Servs. Corp, 730 F. Supp. 1282, 1286 (S.D.N.Y. 1990); Antinoph v. Laverell Reynolds Sec., Inc., 703 F. Supp. 1185, 1188 (E.D. Pa. 1989); Ross v. Bolton, 639 F. Supp. 323, 327 (S.D.N.Y. 1986).

136. Bromberg & Lowenfels, *supra* note 128, at 728.

137. *Id.* at 727–39.

138. *See, e.g.*, Dillon v. Militano, 731 F. Supp. 634, 638 (S.D.N.Y. 1990); *Antinoph*, 703 F. Supp. at 1189.

139. 639 F. Supp. 323 (S.D.N.Y. 1986).

140. *Id.* at 327.

141. Bromberg & Lowenfels, *supra* note 128, at 723.

SEC opinion, *D.H. Blair & Co.*,[142] the SEC imposed on clearing firms "an independent obligation to make appropriate inquiry and take prompt steps to terminate any participation in activity violative of the securities laws."[143] Conceivably, failure to satisfy this obligation could constitute a duty sufficient to establish liability for aiding and abetting an introducing firm's fraud.[144]

Following the 1982 NYSE rule changes, however, the clearing firm's role and obligations changed. In *Stander v. Financial Clearing & Services Corp.*,[145] a New York district court noted that "the simple providing of normal clearing services to a primary broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker."[146] Because the introducing and clearing brokers had executed a clearing agreement—making the introducing firm responsible for supervisory functions required under NYSE Rule 405,[147] as permitted by NYSE Rule 382[148]—the court was unwilling to "find that Rule 405 imposes any fiduciary duty upon [the clearing firm] under the circumstances of this case."[149]

In any case, with the demise of the implied aiding and abetting cause of action, there is no longer a federal civil action for secondary aiding and abetting liability. Following the *Central Bank* decision, many predicted that courts and arbitration panels would extend primary liability to more circumstances than had previously been covered by

142. 44 S.E.C. 320 (1970).
143. *Id*. at 328.
144. *See* Cannizzaro v. Bache, Halsey Stuart Shields, Inc., 81 F.R.D. 719, 721 (S.D.N.Y. 1979). *See generally* Margaret Hall Found., Inc. v. Atl. Fin. Mgmt., Inc., 572 F. Supp. 1475 (D. Mass. 1983); Faturik v. Woodmere Sec., Inc., 442 F. Supp 943 (S.D.N.Y. 1977). It is unclear whether the duty owed was to the customer as well as to the regulators. *See* Fitzpatrick & Carman, *supra* note 12, at 61 (arguing that the courts misunderstood the nature of the requirement when interpreting this section as involving a duty to the customer).
145. 730 F. Supp. 1282 (S.D.N.Y. 1990).
146. *Id*. at 1286.
147. NYSE CONSTITUTION AND RULES, Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405 (Aug. 31, 1999).
148. NYSE CONSTITUTION AND RULES, Rule 382, 2 N.Y.S.E. Guide (CCH) ¶ 2382.
149. *Stander*, 730 F. Supp. at 1287. The *Stander* court did not deal with the kinds of stock fraud described earlier; instead, the case involved excessive and unsuitable trading in a customer account perpetrated by an individual broker employed by the introducing firm. The case turned on whether the clearing firm had the duty to monitor or supervise the individual broker. Because the clearing agreement clearly delegated the supervision of individual brokers to the introducing firm, the court found no liability for the clearing firm. *Id*.

aiding and abetting liability.[150] However, this extension has not materialized.[151] As a result of these developments, the answer to clearing firm liability for the fraud of introducing firms is not likely to be found in primary violations of federal securities laws.

V. SECONDARY LIABILITY FOR CLEARING FIRMS UNDER THE UNIFORM SECURITIES ACT OF 1956

A. Problems Regarding the Development of Case Law

One of the issues facing arbitration panels that hear cases involving clearing firms is the relative lack of post-*Central Bank* case law, in both the federal and the state arena. Ever since the Supreme Court upheld mandatory arbitration for nearly all customer claims against brokers in *Shearson/American Express, Inc. v. McMahon*,[152] the vast majority of cases have gone to arbitration as opposed to federal or state court.[153] Because arbitration awards do not have precedential value and very few cases make it into the court system, there has been very little, if any, development of the law.[154]

A second, related problem with the development of the law in this area is that even when arbitration panels have been willing to extend liability to clearing firms, they are not required to, and rarely do, provide any kind of explanation for their decision.[155] As a result, future arbitration panels that might consider extending liability have no real guidance as to how this might be done and cannot feel confident that their decision is consistent with those of other panels.

Arbitration awards can be appealed to U.S. district courts; courts typically uphold the awards because as long as some theory of liability

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150. *See, e.g.*, S. Scott Luton, *The Ebb & Flow of § 10(b) Jurisprudence: An Analysis of Central Bank*, 17 U. ARK. L. J. 45, 47 (1994).

151. *See* Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1300–03 (1999) (discussing circuit splits regarding the extension of primary liability to "outside professionals"); 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, 46 (1997) (addressing line drawing between primary and secondary liability).

152. 482 U.S. 220, 242 (1987).

153. Koruga v. Wang, No. 98-04276, 2000 WL 33534559 at *10 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.).

154. *Id.* at *11.

155. Arbitration awards are typically a few paragraphs long and simply state who is liable and for how much. Most do not even attempt to justify the award. *See, e.g.*, GMS Group, L.L.C. v. Herbert J. Sims & Co., No. 00-05205, 2002 WL 31058232 (N.A.S.D. Aug. 8, 2002); Rothberg v. Acument Sec., Inc., No. 01-03023, 2002 WL 1948217 (N.A.S.D. Aug. 6, 2002).

makes the award possible, there is no "manifest disregard of the law."[156] In general, the only real authority provided by these decisions is that district courts are willing to hold that clearing firms can conceivably be found liable for something. These types of decisions are better than nothing; plaintiffs' attorneys often rely on them when arguing in favor of expanding liability. However, the decisions do not provide the kind of body of case law available in other areas of law. Since the demise of aiding and abetting liability under section 10(b) and the enforcement of mandatory arbitration clauses in customer agreements, there has been very little case law testing the extent of secondary liability under state law.

B. The Content of the Uniform Securities Act of 1956

The Uniform Act states that there is a private right of action for all fraud claims brought under it.[157] Section 101 is similar to Rule 10b-5:

> It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud,
> (2) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[158]

Section 410 of the Uniform Act limits civil enforcement to buyers of securities.[159] Section 410(b) of the Uniform Act identifies the persons liable under section 101, and provides for a right of contribution:

> Every person who directly or indirectly controls a seller liable under subsection (a), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale, and *every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the non-seller who is so liable sustains the burden of proof that he did not know, and in exercise of reasonable care could not have known, of the*

156. Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056, 1060 (9th Cir. 1991). *See generally* Federal Arbitration Act, 9 U.S.C. § 10 (2000) (providing the law governing the vacation of arbitration awards by courts).
157. UNIF. SEC. ACT § 410 (amended 1958), 7C U.L.A. 266 (2000).
158. *Id.* § 101, 7C U.L.A. 110.
159. *Id.* § 410, 7C U.L.A. 266.

> *existence of the facts by reason of which the liability is alleged to exist.* There is contribution as in cases of contract among the several persons so liable.[160]

Three elements must be established in order to show that section 410(b) applies to a particular defendant: (1) a primary violation of section 101; (2) the defendant is a broker-dealer or agent as required by section 410(b); and (3) the defendant "materially aided" in the sale. The defendant can then establish that it had no reason to know of the facts constituting the violation as an affirmative defense.

The Uniform Act cause of action for secondary liability differs markedly from the former aiding and abetting under section 10(b). First, liability is restricted to the class of persons identified in the statute, which includes broker-dealers. Second, "materially aids in the sale" is not defined, and there is no reason to think it is identical to the former "substantial assistance" requirement under federal law. Finally, the federal standard required that the plaintiff show that the defendant had at least actual knowledge of the primary offense. Under the Uniform Act formulation, however, once the plaintiff has shown that the defendant materially aided in the sale, it is up to the defendant to show that he did not know, and could not have known, "of the facts by reason of which the liability is alleged to exist."[161] This amounts to a negligence standard, which is much easier for plaintiffs to establish.

C. State Court Interpretations of Section 410(b)

Few cases have dealt explicitly with secondary liability for brokerage firms under state antifraud laws. The Alabama Supreme Court remarked in 1986 that "[i]t is interesting that while this section is based almost verbatim on § 410-(b) of the Uniform Securities Act, adopted in Alabama in 1959, and which has been adopted by many other states, there are few cases from other jurisdictions which give guidance" regarding the interpretation of the section.[162] Only a handful of states have considered the extent of secondary liability under statutes based on the Uniform Act, even though the vast majority of states have adopted some form of its antifraud provisions.[163] In all but one case,[164] the courts have recognized that

160. *Id.* § 410(b), 7C U.L.A. 266 (emphasis added).
161. *Id.*
162. Foster v. Jesup & Lamont Sec. Co., 482 So. 2d 1201, 1207 (Ala. 1986).
163. *See* I LOSS & SELIGMAN, *supra* note 9, at 73–76 & nn.114–16.
164. In *Foley v. Allard*, a pre-*Central Bank* decision, the Minnesota Supreme Court decided to follow the federal aiding and abetting test over that provided by its own state statute, which is based on section 410 of the Uniform Act. 427 N.W.2d 647, 650–51

the statute goes considerably beyond the former federal aiding and abetting cause of action.[165]

The Alabama Supreme Court was one of the first courts to interpret section 410(b) in *Foster v. Jesup and Lamont Securities Co*.[166] In *Foster*, the Eleventh Circuit certified a number of questions regarding the application of state securities laws to the Alabama Supreme Court, noting that Alabama securities law—which mirrors the Uniform Act—was significantly broader than federal law. The Alabama court provided the following summary of its blue sky law:

> [A]ll [the plaintiff] need do is establish the defendant's *status*, either as a controlling person, a partner, or an occupant of some other statutory classification [as here a broker-dealer who materially aids in the sale], plus the fact of the seller's liability. The defendant is then left with only one defense . . . . He may show that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the seller's liability is alleged to exist.[167]

Oregon's version of section 410(b) is also very important to this discussion because there is a substantial amount of case law interpreting the provision.[168] This is due at least in part to Oregon's revision to the Uniform Act that extended liability for materially aiding a violation of section 101 to "every person," not just "every broker dealer and

(Minn. 1988). The court based its reasoning on another section of the Minnesota Securities Act, stating: "[T]he Minnesota Securities Act is to be construed so as to 'coordinate the interpretation of [the state statutes] with the related federal regulation.' We have determined, therefore, that federal case law is of considerable value as precedent in deciding issues arising under the act." *Id.* at 650 (citations omitted) (quoting Specialized Tours, Inc. v. Hagen, 392 N.W.2d 520, 534 (Minn. 1986)). The court then applied the three-part federal aiding and abetting test. *Id*. It is not clear what the Minnesota court would have decided in the absence of a federal aiding and abetting theory.

165. *See, e.g.*, Arthur Young & Co. v. Reves, 937 F.2d 1310, 1327 (8th Cir. 1991) (applying Arkansas law), *aff'd sub nom.*, Reves v. Ernst & Young, 507 U.S. 170 (1993); Conn. Nat'l Bank v. Giacomi, 699 A.2d 101 (Conn. 1997); Conn. Nat'l Bank v. Giacomi, 659 A.2d 1166, 1176 (Conn. 1995); Iowa *ex rel* Goettsch v. Diacide Distribs., Inc., 561 N.W.2d 369, 374 (Iowa 1997); Prince v. Brydon, 764 P.2d 1370, 1372 (Or. 1988); Adams v. Am. W. Sec., 510 P.2d 838, 844 (Or. 1973); *Foster*, 482 So. 2d at 1207.

166. 482 So. 2d 1201 (Ala. 1986).

167. *Id.* at 1207 (emphasis in original) (alteration in original) (quoting J. Michael Rediker, *Alabama's "Blue Sky Law"—Its Dubious History and Its Current Renaissance*, 23 ALA. L. REV. 667, 714 (1971)).

168. The *Koruga* panel relied heavily on Oregon case law in determining whether Fiserv had materially aided the sale of securities. *See* Koruga v. Wang, No. 98-04276, 2000 WL 33534559 at *18 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.).

agent."[169] This change has resulted in more cases going into the court system, rather than into arbitration.[170]

D. Applying Section 410(b) to Clearing Firms

1. Definition of Broker-Dealer

Section 401(c) of the Uniform Act defines broker-dealer as "any person engaged in the business of effecting transactions in securities for the account of others . . . ."[171] "Effecting transactions" is not further defined. In *Koruga*, Fiserv Correspondent Services (formerly Hanifen, Imhoff Clearing Corporation) argued that it was not a broker-dealer because it was "not engaged in the business of 'effecting transactions in securities for the accounts of others.'"[172] However, it is difficult to see how this could be the case. Clearing firms are engaged in the business of bringing about, or effecting, securities transactions; that is, after all, why they are retained.[173]

In its amicus brief in support of the clearing firm's appeal of the *Koruga* award, the SIA claimed that a distinction should be made between the registration status of a firm that engages in "'central and specialized' functions that impact on a customer's decision to buy or sell securities" and the essentially "clerical" and "operational" functions performed by the clearing firm.[174] They argued that although a clearing firm is required to register as a broker-dealer, the difference between the functions performed by the two firms is what is relevant to the definition of broker-dealer under the Uniform Act.[175] However, the definition of broker-dealer does not distinguish between effecting transactions, soliciting transactions, or participating in transactions.[176] In fact, primary liability for fraud is applied to broker-dealers who solicit or participate in the sale under section 410(a).[177] In order for a separate provision for secondary liability for broker-dealers to make sense at all, effecting transactions could not be identical to soliciting or participating in them.

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169. OR. REV. STAT. § 59.115(3) (2001).
170. *Koruga*, 2000 WL 33534559 at *18.
171. UNIF. SEC. ACT § 401(c) (amended 1958), 7C U.L.A. 188 (2000). A few cases have addressed whether specific entities come under the categories of "broker-dealer or agent." *See, e.g.*, Atlanta Skin & Cancer Clinic v. Hallmark Gen. Partners, 463 S.E.2d 600, 603 (S.C. 1995) (holding that a bank is not a broker-dealer or agent under the statute).
172. *Koruga*, 2000 WL 33534559, at *16.
173. The *Koruga* panel quickly disposed of Fiserv's argument. *Id.*
174. *See* Brief of Amicus Curiae Securities Industry Association, Inc. at 23, Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001) (No. 00-1415 MA).
175. *See id.*
176. UNIF. SEC. ACT § 401(c), 7C U.L.A. 188.
177. *Id.* § 410(a), 7C U.L.A. 266.

2. *The Material Aid Requirement*

The element most likely to pose problems for those arguing in favor of secondary liability for clearing firms is the "material aid" requirement. Courts have regularly held that the material aid standard is not identical to the former substantial assistance standard.[178] For example, in *Foster v. Jesup & Lamont Securities Co.*,[179] the Alabama Supreme Court considered whether "materially aid" involved a looser standard than, or an identical standard to that imposed by the "substantial factor" requirement necessary to find liability under section 12(2) of the 1933 Act.[180] The court responded that it was not necessary to show that a person was a substantial factor in the sale of a security in order to establish that he had materially aided in the sale of securities.[181]

The courts addressing the statute have interpreted "aiding" broadly.[182] According to one commentator, aiding "focuses upon activities which do not directly lead to the sale, but rather make it possible."[183] Under the Uniform Act, "materiality relates to the importance of the contribution toward making the sale possible."[184] By way of contrast, Ohio's blue

178. A number of states have already held (or have stated in dicta) that "materially aid" does involve a lower standard than "substantial assistance." *See, e.g.*, Arthur Young & Co. v. Reves, 937 F.2d 1310 (8th Cir. 1991) (applying Arkansas law), *aff'd sub nom*., Reves v. Ernst & Young, 507 U.S. 170 (1993); Foster v. Jesup & Lamont Sec. Co., 482 So. 2d 1201 (Ala. 1986); Iowa *ex rel*. Goettsch v. Diacide Distribs., Inc. 561 N.W.2d 369 (Iowa 1997); Prince v. Brydon, 764 P.2d 1370 (Or. 1988).

179. 482 So. 2d 1201 (Ala. 1986).

180. *Id.* at 1204. *Foster* dealt with the sale of an unregistered security under section 12(2) of the 1933 Act rather than fraud in the sale of a security on the secondary market under section 10(b) of the 1934 Act. The test for establishing fraud under section 12(2) relies on whether the aider was a "substantial factor in the sale" and whether the district court had treated the "substantial factor" identically to the "materially aid" requirement. *Id.*

181. *Id*. at 1207–08. The Eighth Circuit relied on the *Foster* court's interpretation of section 410(b) when it considered a similar case based on Arkansas law. In *Arthur Young & Co. v. Reves*, the Eighth Circuit compared Arkansas and Alabama securities laws and agreed that Arkansas has its own statutory aiding and abetting provision. 937 F.2d at 1326. The court concluded that the trial court had set a higher standard than was necessary to meet the "materially aid" standard in its jury instructions but that, because the jury found that the higher standard had been met, there had been no error. *Id.* at 1327. The court did not identify any criteria for "materially aid," stating only that "the trial evidence provides ample support for the jury's verdict." *Id.* at 1326.

182. For a discussion addressing the differences between aiding and participating, and aiding and abetting, see Joseph C. Long, *Developments and Issues in Civil Liability Under Blue Sky Law*, 62 U. CIN. L. REV. 439, 460–63 (1993).

183. *Id*. at 461.

184. *Id*. at 462.

sky laws do not limit aid to material aid—aid of any kind will do.[185] This caveat makes the Ohio statute very broad. The materiality requirement in the Uniform Act provides an important limitation on the type of aid necessary for liability.[186]

The Oregon Supreme Court has provided some guidance in interpreting the material aid requirement. In *Prince v. Brydon*,[187] the court explained that participating in a sale is not necessary or sufficient to establish material aid; instead, it depends on the importance of the party's contribution to the sale.[188] Additionally, in an earlier case, the court held that an attorney had materially aided in the sale of securities even though the aid consisted of preparing documents after the unauthorized sale took place.[189] The court stated that the "sale would and could not have been completed or consummated" without the assistance of the attorney and that the timing of the sale was unrelated to the material aid provided by him.[190]

Prince suggests that activities such as "[t]yping, reproducing, and delivering sales documents" are activities aiding a sale, although they are not necessarily material, because they could be performed by anyone.[191] The term "material" provides the essential limitation on liability in the context of the Uniform Act, just as the term "substantial" provided the limitation in the substantial assistance test. With respect to attorney preparation of documents, "it is a drafter's knowledge,

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185. In *Federated Management Co. v. Coopers & Lybrand*, an Ohio appeals court provided for an expansive interpretation of the Ohio version of section 410. 738 N.E.2d 842, 860–62 (Ohio Ct. App. 2000). The Ohio statute goes significantly beyond section 410, providing that "every person who has participated in or aided the seller in any way in making such a contract or sale" is jointly and severally liable. OHIO REV. CODE ANN. § 1707.43 (West 1994 & Supp. 2002). *See also Federated Mgmt. Co.*, 738 N.E.2d at 861 (noting that the federal requirement that the aider and abettor have the intent to aid in the violation is not required under state law). The *Federated Mgmt. Co*. court held that the participation or assistance may be in any form; contrary to the holding of the trial court, it is not necessary that the aider "induce a purchaser to invest in order to be held liable," although that may be "one factor in determining liability." *Id.*; *see also* Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 424 n.152 (1993).

186. Steinberg, *supra* note 185, at 424–25.

187. 764 P.2d 1370 (Or. 1988).

188. A person may participate without materially aiding or materially aid without participating. Whether one's assistance in the sale is 'material' does not depend on one's knowledge of the facts that make it unlawful; it depends on the importance of one's personal contribution to the transaction. Typing, reproducing, and delivering sales documents may all be essential to a sale, but they could be performed by anyone; it is a drafter's knowledge, judgment, and assertions reflected in the contents of the documents that are "material" to the sale.

Id. at 1371.

189. Adams v. Am. W. Sec., Inc., 510 P.2d 838, 844–45 (Or. 1973).

190. *Id.* at 845.

191. *Prince*, 764 P.2d at 1371.

judgment, and assertions reflected in the contents of the documents that are 'material' to the sale."[192] This seems to be what the district court had in mind in *Hirata Corp. v. J.B. Oxford & Co.*,[193] when it cited *Prince* in support of the proposition that "those courts interpreting § 410 of the Uniform Act have not applied liability for 'materially aiding' to one who merely performed 'ministerial functions.'"[194]

The contrast with ministerial functions is not to be confused with normal or typical functions, however. The *Prince* court makes it clear that "[t]he defense against strict liability . . . was to be a showing of ignorance, not the professional role of the person who renders material aid in the unlawful sale."[195] The normal activities of a lawyer preparing documents do constitute material aid of the sale;[196] the lawyer must make a showing that he "did not know, and, in the exercise of reasonable care, could not have known, of the existence of the facts on which liability is based."[197]

The *Koruga* arbitration panel found that Fiserv had materially aided the sale of securities by executing purchases and sales of securities, passing title to securities, sending confirmation slips and monthly or quarterly statements to customers, insuring customer accounts as required by SIPC, and extending credit to customers and to Hanifen.[198] The panel stated: "To analogize the ministerial role of a data-inputting secretary to the very substantial functions of the clearing broker makes no sense. Without the clearing broker, title in securities cannot pass to or from the customer nor can consideration for the transaction change hands."[199]

In its amicus brief in support of the clearing firm's appeal of the *Koruga* award, the SIA argued that the ordinary activities of clearing brokers are "operational," "clerical," and "ministerial" in nature.[200] The normal activities of a clearing firm with respect to processing

192. *Id*.
193. 193 F.R.D. 589 (S.D. Ind. 2000).
194. *Id.* at 600.
195. *Prince*, 764 P.2d at 1372.
196. *Id.* at 1371–72.
197. *Id.* at 1372 (quoting OR. REV. STAT. § 59.115(3) (2001)).
198. Koruga v. Wang, No. 98-04276, 2000 WL 33534559 at *20–21 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.).
199. *Id.* at *20.
200. *See* Brief of Amicus Curiae Securities Industry Association, Inc. at 17–24, Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001) (No. 00-1415 MA); *see also* Denson v. Bear, Stearns Sec. Corp., 682 So. 2d 69 (Ala. 1996) (upholding summary judgment in favor of the defendant Bear, Stearns on grounds that the plaintiff had not shown that Bear, Stearns had performed anything other than bookkeeping functions with regard to the initial public offering of securities).

transactions and other documents are "ministerial" in the sense that processing, as opposed to selling, is involved. However, the processing involved is quite complex, and the execution of transactions and the transfer of title to securities are not simply clerical activities. They require expertise and systems not available to most introducing firms.[201]

In addition, clearing firms engage in a number of activities that go well beyond simply making the transactions occur.[202] For example, assessments regarding whether to accept an order for processing and when to extend credit involve knowledge and judgment, although the mechanical distribution of monthly statements may not. Decisions regarding whether to execute a transaction in an account after a customer has requested that the clearing firm not execute any further transactions involve judgment. Clearing firms identify an introducing firm's compliance with net capital requirements. As the *Bear, Stearns* SEC action demonstrates, a clearing firm that continues to process transactions with knowledge that the introducing firm is violating the net capital rule is aiding and abetting a violation of federal securities laws.[203]

These activities may be the normal activities of the clearing firm acting in its professional role, but that does not make the activities any less material. As the court in *Prince* noted, a lawyer may be performing the normal professional duties of a lawyer in preparing documents and in so doing materially aid in the sale of securities.[204] The fact that the activities themselves are typical for a lawyer was irrelevant to liability; instead, the relevant question is whether the lawyer had knowledge of facts on which the liability was based.[205] Similarly, the fact that a clearing firm is performing its normal professional responsibilities does not render the duties "ministerial" and therefore outside of the scope of liability. Instead, as long as the duties involve a "personal contribution to the transaction,"[206] the clearing firm will need to show that it did not have knowledge of the fraud.

201. *See* Minnerop, *supra* note 12, at 842–43.

202. In a recent case, a New York district court upheld an arbitration award against Bear, Stearns in connection with the A.R. Baron fraud. McDaniel v. Bear Stearns & Co., 196 F. Supp. 2d 343 (S.D.N.Y. 2002). The arbitration panel had found that the following activities went beyond the scope of normal clearing activities: failing to report commissions and markups, processing trades that it knew were unauthorized, making loans to help A.R. Baron meet net capital requirements, making decisions regarding whether to process certain trades, and placing staff at the office of the introducing firm. *Id*. at 356. The district court held that these activities provided a sufficient basis for upholding the award finding that Bear, Stearns had provided substantial assistance to A.R. Baron and had aided and abetted the fraud under New York law. *Id.*

203. *See supra* notes 54–56 and accompanying text. The SEC can bring aiding and abetting actions under Rule 10b-5. *See supra* note 56.

204. Prince v. Brydon, 764 P.2d 1370, 1372 (Or. 1988).

205. *Id.*

206. *Id.* at 1371.

3. *The Affirmative Defense*

Section 410(b) states that a broker-dealer who materially aids in a sale that is in violation of section 101 is jointly and severally liable with the seller, "unless the non-seller who is so liable sustains the burden of proof that he did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist."[207] Essentially, the defendant must prove that he could not have discovered the facts even had he exercised due care.[208] As the Oregon court stated in *Prince*, for one working in a professional capacity, "[t]he defense against strict liability . . . [is] a showing of ignorance, not the professional role of the person who renders material aid in the unlawful sale."[209] In addition, the ignorance at issue is ignorance of the "facts by reason of which liability is alleged to exist"[210] and not ignorance of the unlawfulness of the sale; the defendant need not even know that the sale was unlawful as long as he knew the facts that gave rise to the liability.[211]

The affirmative defense will be hard to establish for clearing firms dealing with introducing firms engaged in widespread fraud. If the evidence of fraud amounts to a failure legally to satisfy net capital requirements, widespread customer complaints of unauthorized trading and failure to execute sell orders, or other notable signs of fraud, a clearing firm would have known of the facts on which liability is based. The *Koruga* panel appeared to have no difficulty establishing that Fiserv

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207. UNIF. SEC. ACT § 410(b) (amended 1958), 7C U.L.A. 266 (2000).

208. In *Connecticut National Bank v. Giacomi*, the Connecticut Supreme Court held that Connecticut's aiding and abetting statute established a negligence standard as to the knowledge requirement. 699 A.2d 101, 124 n.40 (Conn. 1997). After the plaintiff establishes a prima facie case that a primary securities violation existed and that the defendant materially aided the violation, the defendant "can avoid liability if it can sustain its burden of persuasion that it did not know, and in the exercise of reasonable care could not have known, of the untruth or omission which constituted the violation of the securities law." *Id.* at 123.

209. *Prince*, 764 P.2d at 1372.

210. UNIF. SEC. ACT § 410(b), 7C U.L.A. 266.

211. *See also* Hines v. Data Line Sys., Inc., 787 P.2d 8 (Wash. 1990).

> Ignorance will be bliss only to the extent that [a defendant] can prove that even by the exercise of reasonable care he would have remained ignorant of the true state of affairs. . . . The clear language of [the statute] imposes upon [a defendant] the burden of affirmatively proving that in the exercise of reasonable care they could not have learned [of the existence of the facts giving rise to the liability].

Id. at 18–19.

had actual knowledge of the fraud.[212] If a clearing firm does not know of the fraud, it is likely due to a failure to follow appropriate regulations, which would constitute a failure to exercise due care. In such a case, the clearing firm should have known of the facts on which liability is based. This is true because clearing firms are required to report complaints and violations of net capital to appropriate SROs. These are exactly the types of cases where clearing firm liability ought to extend.

The defense available to clearing firms in less egregious cases is that the firm had no reason to know of the facts constituting the violation. If the clearing firm followed appropriate SEC and SRO rules and regulations, and adhered to its agreements with the introducing firm and its customers, and yet still could not have known of the fraud, then under this interpretation of the affirmative defense, no liability will extend. The defense would seem to be available in most cases involving the fraud of an introducing firm, such as unsuitability claims.

The issue in close cases will be whether the clearing firm should have known of the facts constituting the primary violation. For example, in a case where the introducing firm fabricates trading experience on an option agreement, the clearing firm can argue that in the exercise of reasonable care it could not have known of the existence of the violation. An example of where liability might be extended is in the case of excessive commissions or mark-ups. Clearing firms produce commission reports for introducing firms, for example, and so might be said to know of the facts giving rise to the violation. In addition, a clearing firm may receive complaints from customers regarding excessive commissions.

Under this construction of the knowledge defense, clearing firm liability would not be extended to cases where either the clearing firm had no knowledge of the facts on which the fraud was based, or the clearing firm's lack of knowledge was not due to its failure to follow appropriate regulations or otherwise exercise reasonable care.[213] This standard should not be difficult to meet for most clearing firms under most circumstances. Liability would be imposed in only the most egregious situations—those situations in which the clearing firm knew of the fraud yet continued to aid the introducing firm in perpetrating it and cases in which, had the clearing firm followed the appropriate regulations and procedures, the fraud would have been apparent.

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212. Koruga v. Wang, No. 98-04276, 2000 WL 33534559 at *7–8 (N.A.S.D. Oct. 2, 2000) (Meyer, Hywel & Dunnington, Arbs.).

213. Willful ignorance should be considered knowledge in such cases, because the clearing firm will have had reason to believe that the fraud was occurring, and yet turned a blind eye nonetheless.

E. Federal Preemption?

The SIA has argued that application of section 410(b) to clearing brokers creates "a direct conflict with federal law and regulation,"[214] because in order to come under the affirmative defense provided by section 410(b), the clearing firm must exercise reasonable care.[215] The argument seems to be that insofar as section 410(b) requires that more attention be paid to the activities of the introducing firm, it is in conflict with federal law and federal regulations. Because the Uniform Act is meant to coordinate with federal regulation,[216] blue sky laws are not able to impose any additional duties on clearing firms.[217] However, the antifraud provisions of the Uniform Act are not preempted by either SRO or SEC regulation nor are they preempted by any federal legislation.[218]

First of all, blue sky laws work in conjunction with other forms of regulation and are valid insofar as there is no explicit conflict with federal law. States are free to enact legislation imposing duties additional to those provided by self-regulatory agencies. The regulatory framework provided by SROs such as the NYSE or NASD does not preempt state law. According to the Supreme Court, state law must not conflict with SRO rules "only if the rules are directly related to the purpose of the 1934 Act and are designed to insure fair dealing and investor protection."[219] NYSE Rule 382 and NASD Rule 3230 are internal rules. There is no private right of action available to investors for their violation. As a result, their purpose does not seem connected to the purposes of the 1934 Act.[220] In addition, section 410(b) does not create a

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214. *See* Brief of Amicus Curiae Securities Industry Association, Inc. at 26, Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001) (No. 00-1415 MA).

215. *Id*. at 25–26.

216. UNIF. SEC. ACT § 415 (amended 1958), 7C U.L.A. 320 (2000).

217. *See* Brief of Amicus Curiae Securities Industry Association, Inc. at 26, *Koruga* (No. 00-1415 MA).

218. For an account of the constitutional limits on the preemption of state securities laws, see generally Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS., Summer 1997, at 169. *See also* Brief of Amicus Curiae North American Securities Administrators Association, Inc. at 5–22, *Koruga* (No. 00-1415 MA) (criticizing preemption arguments made by appellant and the SIA); I LOSS & SELIGMAN, *supra* note 9, at 41–42.

219. Duffield v. Robertson Stephens & Co., 144 F.3d 1182, 1201 (9th Cir. 1998) ("The rules of NASD and the NYSE are not fairly attributable to the government unless they carry the force of federal law."); *see also* Brief of Amicus Curiae North American Securities Administrators Association, Inc. at 16, *Koruga* (No. 00-1415 MA).

220. *See* Brief of Amicus Curiae North American Securities Administrators

conflict with these rules; the rules set SRO minimum standards for participation in the securities markets, but there is no reason to suppose that Congress or the states cannot create higher standards.[221] In fact, the 1998 SEC-approved amendments to NYSE Rule 382 and NASD Rule 3230 state that the rule changes are not intended to affect any "liabilities under law."[222]

The 1933 and 1934 Acts explicitly preserve state causes of action.[223] State blue sky laws had existed for many years prior to the 1933 and 1934 Acts.[224] Although the Securities Litigation Uniform Standards Act of 1998 preempts some state causes of action, it applies to class actions and not to those suing in an individual capacity.[225] By limiting the preemption of state antifraud laws to securities class actions, Congress has continued to make state blue sky and common law causes of action available to individual investors.[226]

VI. CONCLUSION

The *Koruga* award demonstrates the potential power of state law in establishing secondary liability for clearing firms. A careful reading of the Uniform Act shows that clearing firms may be liable for the fraud of introducing firms under some circumstances. Consistent application of state law, as it presently exists in states adopting the antifraud provisions of the Uniform Act, provides a means for extending secondary liability to clearing firms for the fraud of introducing firms.

Liability under the Uniform Act does not impose too heavy a duty on clearing firms. If a clearing firm had no knowledge of the fraud and follows the regulations imposed by applicable SROs and the SEC, that firm should not be liable. All that is required under these circumstances is the normal monitoring procedures that should be in place in all clearing

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Association, Inc. at 16 (No. 00-1415 MA).

221. *Id.*

222. *See* NASD Notice to Members No. 99-57, at 1 (July 19, 1999), http://www.nasdr.com/pdf-text/9957ntm.txt; Brief of Amicus Curiae North American Securities Administrators Association, Inc. at 20, Koruga v. Fiserv Correspondent Servs., 183 F. Supp. 2d 1245 (D. Or. 2001) (No. 00-1415 MA) (citing Proposed Rule Change by NYSE, File No. SR-NYSE-97-25, at 7–8 (Nov. 25, 1998)).

223. 15 U.S.C. § 77p (2000) (stating the rule under the 1933 Act) ("[T]he rights and remedies provided by this [Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity."); 15 U.S.C. § 78bb(a) (2000) (stating the rule under the 1934 Act) ("[T]he rights and remedies provided by this [Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity.").

224. For a history of the development of blue sky laws, see I LOSS & SELIGMAN, *supra* note 9, at 31–43.

225. 15 U.S.C. § 77p.

226. For a discussion of legislative history preserving private individual causes of action, see Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 2 n.2 (1998).

firms. However, in cases like the Duke & Company and A.R. Baron frauds, where the clearing firms were found to have actual knowledge of the fraud, the firm would be liable to the defrauded investor.

Clearing firms argue that the imposition of liability will drastically increase the costs of clearing and put smaller introducing firms out of business. However, under the interpretation of the Uniform Act explored above, clearing firms would not be required to have in place any additional monitoring procedures beyond those required by their SROs and the SEC. They simply would not be allowed to profit from the fraud of introducing firms once they know of the fraud, or benefit from failing to follow those regulations, which are often designed specifically to prevent fraud. Any profits received in this manner are illegitimate in any case, and it can hardly be argued that preventing clearing firms from realizing them increases their costs.

Although existing liability under state law may not go far enough for some and will not help residents of those states where liability follows federal law, victims of fraud in Uniform Act states may be able to obtain some relief by focusing on state law. Existing state law as constructed under the Uniform Act does not leave clearing firms open to liability for all activities of an introducing firm, nor should it. It does, however, provide for potential liability when clearing firms provide knowing assistance to introducing firms that are committing fraud.

Clearing firms are in an ideal position to prevent fraud. Smaller brokerage firms require their services. Clearing firms provide access to the securities markets for these firms. They also come to know the business of the firm through day-to-day interaction. By making it expensive for clearing firms to continue to clear for introducing firms engaged in fraud, they are prevented from profiting from defrauded investors. By preventing introducing firms engaged in fraud from having access to securities markets, we provide a powerful means of controlling fraud. Civil liability of this type puts pressure on clearing firms to be more selective in their choice of customers and makes it more costly for them to ignore mounting customer complaints against introducing firms.

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