NOTES

BAR *BARON* AT THE GATE: AN ARGUMENT FOR EXPANDING THE LIABILITY OF SECURITIES CLEARING BROKERS FOR THE FRAUD OF INTRODUCING BROKERS

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The securities brokerage industry is divided into those brokers who process their own trades and those brokers who use other firms to process their trades. The latter group, called "introducing brokers," send their customers' trade orders to "clearing brokers," who then make the actual trades. Recent highly publicized cases of fraud by introducing brokers have led to closer scrutiny of the introducing broker-clearing broker relationship, and in particular, speculation over whether clearing brokers should be liable when they clear the trades of introducing brokers who are committing fraud. As the law now stands, clearing brokers are effectively immune from this type of liability, and the clearing broker industry has argued that any expansion of their liability would lead to clearing brokers abandoning the market. This Note uses the analytical structure of gatekeeping liability to argue for expanding clearing brokers' liability for introducing brokers' fraud.

INTRODUCTION

On July 3, 1996, the securities brokerage firm[1] A.R. Baron & Co. (Baron) was placed in liquidation proceedings under the Securities Investor Protection Act of 1970.[2] This was no ordinary bankruptcy, however. Before Baron went bankrupt, it perpetrated a $75 million stock fraud against scores of investors[3] that Forbes rated as one of the top fifteen "greatest investment rip-offs" of the year.[4] Baron used

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1 A securities broker effects transactions in securities for others, usually charging a commission. They are also called "broker-dealers." See Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78(c)(4) (1994).

2 See 15 U.S.C. § 78aaa (1994); Schwartz v. Bear, Stearns & Co., N.Y. L.J., Sept. 3, 1998, at 22 (N.Y. App. Div. Sept. 2, 1998) (giving information about fraud and bankruptcy of A.R. Baron & Co. (Baron)).

3 See Gretchen Morgenson, A Pivotal Point in Inquiry for Bear Stearns, N.Y. Times, Aug. 21, 1998, at D5 (describing Baron fraud).

4 See Dan Seligman, Swindles of the Year, Forbes, June 14, 1999, at 278, 280.

standard fraud techniques to bilk its customers out of millions. These techniques included unauthorized trading on customer accounts, implementing a "No Net Sales" policy,[5] and engaging in abusive sales practices.[6] Baron used all three of these practices to inflate artificially the price of "house stocks," which are stocks of small companies that are traded mostly or entirely by one brokerage firm.[7] In a typical fraud, members of the brokerage buy up large quantities of these house stocks at low prices early on; the introducing broker then inflates the stock's price by the methods listed above. The early buyers then sell their shares at a tidy profit, the broker stops inflating the stock price, and the introducing firm's customers are left to bear the loss as the stock's price falls.[8]

Baron perpetrated a large portion of its fraud by utilizing the well known Wall Street brokerage firm Bear, Stearns & Co. (Bear Stearns) as its "clearing broker." That is, Bear Stearns effected the actual trades of securities that Baron ordered for its customers' accounts.[9] According to published news reports, Bear Stearns knew that Baron was committing fraud, yet continued to clear Baron's trades—thus profiting from commissions on the fraudulent activity.[10] A class ac-

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[5] A "No Net Sales" policy means that a broker cannot sell a customer's stock until he has gotten an order from that same customer to buy another stock that the brokerage wants to sell.

[6] See Gretchen Morgenson, Sleazy Doings on Wall Street, Forbes, Feb. 24, 1997, at 114, 117-18 (detailing Baron's fraudulent practices); see also Bureau of Investor Protection and Sec., New York Attorney Gen., Report on Micro-Cap Stock Fraud 29 (1997) [hereinafter N.Y. Att'y Gen. Rep.] (relating common fraud techniques of brokers: "[T]here is generally a high-powered campaign to get the client to buy; at some point, when the client decides to sell, there are almost always a variety of obstacles in the way until the stock in question has lost most of its value.").

[7] See Morgenson, supra note 6, at 117 (describing Baron's propping up of its house stocks).

[8] See N.Y. Att'y Gen. Rep., supra note 6, at 29-32, 34-43 (detailing different techniques that introducing brokers use to commit fraud).

[9] See Morgenson, supra note 6, at 114 (describing relationship of Bear, Stearns & Co. (Bear Stearns) to Baron). A clearing broker like Bear Stearns clears trades by processing the actual buying and selling of securities, as well as performing some administrative functions. Clearing brokers (sometimes called "carrying brokers") take orders to clear trades from introducing brokers like Baron. Introducing brokers do not have the resources to clear their customers' trades; they use clearing brokers to do so. See infra text accompanying notes 31-42; see also N.Y. Att'y Gen. Rep., supra note 6, at 3, 70-73 (describing how clearing brokers enable introducing broker fraud); William J. Fitzpatrick & Ronald T. Carman, An Analysis of the Business and Legal Relationship Between Introducing and Carrying Brokers, 40 Bus. Law. 47, 48-53 (1984) (providing detailed overview of clearing broker-introducing broker relationship); Henry F. Minnerop, The Role and Regulation of Clearing Brokers, 48 Bus. Law. 841 (1993) (same).

[10] See Larry Celona & Evelyn Nussenbaum, Bear Stearns Exec's Fraud Caught on Tape, N.Y. Post, Jan. 21, 1999, at 28 (stating that prosecutors in Manhattan District Attorney's office have audiotape of Bear Stearns executive allegedly admitting that Bear Stearns knew Baron was committing fraud while Bear Stearns was clearing Baron's trades).

tion was filed against Bear Stearns in New York state court following the Baron bankruptcy claiming that Bear Stearns had a duty to inform Baron's customers once it became aware that Baron was perpetrating fraud.[11] The court dismissed the suit against Bear Stearns,[12] holding that "a clearing broker owes no duty of disclosure to the clients of an introducing broker."[13] This holding is no aberration, but closely follows current securities law. A clearing firm is free to profit from clearing trades for a broker that the clearing firm *knows* is committing fraud.[14]

The fallout from Baron's bankruptcy, and from the subsequent criminal investigations of both Baron and Bear Stearns,[15] has spurred calls for greater scrutiny of the relationship between introducing brokers and their clearing brokers.[16] The Securities and Exchange Commission (SEC) recently accepted proposed revisions of the administrative regulations governing this relationship.[17] The current chairman of the SEC, Arthur Levitt, plans to focus on this problem,

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11 See Schwartz v. Bear, Stearns & Co., N.Y. L.J., Sept. 3, 1998, at 22 (N.Y. App. Div. Sept. 2, 1998).

12 See id.

13 Id. (quoting In re Blech Sec. Litig., 928 F. Supp. 1279, 1295-96 (S.D.N.Y. 1996)).

14 See Joshua Hallford, Dismissal of Bear Lawsuit Lets Clearers off the Hook, Sec. Industry News, Sept. 7, 1998, available in 1998 WL 9597472 (describing holding as in line with current law in this area); see also infra Part I.A.

15 In August 1999, the Securities and Exchange Commission (SEC) and the Manhattan District Attorney settled their investigations with Bear Stearns. Under the terms of the settlement, Bear Stearns agreed to pay a fine of $38.5 million. In the settlement, the SEC charged that Bear Stearns actively participated in the Baron fraud. The Manhattan District Attorney kept open its criminal investigation of Bear Stearns Securities president Richard Harriton, who has resigned from the firm. See Gretchen Morgenson, SEC Fines a Bear Stearns Unit in Fraud Case After Long Inquiry, N.Y. Times, Aug. 6, 1999, at A1 (describing investigation and settlement).

16 See Paul Beckett, Levitt Wants SEC and Justice Agency to Work Together Against Bad Brokers, Wall St. J., Mar. 27, 1998, at A3 (describing calls for investigation of clearing relationship); Evan J. Charkes, Clearing Firm Not Liable for Introducing Broker?, N.Y. L.J., Sept. 24, 1998, at 5 (1998) (same); NYSE, SEC May Require Clearing Firms to Report Suspicious Trades, Operations Mgmt., June 2, 1997, available in 1997 WL 12186034 (same).

17 See Clearing Agreements, 64 Fed. Reg. 31,024 (1999) (describing and approving proposed rule change for National Association of Securities Dealers (NASD)) [hereinafter NASD Order]; Carrying Agreements, 64 Fed. Reg. 31,338 (1999) (describing and approving proposed rule change for New York Stock Exchange (NYSE)) [hereinafter NYSE Order]; see also Jed Horowitz, Clearing Firms Breathe Easy, Endorsing NYSE Rule Changes, Investment Dealers' Dig., Oct. 13, 1997, at 3, 3-4 (describing proposal). The SEC oversees several self-regulating organizations (SROs) such as the NYSE; the SROs promulgate rules that govern their members. The SROs must get approval from the SEC for any rule changes.

It is not surprising that the SEC took so long to consider the currently proposed rule changes, as similar rule changes in 1982 also had a long period of gestation. See Minnerop, supra note 9, at 849 n.41 (describing process leading up to 1982 rule changes).

specifically on clearing brokers' responsibilities, in his second term.[18] The North American Securities Administrators Association (NASAA) has put pressure on the New York Stock Exchange (NYSE) to tighten supervision of the clearing relationship,[19] while several state securities regulators have also urged reform.[20] As former New York State Attorney General Dennis Vacco stated in his 1997 report on securities fraud, "[i]t is time to re-examine the responsibilities and obligations of clearing firms in light of the widespread fraud" that introducing brokers commit.[21] Such fraud has increased dramatically in the past few years,[22] and has the potential to affect a large portion of the population.[23]

The heightened scrutiny of the introducing broker-clearing broker relationship following the Baron fraud has centered on whether a clearing broker can be held liable for the wrongdoing of its introducing broker. Under current law, clearing brokers enjoy virtual immunity from liability in this area.[24] After the full magnitude of the Baron fraud came to light, the NYSE considered reducing or abolishing this immunity.[25] Clearing firms vigorously opposed this change and engaged in an extensive public relations campaign against it, arguing that any change in clearing brokers' liability status would be the death knell of the clearing industry.[26] The lobbying campaign worked: The

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18 See Beckett, supra note 16, at A3 (describing Levitt's plans).

19 See NYSE Believed to Be Taking a Second Look at Clearing Firms' Immunity, Sec. Wk., Sept. 15, 1997, available in 1997 WL 9104002 (describing stance of North American Securities Administrators Association (NASAA)).

20 See id. (describing state securities regulators' plans); see also Paul Beckett, National Securities Clearing Role May Expand in Latest SEC Effort to Stop Small-Stock Abuses, Wall St. J., June 11, 1998, at C7 (same).

21 N.Y. Att'y Gen. Rep., supra note 6, at 3.

22 See id. at 1-2, 23 (stating that investor complaints of securities fraud to New York Attorney General's Bureau of Investor Protection and Securities increased by 40% in 1996 and by almost another 40% in 1997).

23 See id. at 13 (quoting president of NASAA as stating that "one in three households in the United States now owns securities compared to one in 17 households in 1980").

24 See infra Part I.

25 See NYSE Believed to Be Taking a Second Look at Clearing Firms' Immunity, supra note 19 (describing early NYSE reactions to Baron fraud). The NYSE, like the NASD, is an SRO that governs the activities of firms that are members of its exchange. SROs are in turn watched over by the SEC, which approves rule changes proposed by the SROs, and also promulgates its own regulations of the securities markets pursuant to the Securities Act of 1933, 15 U.S.C. § 77a-77aa (1994), and the Securities Exchange Act of 1934, 15 U.S.C. § 78a-78jj (1994). The SEC can also suggest to the SROs that a rule change should be made.

26 See Horowitz, supra note 17, at 3, 3 (quoting head of mid-sized clearing firm as saying, "'If they ever made us responsible for our clients, you can forget about future clearing for the securities industry'"); id. (quoting policy paper sent by Bear Stearns to NYSE as warning that "[i]f clearing firms are forced to invest in compliance programs to monitor introducing brokers' sales practices . . . they 'quite likely' would limit the number

recently accepted rule changes that the NYSE and the National Association of Securities Dealers (NASD) proposed to the SEC have left clearing brokers' immunity intact.[27] Clearing brokers are now hoping that these modest rule changes are enough to satiate the spirit of reform that followed the Baron collapse.[28]

This Note argues for expanding the liability of clearing brokers in certain instances of introducing broker fraud. This argument is based on efficiency considerations and utilizes Professor Reinier Kraakman's analytical concept of "gatekeeper liability," which is defined as "liability imposed on private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers."[29] Part I of this Note traces the development of the law governing the relationship between introducing brokers and clearing brokers.[30] Part II argues for expanding the liability of clearing brokers for the actions of their

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of brokers they work with or even 'abandon . . . the clearing business outright'"); Edward Kountz, Regulators Mull One Repository for Clearing Data, Sec. Industry News, Feb. 9, 1998, available in 1998 WL 9596114 (describing clearing industry officials' fear regarding increased costs); Steve Quickel, Keeping Up with the Market Boom, Institutional Investor (Special Section on Correspondent Clearing), Nov. 1997, at SS3, SS4-SS6 (stating position of lawyer that "any effort to make clearing firms responsible for an introducing firm's sales practices . . . would not only be unjustified as a matter of law, but would have a negative impact on the economic foundation for the industry's existence").

27 See NYSE Order, supra note 17, at 31,339 (acceding to NYSE's interpretation of rule changes as not expanding clearing brokers' liability); Gerald B. Kline & Raymond L. Moss, Liability of Clearing Firms: Traditional and Developing Perspectives, in Securities Arbitration 1998 Redefining Practices and Techniques, at 139, 155 (PLI Corp. Law & Practice Handbook Series No. 1062, 1998), available in Westlaw, 1062 PLI/Corp 139 [hereinafter Securities Arbitration 1998] (reporting that NYSE and NASD clearly stated that proposed changes were not intended to change liability rules in clearing relationship); see also Horowitz, supra note 17, at 3 (same).

28 See Quickel, supra note 26, at SS8 (describing clearing brokers' attitudes towards proposals).

29 Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 53 (1986) (introducing analytical structure for determining when to impose "gatekeeper liability"). Many commentators have applied Kraakman's analytical structure to various situations. See, e.g., Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916, 934-49 (1998) (arguing against imposition of gatekeeper liability on financial underwriters); Ted J. Fiflis, Responsibility of Investment Bankers to Shareholders, 70 Wash. U. L.Q. 497, 497-521 (1992) (arguing for imposition of gatekeeper liability on investment bankers who issue fairness opinions); Howell E. Jackson, Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions, 66 S. Cal. L. Rev. 1019, 1049-72 (1993) (arguing against imposition of gatekeeper liability on lawyers in financial services industry); Roger J. Buffington, Note, A Proposed Standard of Common Law Liability for the Public Accounting Profession, 5 S. Cal. Interdisc. L.J. 485, 522-38 (1997) (arguing for imposing gatekeeper liability on public accounting professionals).

30 In the commodities futures trading market, there are entities termed "introducing firms" and "clearing firms," which perform similar functions, but the law governing the liability of commodities clearing firms is different. See infra note 104.

introducing brokers. Part III presents a specific proposal for new liability standards for clearing brokers.

I
THE LAW GOVERNING THE INTRODUCING BROKER-CLEARING BROKER RELATIONSHIP

Trading securities requires both a large investment in equipment and expertise as well as the large capital stake required by SEC regulations.[31] Introducing brokers generate customer investment business and give securities trading advice, but they either cannot or do not want to take on the costs associated with building up the capacity, expertise, and capital necessary to trade the actual securities.[32] In a typical securities clearing arrangement,[33] introducing brokers formally contract with clearing brokers to perform the securities trades and other "back room functions."[34] Introducing brokers are thus able to engage in the securities brokerage business without investing large amounts of capital.[35] Clearing brokers are usually full-service brokerage houses with their own customers, who also have the capacity to do more trading.[36] Clearing brokers use this excess capacity to clear the trades of introducing brokers.[37] Clearing trades is a highly profitable business; for example, Bear Stearns, the clearing industry's largest

[31] The "Net Capital Rule" establishes regulatory capital requirements for brokers. See 17 C.F.R. § 240.15c3-1 (1998). The minimum amount of capital required for clearing and full service brokers varies from firm to firm and depends upon factors like the size of the customer margin debts and the firm's ability to deliver securities promptly. The minimum floor requirement of capital for such brokers is $250,000. The minimum capital requirement for introducing brokers is $5000 if the introducing broker does not send, receive, or hold securities or funds for customers; and $50,000 if the introducing broker receives and disburses customer funds and receives but does not hold customers' securities. See 17 C.F.R. §§ 240.15c3-1(a)(1)(i)-(ii), (a)(2)(i)-(vi) (1998).

[32] See Minnerop, supra note 9, at 842-43 (describing introducing brokers).

[33] By far most clearing arrangements are "fully disclosed" agreements, in which the investors' names and addresses are disclosed to the clearing firm, so that the firm can send such items as account statements and trade confirmations directly to the customer. See id. at 843 (describing types of clearing agreements). Thus, even though the clearing broker formally contracts with the introducing broker, it does have significant contact with the introducing broker's customers. The other type of clearing agreement sometimes used in the industry is the "omnibus" agreement, in which neither the clearing broker nor the customer is aware of the other's identity. See id. This Note is not concerned with omnibus clearing agreements.

[34] "Back room" functions include: maintaining detailed records for accounts, mailing monthly statements and trade confirmations to customers, processing dividends and proxy materials, safeguarding customers' funds and securities, and extending credit to the customer. The original agreement between the introducing and clearing brokers specifies who is to perform which services. See id. at 844-46 (detailing clearing brokers' functions).

[35] See Fitzpatrick & Carman, supra note 9, at 48-49 (describing clearing relationship).

[36] See Minnerop, supra note 9, at 844-46 (describing clearing brokers).

[37] See id. (describing clearing relationship).

broker, has generated more than 30% of its pretax profits from its clearing business in the past several years, which translates into roughly $165 million of *profit* per year.[38]

The end result of this division of labor is a lowering of transaction costs,[39] which has brought about an increase in the volume of transactions in the securities market.[40] Introducing brokers profit by serving segments of the market that the big brokerage houses generally ignore (small investors who otherwise might not invest in the market[41]), while clearing brokers profit by making full use of equipment and expertise in which they have already heavily invested.[42] Thus, small investors, introducing brokers, and clearing brokers all benefit from the introducing-clearing relationship.

Two main legal forces have shaped the introducing-clearing broker relationship: SEC regulations and case law involving those regulations. While the two are closely intertwined, analyzing them separately allows for a clearer presentation of the relationship's development.

A. *The Development of Regulation*

The basic structure of the current regulatory law governing liability within clearing relationships was set forth in February 1982, when the SEC approved amendments to NYSE Rules 382 and 405.[43] These amendments were meant to clarify the scope of responsibility and lia-

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38 See Patrick McGeehan & Michael Siconolfi, New Rules Expected on Clearing: More Responsibility Seen for Big Firms, Wall St. J., June 4, 1997, at C1 (giving figures for Bear Stearns's clearing business); Morgenson, supra note 6, at 114 (same). Bear Stearns itself boasts that it handles 10% of the NYSE's total daily volume, more than 100,000 trades daily. See Bear Stearns Homepage (visited Jan. 5, 1999) <http://www.bearstearns.com/about/abs.htm>.

39 Transaction costs are lowered because the different brokers specialize in their respective areas, and the upfront fixed costs of making the actual trades (e.g., the cost of computer equipment, personnel training, NYSE membership) are borne by only a limited number of brokers. See Minnerop, supra note 9, at 843 (describing economic benefits of clearing relationship).

40 See id. (describing effect of clearing relationship on securities market volume).

41 See N.Y. Att'y Gen. Rep., supra note 6, at 2, 34 (describing typical customers of introducing brokers).

42 See Minnerop, supra note 9, at 844 (describing clearing relationship).

43 Order Approving NYSE Proposed Rule Change, 42 Fed. Reg. 8284 (1982). The SEC also approved similar rule changes for American Stock Exchange (AMEX) and the NASD in 1982 and 1994, respectively. See Order Approving Proposed Rule Change, 47 Fed. Reg. 30,333 (1982); Order Granting Approval of Proposed Rule Change Concerning the Imposition of Substantive and Procedural Requirements on Members Entering into Clearing Agreements, 59 Fed. Reg. 4297 (1994); see also Minnerop, supra note 9, at 849-50 (discussing these rule changes). The discussion in this section focuses on the NYSE rules, but applies equally to the AMEX and NASD rules as well.

bility within this area.[44] NYSE Rule 382 was amended to require that the original clearing agreement specifically designate which broker was responsible for a list of brokering functions.[45] Each clearing agreement must then be submitted to the NYSE for review and approval.[46]

While Rule 382 takes no position as to who should assume what responsibility, it allows clearing brokers to take on all of the mechanics of trading[47] while avoiding responsibility for monitoring customers' accounts to ensure that the account activity fits with the customer's investment goals.[48] Amended Rule 405 eliminated material that addressed the relationship between introducing and clearing brokers because the amended Rule 382 is now considered exclusively to control that relationship. This allows all Rule 405-type responsibilities[49] to be allocated to the introducing broker in the original clearing agreement.

The effect of these rule changes has been to make it extremely difficult for an investor to hold the clearing broker liable if the introducing broker commits fraud, mismanagement, or some other actiona-

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[44] See Order Approving NYSE Proposed Rule Change, supra note 43. Prior to those amendments, the growth of the introducing-clearing business was hampered by a lack of clarity concerning the rules of liability. See Fitzpatrick & Carman, supra note 9, at 51-52 (discussing 1982 amendments).

[45] These functions include: "1) opening, approving, and monitoring of accounts; 2) extension of credit; 3) maintenance of books and records; 4) receipt and delivery of funds and securities; 5) safeguarding of funds and securities; 6) confirmations and statements; and 7) acceptance of orders and execution of transactions." NYSE Rule 382(b), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (1995).

[46] See NYSE Rule 382(a), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (1995).

[47] See supra note 34 and accompanying text.

[48] See Minnerop, supra note 9, at 849 (stating that 1982 rule changes "freed clearing firms of all 'know your customer' responsibilities with respect to introduced accounts," (citing NYSE Information Memo, No. 82-12 (Mar. 5, 1982) in support of this claim)). But cf. N.Y. Att'y Gen. Rep., supra note 6, at 72 n.109 (arguing that clearing brokers' claim of immunity from liability following the 1982 rule changes "should be regarded with suspicion"). This Report argues that the clearing brokers' claim is based on a "two-paragraph SEC release," and that it is doubtful that these two paragraphs should be given the weight and interpretation that they have been. Id. The courts, however, have generally agreed with the clearing brokers' position on this issue. See infra Section I.B.

[49] The relevant responsibilities are set forth in Rule 405 as follows:

> Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to
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> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.
>
> (2) Supervise diligently all accounts handled by registered representatives of the organization.

NYSE Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994).

ble behavior.[50] Because clearing agreements normally stipulate that the introducing broker is responsible for monitoring the investor's account,[51] and the investors themselves must agree to this arrangement, investors are hard-pressed to claim that the clearing broker had a duty to monitor their accounts. Clearing brokers are thus able to contract out of liability. Since 1982, the courts, with rare exceptions, have held clearing brokers liable only upon a showing that they effectively controlled the daily activities of the introducing broker.[52] The 1982 rule changes have also caused an explosion in the number of introducing brokers in the securities industry.[53] Given that introducing brokers are often judgment proof (unlike the "deep pocket" clearing brokerage firms), defrauded customers are often left with no legal recourse.[54]

Prompted by the Baron fraud, the SEC recently amended the regulations governing the introducing-clearing relationship.[55] The rule changes involve heightened notification requirements for clearing brokers.[56] The SEC is also considering creating a centralized electronic repository of clearing data (in order to help regulators spot fraud).[57] Regulators originally considered reducing or removing the clearing brokers' current immunity to liability.[58] This possibility was rejected, however, after hard lobbying by the clearing industry.[59] The clearing industry regards the proposed changes as "not a particular burden"[60] and "not overly onerous."[61] While the clearing industry is

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50 See Philip M. Aidikoff et al., Clearing Firm Liability: A Forward Looking Analysis, in Securities Arbitration 1998, supra note 27, at 113, 121-22 (describing 1982 rule changes as "repealing" clearing broker liability in most cases); see also infra notes 64-65 and accompanying text.

51 See Aidikoff et al., supra note 50, at 121-22 (describing typical clearing firm practice of disclaiming liability because of clearing agreement).

52 See infra Section I.B.

53 See Minnerop, supra note 9, at 846-47 (describing growth of clearing industry since 1982).

54 See N.Y. Att'y Gen. Rep., supra note 6, at 19-20 (stating that brokers that commit micro-cap fraud—a common area of fraud for introducing brokers—are often thinly capitalized, and "go out of business once the complaints hit"(citing Baron as example)).

55 See NASD Order, supra note 17; NYSE Order, supra note 17.

56 See NASD Order, supra note 17; NYSE Order, supra note 17.

57 See Kountz, supra note 26 (describing electronic repository proposal).

58 See NYSE Believed to Be Taking a Second Look at Clearing Firms' Immunity, supra note 19 (describing regulators' original stance).

59 See NYSE Order, supra note 17, at 31,339 (noting that amended rule "would not hold the carrying firm responsible for the actions of their introducing firms"); Horowitz, supra note 17, at 3-4 (describing clearing firms' lobbying practices and regulations NYSE ultimately proposed).

60 Horowitz, supra note 17, at 3.

61 Quickel, supra note 26, at SS6-SS7.

content with these proposals, investor advocates are decidedly not, since they leave the current liability laws in place.[62]

B. *The Development of Case Law*

The case law in this area is to a large extent determined by the SEC's regulations governing clearing and introducing brokers. The outcomes of lawsuits attempting to hold clearing brokers liable for introducing brokers' fraud fall into pre- and post-1982 categories, delineated by the SEC's 1982 changes of Rules 382 and 405.[63] Courts were much more likely to hold clearing brokers liable before 1982[64] than after.[65] This simple breakdown is complicated, however, by the many different causes of action that plaintiffs have used to impute liability upon a clearing broker. The five main causes of action utilized by plaintiffs are: 1) primary liability for fraud (defined under SEC Rule 10b-5[66]); 2) aiding and abetting liability; 3) controlling person liability under section 20(a) of the 1934 Exchange Act;[67] 4) liability under an agency claim; 5) liability on a contract, either directly or as a third-party beneficiary.

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[62] See McGeehan & Siconolfi, supra note 38, at C1; Gary Weiss, Is This Any Way to Fight Fraud?, Bus. Week, June 21, 1999, at 172, 172 ("By giving the appearance of action, while merely ratifying the status quo cherished by Wall Street, the new rules are arguably worse than nothing at all.").

[63] See supra text accompanying notes 43-54.

[64] See, e.g., Cannizzaro v. Bache, Halsey Stuart Shields, Inc., 81 F.R.D. 719, 721 (S.D.N.Y. 1979) (denying clearing broker's motion for summary judgment); Faturik v. Woodmere Securities, Inc., 442 F. Supp. 943, 945 (S.D.N.Y. 1977) (denying clearing broker's motion to dismiss because of close relationship alleged between clearing and introducing brokers); Hawkins v. Merrill Lynch, 85 F. Supp. 104, 122-24 (W.D. Ark. 1949) (holding clearing firm liable because it controlled introducing firm, failed to act in good faith, and induced introducing firm's fraudulent acts); In re D.H. Blair & Co., File Nos. 3-329, 88-239, 1970 WL 5645, at *5 (S.E.C. May 21, 1970) (holding clearing firm liable because it knew of "serious irregularities" in account at issue).

[65] See, e.g., Carlson v. Bear Stearns & Co., 906 F.2d 315, 318 (7th Cir. 1990) (affirming judgment finding clearing broker not liable for introducing broker's fraud); Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990) (same); In re Blech Sec. Litig. (*Blech I*), 928 F. Supp. 1279, 1295 (S.D.N.Y. 1996) (dismissing fraud claims against clearing broker based on section 10(b) of 1934 Act); cf. In re Blech Sec. Litig. (*Blech III*), 961 F. Supp. 569, 582 (S.D.N.Y. 1997) (denying clearing broker's motion to dismiss because complaint alleges that clearing broker itself engaged in kind of conduct prohibited by section 10(b)).

[66] 17 C.F.R. § 240.10b-5 (1998). Some fraud claims are also made under state common law, but for brevity, this Note will only address section 10(b) fraud.

[67] 15 U.S.C. § 78t(a) (1994):

> Every person who, directly or indirectly, controls any 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.

The majority of claims against clearing brokers utilize the first three causes of action listed above, which fall under federal law, in contrast to the latter two state law-created causes of action.[68] A survey of the current law governing these causes of action shows that defrauded investors currently have little chance of prevailing in a suit against their clearing brokers.

1. *Federal Law-Created Causes of Action*

Claims under federal law usually are made under section 10(b) of the 1934 Act and SEC Rule 10b-5.[69] To state a successful claim for primary liability for fraud under section 10(b), a plaintiff must allege, inter alia, that he has suffered damage "caused by reliance on the defendant's misrepresentations or omissions of material facts, or on a scheme . . . to defraud."[70] In suits against clearing brokers, customers of introducing brokers have had difficulty meeting the requirement of alleging a misrepresentation, omission of material fact, or scheme to defraud on the part of the clearing broker. Courts have held that an allegation that the clearing broker knew that the fraud was being perpetrated but failed to tell the customers is not sufficient to meet the requirement of misrepresentation or omission of material fact.[71] Because a clearing broker has not been held to have a fiduciary relationship[72] with the introducing broker's customers, the clearing broker has no duty to disclose what it knows of the fraud.[73] Since a clearing broker has no duty to disclose, its silence is not an omission of material

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[68] See Minnerop, supra note 9, at 851 (stating most frequent causes of action).

[69] See id.

[70] 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)). The other pleading requirements are that the misrepresentation or omission was made with scienter, occurred in connection with the purchase or sale of securities, and was promulgated through the use of the mails, an instrument of interstate commerce, or a securities exchange facility. See id.

[71] See *Blech I*, 928 F. Supp. at 1295-96 (holding that "[e]ven if [the clearing broker] knew but failed to disclose a material fact, no plaintiff can claim to have been defrauded by that omission, because, as a matter of law, a clearing broker owes no duty of disclosure to the clients of an introducing broker"); *Connolly*, 763 F. Supp. at 10 (stating that courts have not found clearing firms liable under Rule 10b-5 for their failure to disclose introducing broker's fraud to customers); see also Kline & Moss, supra note 27, at 144-46 (stating that section 10(b) claims against clearing brokers fail because clearing broker owes no duty of disclosure to introducing broker's customers).

[72] A fiduciary relationship is a relationship founded on trust or confidence reposed by one person in another, with the latter person exercising domination or control over the former. See Black's Law Dictionary 625 (6th ed. 1990).

[73] See *Connolly*, 763 F. Supp. at 10 (stating that "courts have consistently held that clearing firms cannot be primarily liable under Rule 10b-5 because such firms generally have no duty to disclose").

fact or scheme to defraud under section 10(b).[74] Further, courts have held that the act of clearing trades with knowledge of the underlying fraud does not comprise engaging in a scheme to defraud with scienter.[75]

Since 1982, therefore, clearing brokers have been able to point to the original clearing agreement to define their role as purely administrative.[76] As long as they do not step out of this role, they have not been held directly liable for fraud.[77]

Plaintiffs can also attempt to allege controlling person liability under section 20(a) of the 1934 Act.[78] A plaintiff making a claim under this section must show that the clearing firm directly or indirectly controlled the introducing firm that committed the section 10(b) fraud.[79] Upon such a showing, the clearing firm can still avoid liability by showing that it acted in good faith and that it did not directly or indirectly induce the introducing broker's wrongdoing.[80]

As may be expected, courts have presumed that clearing brokers do not control their introducing brokers, as it is the introducing bro-

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[74] See *Blech I*, 928 F. Supp. at 1295-96 (stating that lack of duty owed by clearing broker to customer undermines primary liability fraud claim); *Connolly*, 763 F. Supp. at 10 (same).

[75] See *Blech I*, 928 F. Supp. at 1295 (holding that complaint did not properly allege primary fraud by clearing broker, as it merely alleged that clearing broker acted in ways that were standard practice for clearing brokers); Dillon v. Militano, 731 F. Supp. 634, 636 (S.D.N.Y. 1990) (holding that, because clearing broker performed mere "bookkeeping" or "clerical" functions on orders from introducing broker, primary liability for fraud cannot attach to clearing broker); Schwarz v. Bear, Stearns & Co., N.Y. L.J., Sept. 3, 1998, at 22 (N.Y. App. Div. Sept. 2, 1998) (holding that "as a matter of law, a clearing broker owes no duty of disclosure to the clients of an introducing broker") (citing Riggs v. Schappell, 939 F. Supp. 321, 329-30 (D.N.J. 1996), and *Blech I*, 928 F. Supp. at 1295-96).

[76] See supra text accompanying notes 43-54.

[77] See *Blech III*, 961 F. Supp. 569, 584-85 (S.D.N.Y. 1997) (denying clearing broker's motion to dismiss section 10(b) claims alleging that clearing broker directed and pressured introducing broker to engage in fraudulent activity because such acts went beyond normal clearing activities); supra notes 72-73.

An alternative route to recovery is aiding and abetting liability. Before 1994, investors defrauded by an introducing broker could hold the clearing broker liable under a claim of aiding and abetting the fraud under section 10(b). See, e.g., *Dillon*, 731 F. Supp. at 638 (setting out aiding and abetting requirements). In April 1994, however, the Supreme Court held that a private plaintiff may not maintain an aiding and abetting suit under section 10(b), effectively eliminating the aiding and abetting cause of action from the defrauded investor's arsenal. See Central Bank v. First Interstate Bank, 511 U.S. 164, 175-76 (1994). Defrauded investors can, however, use state law for an aiding and abetting claim, if the state has such a law. See State v. Diacide Distribs., Inc., 561 N.W.2d 369 (Iowa 1997) (allowing for use of Iowa aiding and abetting statute in fraud claim against clearing broker).

[78] 15 U.S.C. § 78t(a) (1994); see supra note 67.

[79] See 15 U.S.C. § 78t(a) (1994).

[80] See id.

ker who hires the clearing broker as its agent.[81] Indeed, this presumption is so strong that "no recent case has held that a clearing firm controlled its introducing firm within the meaning of section 20(a) or otherwise."[82]

2. *State Law-Created Causes of Action*

There are two types of state law-created causes of action that defrauded customers generally can use against clearing brokers: agency claims[83] and contract claims.

As with controlling person liability, courts start with a presumption that introducing brokers are not the agents of clearing brokers.[84] Courts make this presumption because the introducing broker hires the clearing broker;[85] thus, it seems more likely that the clearing broker is the agent of the introducing broker, rather than vice versa.[86] While this presumption makes sense when considering actual or inherent authority of an agent,[87] the situation is more complicated concern-

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[81] See, e.g., Carlson v. Bear, Stearns & Co., 906 F.2d 315, 318 (7th Cir. 1990) ("The mere fact that a broker has acted as a clearing agent in circumstances where it is alleged, as here, that the registered representative of the introducing broker defrauded customers, is insufficient to impose controlling person liability on the clearing agent.").

[82] Minnerop, supra note 9, at 857; see also Kline & Moss, supra note 27, at 147-49 (describing "difficulties of proving a Section 20(a) claim against clearing brokers").

[83] The Restatement (Second) of Agency § 1 (1958) defines agency as the "fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." A principal is the party on whose behalf action is taken; the agent performs the action. See id. Under general agency law, there are three ways for liability to attach to a principal for the acts of his agent. First, an employer is liable for his employee's torts committed while acting within the scope of the employment; this is the doctrine of "respondeat superior." See id. § 219. Second, a principal can be liable for a loss caused by a person's reliance upon a tortious representation of the principal's agent, if the representation is authorized or apparently authorized by the principal, or if the agent normally has the power to make that type of representation for the principal. See id. § 257. Third, a principal can be liable to others for the fraud committed by his agent if he put the agent in the position which enabled the agent, while apparently acting within his authority, to commit the fraud. See id. § 261.

[84] See, e.g., Katz v. Financial Clearing & Servs. Corp., 794 F. Supp. 88, 94 (S.D.N.Y. 1992) ("An introducing broker is not acting as an agent of the clearing broker when the introducing broker makes fraudulent misrepresentations to its customers.").

[85] See supra notes 31-37 and accompanying text.

[86] Two commentators argue strongly that this is the way the relationship should be viewed and that any court reversing this presumption labors under a fundamental misunderstanding of the introducing-clearing relationship. See Fitzpatrick & Carman, supra note 9, at 53-54, 63-64 (criticizing case holding that introducing broker was agent of clearing broker).

[87] An agent has actual authority when the principal expressly or implicitly has given the agent this authority. See Restatement (Second) of Agency § 1 (1958). An agent has inherent authority when the principal has not given the agent this authority, but the agent is the kind of agent that would ordinarily possess such authority. See id. § 8A, 8A cmt. b. The

ing apparent authority.[88] In order to overcome prospective investors' hesitancy to invest with brokers that do not have name recognition, introducing brokers often strongly emphasize their relationship with a well-known clearing broker, "almost to the point of stating that they are partners."[89] Clearing brokers know this, and often promote this aspect of their services when advertising to introducing brokers.[90] These clearing brokers can always argue that they are not responsible for the appearance of authority that an introducing broker creates by its unilateral actions.[91] But if a clearing broker's actions create the impression in the introducing broker's customers that the introducing broker is the agent of the clearing broker, then an action may lie against the clearing broker under an apparent authority theory.[92] This raises the following question: What kind of actions by a clearing broker are (reasonably[93]) sufficient to create an impression that the introducing broker is the clearing broker's agent? At least one court has held that merely clearing trades does not rise to the level of such an

courts' presumption makes sense given that both of these forms of agency authority require an actual agent-principal relationship. Further, since introducing brokers hire the clearing brokers, it does not seem correct to characterize the former as being actual agents of the latter. See Fitzpatrick & Carman, supra note 9, at 53-54, 63-64 (arguing that introducing brokers are not agents of clearing brokers).

[88] Apparent authority arises in an agent when the principal's actions convey the impression to a third party that an agent has certain authority that he may or may not actually possess. See Restatement (Second) of Agency § 8 (1958) (defining apparent agency as "the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons").

[89] N.Y. Att'y Gen. Rep., supra note 6, at 3.

[90] See id. at 71 (describing clearing brokers' promotional activities).

[91] See Restatement (Second) of Agency § 8 (1958).

[92] See id. Some of the more responsible clearing brokers, not comfortable with boiler room introducing firms using their good name to drum up business, have purposely changed the name of their clearing subsidiary to a name that is dissimilar to their well-known brokerage name. In this way they attempt to prevent introducing broker customers from being misled into thinking that the well-known brokerage firm is actually their broker. Donaldson, Lufkin & Jenrette, Merrill Lynch, and Prudential Securities all use different names for their clearing subsidiaries (Pershing, Broadcourt Capital Corp., and Wexford, respectively). Yet many clearing brokers have not gone this route; Bear Stearns is the biggest example. Thus, customers of introducing brokers have continued to be confused. See N.Y. Att'y Gen. Rep., supra note 6, at 72 (stating that use of dissimilar names for clearing subsidiary is "the emerging, best practice" for well-known brokerage firms).

[93] While the Restatement does not include the term "reasonably" in its definition of apparent authority, see supra note 92, it only makes sense to require that the customer's belief of agency authority must be based upon a reasonable inference, and in fact, courts have so held. See, e.g., Three-Seventy Leasing Corp. v. Ampex Corp., 528 F.2d 993, 996 (5th Cir. 1976); Billops v. Magness Constr. Co., 391 A.2d 196, 198 (Del. 1978).

action; some further act is required, and the court seemed to imply that this further act must be substantial.[94]

The second type of state-created cause of action is breach of contract. Such claims arise either from the original clearing agreement between the clearing and introducing brokers, or from a direct agreement between the clearing broker and the customer. The former type of agreement is required under NYSE Rule 382 and its NASD and American Stock Exchange (AMEX) correlates.[95] Although not required by regulation, the latter type of agreement is used by a number of clearing brokers.[96] All defrauded customers can make a contract claim against their clearing brokers as third party beneficiaries on the original clearing agreement.[97] This cause of action, however, is only available in the limited situations in which the clearing broker violated the original clearing agreement.[98] A breach of an agreement between the clearing broker and customer would give rise to a claim of direct liability.[99] Since this type of agreement is not required by law, how-

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[94] See Riggs v. Schappell, 939 F. Supp. 321, 328-30 (D.N.J. 1996) (rejecting plaintiff's claim that clearing broker imbued introducing broker with apparent authority by performing normal clearing duties); id. at 326 n.5 (noting that "such an allegation turns the relationship between an introducing broker . . . and the clearing brokers . . . on its head").

[95] See NYSE Rule 382(a), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (1995) (requiring these agreements); NASD Rule 3230, Rules of Fair Practice, N.A.S.D. Manual (CCH) 4922 (1997); AMEX Rule 400, Am. Stock Ex. Guide (CCH) ¶ 9429A (1998); see also supra note 43.

[96] See Minnerop, supra note 9, at 865 (describing SRO rules and clearing brokers' practices in this area).

[97] See Flickinger v. Harold C. Brown & Co., 947 F.2d 595 (2d Cir. 1991) (establishing third-party beneficiary liability for customers in the introducing-clearing broker context by holding that customer was intended beneficiary of clearing agreement).

[98] Since these agreements generally allocate only administrative and "back room" functions to clearing brokers, and most introducing broker fraud does not depend upon the clearing broker's failure to perform these functions, *Flickinger*, 947 F.2d 595, is not very relevant for most defrauded customers seeking to recover their loss. See Minnerop, supra note 9, at 867 (discussing scope of *Flickinger*).

[99] This type of claim was used in Fine v. Bear, Stearns & Co., 765 F. Supp. 824 (S.D.N.Y. 1991), and In re Lloyd Securities, No. 90-0985S, 1992 Bankr. LEXIS 1706 (Bankr. E.D. Pa. Oct. 29, 1992). In both *Fine* and *Lloyd*, the plaintiffs showed that the clearing broker failed to properly safeguard their funds, and thus claimed that the clearing brokers breached the clearing broker-customer agreement. See *Fine*, 765 F. Supp. at 826-27; *Lloyd*, 1992 Bankr. LEXIS 1706, at *5-*8, *23-*24. Yet the plaintiff prevailed on this issue in *Lloyd*, but did not in *Fine*, even though the behavior of the clearing brokers was almost identical. See *Fine*, 765 F. Supp. at 830; *Lloyd*, 1992 Bankr. LEXIS 1706, at *24-*25, *28-*29. The *Lloyd* court distinguished *Fine* by saying that the customer agreement in *Fine* placed all of the responsibility for handling the customer's funds with the introducing broker, not the clearing broker. See id. at *39-*40. One commentator, however, argues that the court misrepresented the *Fine* customer agreement, and that the difference in the two cases can be better explained by the fact that the *Fine* clearing broker followed standard industry procedure, while the *Lloyd* broker deviated from normal clearing broker practices. See Minnerop, supra note 9, at 865-66.

ever, many defrauded customers cannot use direct contractual liability.

3. *Summary*

While state and federal law does provide some defrauded investors with a means of recovery against their clearing brokers, the scope of this relief effectively is limited to situations in which the clearing broker acts abnormally (e.g., it actively controls the actions of the introducing broker, or it neglects to perform its limited duties under the original clearing agreement). For the most part, clearing brokers have been immune from legal liability for the acts of introducing brokers.

II
AN ARGUMENT FOR IMPOSING GATEKEEPER LIABILITY ON CLEARING BROKERS

Clearing brokers are agents of introducing brokers; they are hired by introducing brokers to do a specific job.[100] If their liability is expanded to include responsibility for some of the introducing brokers' wrongdoing, then the law would in effect force clearing brokers into a supervisory role.[101] From this perspective, it is a serious step to hold clearing brokers liable for introducing brokers' fraud because the law does not often hold agents responsible for the wrongdoing of the principal that hired them.[102] The clearing broker-introducing broker relationship is a special one, however, and arguments that treat it as just another principal-agent relationship are misleading. This Part presents an argument for treating the introducing-clearing relationship differently and, specifically, for imposing some liability on clearing brokers.

There are several reasons that clearing brokers should be liable for certain types of introducing broker fraud. Some argue that preserving the integrity of the securities markets requires such liability.[103] Others claim that the law covering the introducing-clearing relationship should be made consistent with other areas of the law that im-

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100 See supra notes 32-37 and accompanying text.

101 This would involve a reversal of respondeat superior, as it was the introducing broker who hired the clearing broker rather than vice versa. See Fitzpatrick & Carman, supra note 9, at 53-54.

102 Arguments against holding clearing brokers liable for introducing brokers' misdeeds often focus on the agent-principal nature of the clearing-introducing relationship. See, e.g., id. at 53-54, 63-64.

103 See, e.g., Aidikoff et al., supra note 50, at 136 (arguing that increased liability for clearing brokers is needed to protect investors and preserve integrity of markets).

pose such liability.[104] This Note centers instead on efficiency maximization concerns,[105] and presents reasons why total societal wealth would be maximized by making clearing brokers liable for some types of fraud that introducing brokers commit.

The type of liability that should be imposed on clearing brokers is "gatekeeper liability," which is "liability imposed on private parties who are able to disrupt misconduct by withholding their cooperation from the wrongdoers."[106] These private parties are "gatekeepers."[107] The role that clearing brokers play in securities trading[108] makes them natural gatekeepers. Introducing brokers require the services of clearing brokers in order to trade securities; if clearing brokers withhold their services from an introducing broker who wants to engage in

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[104] In both the arbitration of securities disputes and in commodities fraud cases, clearing brokers are more likely to be held liable for introducing brokers' fraud. See Jerry W. Markham, Commodities Regulation: Fraud, Manipulation & Other Claims § 4.05 (1998) (stating that Commodities Futures Trading Commission (CFTC) has utilized broad concept of agency/respondeat superior liability theory to hold commodities clearing brokers liable for introducing broker fraud, and that CFTC has rejected presumed independence of introducing brokers from clearing brokers); Kline & Moss, supra note 27, at 151-53, 156-57 (stating that there is evidence that defrauded customers have better chance against their introducing broker in arbitration than at trial, and that this is likely because in arbitration, "legal standards often succumb to equity-driven decisions").

[105] Cf. R.H. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 passim (1960) (presenting theoretical structure for determining liability rules that maximize social efficiency).

[106] See Kraakman, supra note 29, at 53 (defining gatekeeper liability). Kraakman first introduced the concept of gatekeeper liability in Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857, 888-96 (1984). Kraakman's analytical structure of gatekeeping liability is helpful for focusing on the probable efficacy of different types of deterrence as well as for weighing the different costs and benefits involved. See Lawrence G. Baxter, Reforming Legal Ethics in a Regulated Environment: An Introductory Overview, 8 Geo. J. Legal Ethics 181, 194 (1995) (stating that Kraakman's analytical framework allows consideration of what is "truly important"—efficacy and efficiency).

[107] See Kraakman, supra note 29, at 53 (defining gatekeepers). Kraakman distinguishes between gatekeeping liability and "whistleblowing": A whistleblower not only withholds cooperation from a wrongdoer, but also discloses the misconduct to the victim or the appropriate authorities. See id. at 56. The scheme of liability this Note proposes to apply to clearing brokers is a combination of gatekeeping and whistleblowing. This Note will address Kraakman's arguments concerning the increased costs of whistleblowing. See infra Part III. Since whistleblowing and gatekeeping are the same kind of third-party liability scheme, however, the conceptual scheme for the success and superiority of gatekeeping applies to a liability scheme of gatekeeping plus whistleblowing. See Kraakman, supra note 29, at 58-60; see also Richard W. Painter, Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules, 63 Geo. Wash. L. Rev. 221, 238-40 (1995) (applying basic gatekeeping analytical structure to application of whistleblowing liability to lawyers).

[108] See supra notes 32-37 and accompanying text.

misconduct, then the introducing broker would be unable to engage in that misconduct.[109]

In selecting a rule of liability, it is preferable to choose a liability regime that has the best combination of minimizing the total costs of misconduct and enforcement, while maximizing the benefits to society from the underlying conduct.[110] Thus, imposing gatekeeper liability would be warranted only if it could prevent the wrongdoing more economically than any possible alternative. Professor Kraakman offers the following four criteria for analyzing whether imposing gatekeeper liability would be warranted in a given situation: "(1) serious misconduct that practicable penalties [against the wrongdoer] cannot deter; (2) missing or inadequate private gatekeeping incentives; (3) gatekeepers who can and will prevent misconduct reliably, regardless of the preferences and market alternatives of wrongdoers; and (4) gatekeepers whom legal rules can induce to detect misconduct at reasonable cost."[111]

A. *Serious Misconduct That Practicable Penalties Against the Wrongdoer Cannot Deter*

The misconduct addressed here—primarily fraud committed by introducing brokers—is serious indeed, as highlighted by the A.R. Baron case, which involved a fraud of seventy-five million dollars.[112] Professor Kraakman identifies three factors which determine the likely effectiveness of direct deterrence against a wrongdoer: "the costs of detection and prosecution, the returns on misconduct, and the attributes of wrongdoers that blunt deterrence (such as limited assets or capacity)."[113]

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109 See N.Y. Att'y Gen. Rep., supra note 6, at 3 (discussing essential role clearing brokers play for micro-cap brokerage firms, subset of introducing firms that has high rate of fraudulent activity).

110 Maximizing benefits to society (or, broadly speaking, wealth) seems quite natural to use as a goal within the securities context, where profit is usually the primary motive of the participating parties. See generally Kraakman, supra note 29 (using efficiency maximization as evaluative criteria of gatekeeper liability, and setting out securities market as typical area in which to apply such liability).

111 Kraakman, supra note 29, at 61.

112 See Morgenson, supra note 3, at D5 (describing amount of Baron fraud).

113 Kraakman, supra note 29, at 61. Kraakman examines the influence of these factors on the effectiveness of penalties in Jennifer Arlen & Reinier Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes, 72 N.Y.U. L. Rev. 687, 755-79 (1997). Since that article is concerned with deterring wrongdoing by employees, it makes some assumptions about the wealth attributes of the acting agents that do not necessarily hold for brokerage firms. Still, the following formula shows when an agent will engage in wrongdoing:

$$b \geq c(P) + p'(M)W$$

While the costs of detection and prosecution of introducing broker fraud are substantial, this is not enough to conclude that these costs are unusually high compared to other fraud.[114] Thus, the first factor is not dispositive. When the direct penalties levied against the misconduct are small or variable compared to the possible returns, however, gatekeeping liability is likely to be a more effective enforcement device than direct liability.[115] The New York State Attorney General's Report on Micro-Cap Fraud emphasizes that the penalties against fraud do not deter introducing brokers from committing misdeeds, as the possible rewards are viewed as far outweighing the risks of prosecution and punishment.[116] Because introducing broker fraud involves the possibility of a very large payoff relative to small or variable direct penalties,[117] direct deterrence is likely to be ineffective, or at least undereffective.

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where "b" is the benefit of wrongdoing to the agent, "c(P)" is the cost of wrongdoing to the agent, "$p^i(M)$" is the probability of detection, given monitoring M and reporting i, and W is the agent's wealth. See id. at 759.

[114] See N.Y. Att'y Gen. Rep., supra note 6, at 66 (describing how many introducing brokers are adept at using certain techniques to avoid legal sanctions, including: cold callers fraudulently using names of registered brokers, broker licenses being obtained by illegal means, brokers buying lists of well-off customers from one another, firms engaging in "regulatory drills" to test how quickly their brokers can get rid of incriminating materials). There is also evidence that the amount of such fraud being perpetrated has risen precipitously, while the resources allotted to combating the fraud have lagged. See id. at 1-2, 5 (stating that fraud complaints and inquiries to New York Attorney General's Office rose by 40% in 1996 and almost that much in 1997, and that "the number of new investors, the number of complaints and the amount of fraud have all out-paced the resources of state securities regulation").

[115] See Kraakman, supra note 29, at 92-93 (using securities regulation to illustrate greater effectiveness of gatekeeping liability, particularly when applied to small perpetrators of "big-ticket" frauds, as opposed to "well-heeled" firms whose large asset bases leave them susceptible to civil judgments and fines).

[116] See N.Y. Att'y Gen. Rep., supra note 6, at 67 (describing attitude of fraudulent brokers that "the rewards [of fraud] far outweigh the risks of detection, prosecution, or punishment").

[117] A natural question to ask here is: Why not raise the penalties for fraud? Interestingly, the New York State Attorney General's recommendations for reducing micro-cap stock fraud include increased resources and legal authority for investigation, enforcement, registration of brokers, and investor education, as well as increased duties for clearing firms. No mention is made of increased direct penalties for fraud. See id. at 120-21, 133-36. The problem with increasing penalties seems to be that penalties against a firm are naturally limited to putting it out of business and collecting fines out of whatever assets (likely, quite small) the firm has. It can also be quite difficult to track and punish the individuals who work for the fraudulent firms. See id. at 66-67 (relating tactics used by individuals who work for "boiler room" firms to avoid regulators); cf. Kraakman, supra note 29, at 88 ("The most promising circumstances for third-party enforcement of any sort are . . . occasions when expected penalties against wrongdoers cannot be increased.").

Imposing criminal penalties for fraud against individual brokers might seem to be an effective way to increase penalties when increasing fines won't work. The criminal penalties imposed against Baron employees would seem to support this position. But it can be

The third factor that affects direct deterrence concerns the attributes of wrongdoers that undermine the deterrent effect of direct penalties. Introducing brokers have one such attribute: limited assets, especially in proportion to the level of fraud they can perpetuate. The Net Capital Rule establishes that introducing brokers need only keep $50,000 in capital on hand if they receive and disburse customer funds and securities.[118] These capital requirements pale in comparison to the millions that introducing brokers can obtain via fraud.[119] The fact that so many plaintiffs have attempted to hold clearing brokers liable for the fraud that their introducing brokers committed underscores the fact that introducing brokers are "shallow pockets," with limited assets compared to the amount of fraud they can commit.[120]

The possible returns from fraud dwarf both the capital introducing brokers are required to keep and the cost of any direct penalties imposed for such fraud. Introducing brokers will not be deterred by any practicable direct penalties, thereby satisfying the first condition for warranted gatekeeper liability.

B. Missing or Inadequate Private Gatekeeping Incentives

The second condition is based on a general preference for giving private individuals the ability to decide for themselves whether they want to purchase insurance against a risk, rather than compulsory insurance for everyone by law.[121] To clarify this discussion, it is instructive to view the gatekeeping monitoring performed by clearing brokers as a kind of insurance.[122] There is a risk to the investor of the

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very difficult to track down the individual brokers who commit the fraud, as the brokers often jump from one firm to another, sometimes use other brokers' names, and sometimes illegally obtain broker licenses or work without a license. See N.Y. Att'y Gen. Rep., supra note 6, at 2, 66.

118 See supra note 31 (describing Net Capital Rule).

119 See, e.g., Susan Harrigan, Many Unhappy Returns: Ex-Stratton Customers Still Fighting to Recoup $130 Million, Newsday, Dec. 20, 1998, at F6, available in 1998 WL 2698830 (documenting Stratton Oakmont's $130 million fraud); Morgenson, supra note 3, at D5 (describing Baron's $75 million fraud); Morgenson, supra note 6, at 117 (describing D. Blech's $200 million fraud and Sterling Foster's $53 million fraud).

120 See N.Y. Att'y Gen. Rep., supra note 6, at 19-20 (noting that introducing brokerage firms are "generally very thinly capitalized," and will go bankrupt once exposed as fraudulent, while individuals working there "walk[ ] away with a ton of cash"); supra Part I.B (detailing cases of defrauded investors attempting to hold clearing broker liable).

121 Cf. Alan Schwartz, Proposals for Products Liability Reforms: A Theoretical Synthesis, 97 Yale L.J. 353, 355 (1988) (evaluating liability problems using "consumer sovereignty" norm, according to which "the law should reflect the preferences of competent, informed consumers regarding risk allocation").

122 See George L. Priest, The Current Insurance Crisis and Modern Tort Law, 96 Yale L.J. 1521, 1525 (1987) ("Expanded tort liability . . . is a method of providing insurance to individuals . . . who have not purchased or cannot purchase insurance themselves.").

harm of being defrauded by the introducing broker. The investor can buy insurance against this harm from the clearing broker by paying higher costs for his trades; in return, the clearing broker tries to prevent the introducing broker from committing fraud.[123] If the clearing broker fails to prevent the fraud in a situation in which it should have, it pays the cost of the fraud.[124]

If there is a need for a gatekeeping/insurance function in a certain situation, then generally it is most efficient for the private parties involved to contract for that insurance themselves, as long as they are behaving rationally and the market is operating properly.[125] If the market is not operating properly—i.e., if the incentives to perform this contracting are missing or inadequate—then, and only then, should gatekeeper liability be imposed by law.[126]

Thus, the key question is whether the investors' incentives to contract with the clearing brokers for gatekeeping are missing or inadequate. In fact, the very existence of demands for imposing greater liability on clearing brokers through regulation[127] demonstrates the failure of the private market for gatekeeping.[128] If this private market were working, there would be no need to impose liability through regulation in order to prevent the widespread fraud that now exists in this area. This answer can be supported by a consideration of the mechanisms that probably have caused this breakdown in the private market. Such consideration can also serve to answer the counterargument that investors do not contract for gatekeeping insurance simply because they do not think the insurance is cost efficient.

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123 Cf. id. ("[T]he expansion of tort liability will lead to the provision of insurance along with the sale of the product or service itself, with a portion of the insurance premium passed along in the product or service price.").

124 While this situation may be different from a standard insurance relationship because the clearing broker actively tries to prevent the harm from occurring (instead of just giving incentives to the customer—in the form of lower insurance rates, for example—to act in a less risky manner), the overall structure of the relationship is the same: The customer pays a fee to protect himself against the possibility of a future harm that would be difficult for him to bear. See id. (describing liability as a method of insurance); see also Kraakman, supra note 106, at 891-92 (discussing how gatekeepers will charge high risk premiums to their customers in return for bearing liability risk).

125 See Kraakman, supra note 29, at 94 (stating general preference for private market enforcement).

126 See id. (finding gatekeeping liability valuable only if private market alternatives are inadequate).

127 See supra notes 15-28 and accompanying text.

128 See Baxter, supra note 106, at 191 (arguing that calls for greater vicarious responsibility imposed on lawyers in financial services context indicate that private market for gatekeeping has failed in that area).

A customer can use two methods to obtain private insurance against fraud[129] from a clearing broker: (1) directly acquiring it by contracting for it in the original clearing agreement, or (2) indirectly acquiring it by avoiding or discounting the services of introducing brokers who use clearing brokers that have previously cleared trades for fraudulent introducing brokers.[130] The indirect insurance works by giving introducing brokers incentives to use clearing brokers that only associate with legitimate introducing brokers. Such clearing brokers would likely charge more for their services to cover the costs of monitoring; these extra charges would then be passed on to the customer as a de facto insurance premium.[131]

This Section presents two explanations for why the private insurance market fails in the introducing-clearing process. The first concerns the relatively low level of investing sophistication of the average customer of an introducing broker. The value of the introducing broker industry is that it covers areas of the market that are likely to be ignored or underserved by the big self-clearing brokerage houses.[132] Most of the introducing firms that use big clearing firms like Bear Stearns are legitimate enterprises: small over-the-counter marketmaker firms, hedge funds, and money managers.[133] The introducing broker market, however, also includes "boiler room" or "bucket shop" operations, which are firms that target unsophisticated investors,[134] usually through aggressive cold-calling techniques.[135] These high-pressure, aggressive introducing brokers often engage in fraud, and they rely on clearing brokers to help them perpetrate this

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129 This Section will continue to equate purchasing gatekeeping services with obtaining fraud insurance. See supra note 124.

130 See Kraakman, supra note 29, at 61-62 (describing these methods).

131 See id. at 93-94 (describing indirect insurance effect in "the market alternative" by illustrations of several different markets).

132 See supra note 41 and accompanying text.

133 See Morgenson, supra note 3, at 114 (describing most introducing brokers as legitimate).

134 See N.Y. Att'y Gen. Rep., supra note 6, at 58-69 (providing detailed description of "boiler room" or "bucket shop" brokerage in operation). The targeted investors are also often wealthy and educated. See id. at 27 (stating that highly educated, wealthy customers are just as susceptible to fraud as those less educated in financial matters because they "fail to devote sufficient time to ground themselves in the details of their investments, electing to leave their investment decisions to others"); see also id. at 34 (stating that fraud-committing introducing brokers target owners of small businesses with annual incomes "of at least $100,000 but who are not sophisticated investors" and "retired persons who have received lump-sum payments of their pensions or life insurance payments upon the death of their spouse").

135 See id. at 2-3 (describing cold callers as reading from prepared scripts that "can often lead to serious fraud, involving misrepresentations, outlandish claims, and guarantees"); Jane Bryant Quinn, Beware of Crooks Calling with Stocks, Baltimore Sun, Nov. 17, 1997, at 15C (detailing fraudulent techniques of cold-calling securities brokers).

fraud.[136] This reliance occurs in two ways: The clearing brokers make the actual trades necessary to the fraudulent scheme,[137] and they lend their name, and hence their good reputation, to the "boiler room" operation.[138] Defrauded customers of introducing brokers often state that they trusted their introducing broker specifically because of the apparent relationship to the well-known clearing firm backing the introducing broker.[139]

It is unrealistic to expect unsophisticated investors to negotiate for gatekeeping insurance terms in a boilerplate clearing agreement[140]—an agreement to which they are not a party, and which comes to them already signed.[141] It is even more unrealistic to expect these unsophisticated investors to acquire fraud insurance indirectly by avoiding clearing brokers that have previously cleared for fraudulent introducing brokers. This indirect insurance requires customers to research a clearing firm's past associations thoroughly. Customers who do not normally invest or who regularly leave their investment decisions to others[142] are unlikely to perform such research. Evidence suggests that this indirect method of insurance is not utilized to any significant extent by investors who use introducing brokers.[143]

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136 See Aidikoff et al., supra note 50, at 118 (stating that clearing firms "substantially enabl[e] . . . fraud to be practiced by introducing firms"); N.Y. Att'y Gen. Rep., supra note 6, at 1-3 (citing rapid increase from 1995 to 1997 in number of public complaints of fraud received by New York Attorney General's Office, highlighting aggressive micro-cap introducing brokers as particularly egregious sources of fraud, and describing reliance of introducing brokers on clearing brokers).

137 See supra note 34 and accompanying text.

138 See N.Y. Att'y Gen. Rep., supra note 6, at 3 (stating that "[s]mall brokerage firms aggressively boast of their relationship with well-known larger firms—almost to the point of stating that they are partners"); see also NYSE Believed to Be Taking a Second Look at Clearing Firms' Immunity, supra note 19 (stating that introducing brokers try to use their clearing brokers' famous names to gain respectability with prospective investors).

139 See, e.g., Charkes, supra note 16, at 5 (reporting investors' contentions that introducing brokers misled them into thinking that clearing firm backed up introducing firm); Morgenson, supra note 6, at 117 (quoting defrauded investment manager as saying that Bear Stearns gave cachet to Baron).

140 See supra note 134 (detailing these customers' lack of investing sophistication); cf. Jackson, supra note 29, at 1045-46 (arguing that high level of sophistication of parties in financial services context—banks and lawyers—means that these parties can negotiate for and purchase their own private gatekeeping services).

141 Introducing and clearing brokers enter into a clearing agreement at the beginning of their relationship; each new customer of the introducing broker simply gets notice of this pre-existing agreement. See NYSE Rule 382(c), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (1995) (requiring only that each new customer of introducing broker receive notice of existence and terms of clearing agreement).

142 See supra note 134.

143 For example, Bear Stearns has cleared for several introducing brokers that have been shut down by regulators in high-profile actions because of improprieties or fraud. These include: Rooney Pace, Inc., shut down in 1987; D. Blech & Co., which failed in 1994 and reportedly left investor losses of $200 million; Stratton Oakmont, shut down in 1997;

The second explanation for the failure of the private insurance market involves redundancy costs and free ridership. This explanation is not an alternative to the first, but works in conjunction with it: The market mechanisms referred to in both explanations are likely to affect the average introducing broker customer.

Redundancy costs arise with indirect insurance. If individual investors are responsible for investigating the history of a clearing firm, the same research will have to be done repeatedly by different customers. The investors are thus likely to duplicate each other's efforts, creating redundancy costs. Compare this to a regime in which investors know that clearing firms engage in monitoring of introducing brokers because it is mandated by law. The latter regime involves no duplication of efforts, and thus will have an efficiency advantage over the former.[144]

The question then becomes whether this efficiency advantage is superseded by other costs associated with mandating insurance. Assume for now that the only potentially offsetting cost is the cost of mandating insurance for customers who do not want it. Assume also that investors benefit from having this insurance.[145] Given these assumptions, the only reason a rational investor would refuse such insurance is that the investor has other means of insuring the honesty of his introducing broker, or knows that he is not likely to be a victim of introducing broker fraud, thus making the mandatory insurance redundant. The issue then is whether this redundancy cost, which applies only to a small subset of investors,[146] offsets the savings of redundancy costs that mandatory insurance brings.[147] Since almost all

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and of course, the widely publicized Baron bankruptcy in 1996, which, as noted earlier, has led to criminal investigations of Bear Stearns. See Morgenson, supra note 6, at 116-17 (detailing these actions). Yet there has been no evidence of any drop-off in Bear Stearns's clearing business following its clearing for these high-profile fraudulent introducing brokers: Bear Stearns had 725 clearing clients in 1987, 2100 in 1996, and has over 2500 today. See id. at 114 (giving numbers for 1987 and 1996); Bear Stearns Homepage (visited Jan. 5, 1999) <http://www.bearstearns.com/about/abs.htm> (providing current data on number of clearing clients). If investors were using indirect insurance to protect against introducing broker fraud, one would expect the number of Bear Stearns's introducing broker clients to decrease following high-profile frauds, but in fact the number of their clients has increased.

144 This conclusion rests upon the assumption that the clearing firm's costs of monitoring are less than the aggregate of individual customers' costs of monitoring.

145 This assumes that the other aspects of the market are such that having mandatory insurance through clearing broker monitoring increases overall efficiency in these areas. See supra Part II.A; infra Part II.C-D.

146 See supra note 134 (describing lack of investing sophistication of typical introducing broker customer).

147 This redundancy cost could be eliminated by implementing an "opt-out" possibility, where an investor could choose to opt out of the usually mandatory insurance. This, however, would lead to free rider problems. See infra note 153 and accompanying text.

investors bear redundancy costs under a regime with no mandatory insurance, and only a small subset of investors bear such costs under a mandatory insurance regime, it seems highly unlikely that the latter costs would offset the former.[148]

The free rider costs that cause the failure of the private insurance market arise with direct insurance against introducing broker fraud. If it is up to customers individually to contract with their clearing broker to monitor their introducing broker, then each customer would have an incentive to "free ride."[149] A rational investor would wait until another investor has paid the clearing broker for this monitoring insurance, and then would invest with the introducing broker that is being monitored without buying the insurance, thus receiving monitoring insurance at no extra cost to him—a free ride.[150] The rational paying investor, upon realizing that his insurance costs have risen because he is paying for this free rider, would then cancel his insurance.[151] Ultimately, no investors would pay for the insurance because of the threat of free riders, and the insurance would not be utilized, making the market less efficient than it could be.[152] Thus, a regime of direct private insurance would lead to a less efficient introducing-clearing market.

These same market mechanisms can lead to free rider costs if an opt-out possibility is offered under a mandatory fraud insurance regime. A rational investor would invest through an introducing broker whose customers did not opt out of the fraud insurance, and would opt out herself. This rational investor would thus gain the benefit of having her introducing broker monitored, but at no cost to her. The introducing broker's other customers, upon realizing that they are paying for this free rider, would themselves opt out. Ultimately, all

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[148] Also, the redundancy cost to each individual who bears it under a mandatory insurance regime is not likely to be substantially higher than the redundancy cost to each individual who bears it under a nonmandatory regime. In both, the cost that is redundant is the cost to the investor of obtaining fraud insurance on his own. The difference is that individuals who bear redundancy costs under a mandatory regime in effect already have insurance before they decide to invest, while under a nonmandatory regime most investors will need to obtain insurance after they have decided to invest.

[149] See Kraakman, supra note 29, at 95 (discussing related free rider problems with private market for gatekeeping).

[150] See Guido Calabresi, The Costs of Accidents 137 n.4 (1970) (describing free rider, or "free-loader," problem).

[151] The costs of excluding the free rider from the benefit she refuses to pay for are likely to be too great. See Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089, 1095 n.13 (1972) (giving examples supporting claim that excluding free riders is costly).

[152] Cf. Richard A. Posner, Economic Analysis of Law 438-39 (5th ed. 1998) (discussing free ridership problem in similar situation of shareholders monitoring performance of corporation's managers).

investors would opt out of the fraud insurance because of the threat of free riders, and the insurance would not be utilized.

One means of eliminating this free rider problem is to have clearing brokers only monitor the accounts of investors who pay for the monitoring. This would only work to eliminate the benefits of free riding if the clearing brokers also *told* the introducing brokers which accounts they were monitoring. Otherwise, introducing brokers would be deterred from committing fraud on all of their accounts because of the possibility that they were being monitored on any given account, and thus there would still be opportunities to free ride.[153] This situation leads to a perverse outcome: In order to rid the market of free riders and thus make the fraud insurance program effective, clearing brokers would have to inform the introducing brokers as to which accounts were not being monitored. This would enable unscrupulous introducing brokers to commit fraud more easily, since they would be able to target those accounts. That is, making the insurance against fraud more effective requires making fraud easier to commit.

An issue also arises as to whether a regime under which clearing brokers monitor only some of their accounts would be more efficient than a regime under which they monitor all of their accounts. Monitoring accounts would likely involve fairly high fixed costs (the cost of setting up a monitoring system and hiring personnel to run it) and fairly low marginal costs (the cost of monitoring another account, once set up to do so).[154] Clearing firms' extra costs associated with full monitoring would be outweighed by the costs of the extra fraud committed under a selective monitoring regime.[155] Thus, a system of full monitoring would be more efficient than a system of selective monitoring.

Overall, the costs associated with a regime of optional direct and/or indirect fraud insurance would very likely surpass the costs associated with an insurance regime of mandatory monitoring of introducing brokers by clearing brokers. Thus, the market mechanisms brought about by the relatively low level of sophistication of customers, coupled with the costs of free riders and redundancy of certain

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153 Recall that if introducing brokers are deterred from committing fraud on all of their accounts when only a subset are being monitored, then customers can free ride on accounts that pay for this monitoring. See supra notes 149-52 and accompanying text.

154 Cf. Mark S. Lemley & David McGowan, Legal Implications of Network Economic Effects, 86 Cal. L. Rev. 479, 494 (1998) (describing relation of fixed costs and marginal costs, and stating that "economies of scale" arise when fixed costs can be spread out over large number of units).

155 Since clearing brokers would inform introducing brokers which accounts were not being monitored for fraud under a selective monitoring regime, it is very likely that introducing brokers would commit more fraud under such a regime.

investor activity, provide an explanation of why the private insurance market for monitoring introducing brokers does not exist.

C. *Gatekeepers Who Can and Will Prevent Misconduct Reliably, Regardless of the Preference and Market Alternatives of the Wrongdoers*

Good gatekeepers must have two attributes. First, prospective gatekeepers need the expertise to recognize wrongdoing, and second, the interaction between the gatekeeper and wrongdoer must be such that the wrongdoer cannot commit the wrong after the gatekeeper has recognized the wrongdoing. Regarding the first attribute, clearing brokers have both the best expertise and the closest access to information in order to detect introducing broker wrongdoing, especially when compared to the expertise and access of the customers.[156] Since clearing brokers themselves are licensed broker-dealers, they know what fraud is and they can easily detect it.[157] Customers of introducing brokers, on the other hand, tend to be smaller investors without much expertise; their knowledge of the fraud often occurs well after its commission.[158] Further, since clearing brokers both perform the actual trades and keep the transaction records for the customers' accounts, they have access to these signs of fraud.[159] Thus, clearing brokers are best situated to deter introducing broker fraud.[160]

There are two ways a wrongdoer can continue to commit the wrong even after a gatekeeper has recognized the wrongdoing: "by shopping on the market for a compliant gatekeeper or by attempting

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[156] See Charkes, supra note 16, at 5 (relating argument that "clearing firms have the capacity to monitor the accounts of the introducing firms' customers because the clearing firms maintain the actual customer records, including new account forms, margin records and statements of all transactions"); cf. Jackson, supra note 29, at 1040-42 (discussing arguments that lawyers in financial services industry are especially well qualified as gatekeepers because they possess both expertise to recognize wrongdoing and access to inner workings of financial institutions).

[157] See infra text accompanying notes 237-41 for a list of signs of introducing broker fraud to which clearing brokers have access.

[158] See supra notes 134, 139 and accompanying text.

[159] See Charkes, supra note 16, at 5 (arguing that clearing firm has information to discover fraud). Keeping customers' transaction records is one of the duties that NYSE Rule 382 stipulates must be assigned in the original clearing agreement. See supra Part I.A. This duty is usually taken on by the clearing broker. See Minnerop, supra note 9, at 841 (describing assignment of duties).

[160] Note that this does not in any way mean that clearing brokers are in a position to deter *all* introducing broker wrongdoing. If clearing brokers were able to do that in a cost-effective manner, then it would make sense to make them fully liable for introducing brokers' misdeeds. Instead, the only claim needed for this Note is that clearing brokers can detect such wrongdoing more easily and more efficiently than the introducing brokers' customers. Cf. Calabresi, supra note 150, at 135-97 (arguing that in particular contexts, liability for harms should be placed on party that can most cheaply avoid them).

to corrupt a familiar gatekeeper."[161] Introducing brokers are unlikely to be able to corrupt clearing brokers, as clearing brokers are too big and well established, and thus have too much to lose, to engage in a fraudulent enterprise with introducing brokers.[162] The second way of avoiding gatekeeping, though, seems to apply to the introducing-clearing market. Clearing trades is a "spot market" for a specific service that can be performed by a number of readily available, interchangeable entities; it is open to a search for "pliable" gatekeepers—gatekeepers that allow wrongdoing.[163] Thus, it seems that introducing brokers can avoid clearing brokers' gatekeeping by changing clearing brokers until a pliable one is found.

Introducing brokers, however, could not engage in such pliable gatekeeper shopping. Introducing brokers must enter into a contractual relationship and establish ties with a clearing broker even to begin trading, making it costly to move to another clearing broker.[164] Further, it is likely that such jumping from clearer to clearer would alert not only well-informed investors but also the organizations responsible for overseeing introducing brokers (e.g., the NYSE and the NASD). Since these self-regulatory organizations (SROs) must approve each new clearing agreement,[165] the SEC or SRO could easily keep its own list of introducing firms that frequently change their clearing brokers.[166] The combination of the costs of switching clearing

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161 See Kraakman, supra note 29, at 63.

162 See id. at 69 (stating that some gatekeepers will effectively be immune from corruption because cost of corruption to them is so large); Minnerop, supra note 9, at 841 (describing clearing brokers as well-capitalized and attractive "deep pockets" for litigants); see also Fiflis, supra note 29, at 515 (stating that importance to investment bankers of their reputation and assets makes them excellent gatekeepers).

163 See Kraakman, supra note 29, at 63-64, 73 (giving standard example of "spot market" at work as underage prospective bar patron who moves from bar to bar until he finds bouncer who lets him in).

164 See id. at 63 n.24 (stating that "long-term contractual relationships will involve investments in 'governance structures' that make exit or breach costly for both sides").

165 See, e.g., NYSE Rule 382(a), 2 N.Y.S.E. Guide (CCH) ¶ 2382 (1995) (requiring that NYSE approve clearing agreements).

166 The NASD already keeps such a list for individual brokers. There is a form of shopping that goes on among individuals who have worked for brokerage firms that have had their securities registration revoked by the SEC, or have been expelled from membership or participation in an SRO, like the NYSE. These individuals often move on to new brokerage firms and continue to commit their fraud there; each time their firm is shut down, they move to a new one. In order to combat this, the SEC has recently instituted the "Taping Rule," which requires firms that have hired a certain percentage of the aforementioned individuals to tape all of their telephone conversations with existing and prospective customers. The NASD keeps a list on their Internet site of brokerage firms that have been shut down by the SEC or an SRO. See James J. Eccleston, Taping Rule to Unmask Fraud, Chicago Daily L. Bull., Sept. 21, 1998, at 6, available in Westlaw, 9/21/98 CHIDLB 6 (discussing how Taping Rule can help investors avoid abusive sales practices by brokers who have recently moved from brokerage houses that have been shut down by SEC or SRO).

brokers until a pliable one is found and the suspicion such rapid switching would raise would be enough to deter clearing broker shopping.

D. Gatekeepers Whom Legal Rules Can Induce to Detect Misconduct at Reasonable Cost

In the debate over the proper level of clearing broker liability, there seems to be no disagreement over whether legal rules can induce clearing brokers to change their behavior towards introducing brokers.[167] The issue is whether clearing brokers would change their behavior to monitoring and preventing introducing broker fraud, or whether they would change their behavior to abandoning the clearing market entirely.[168] The latter is likely to occur if the costs of detecting fraud are too high.[169]

It may be the case that making the gatekeepers' business too expensive to maintain would maximize the total societal wealth; that is, the gatekeepers' business, with all its consequences, might be a drain on society's wealth.[170] But assuming that this is not the case,[171] the costs imposed on clearing brokers ought not be sufficient to drive them out of the clearing business.

In the arguments made in the aftermath of the Baron fraud, clearing firms continuously insisted that an expansion of their liability would make clearing too costly, and would effectively mean the end of the introducing-clearing brokerage business.[172] This claim would

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[167] Well-capitalized clearing brokers have much to lose by engaging in illegal activity, and thus are very unlikely to engage regularly in conduct that would leave them open to civil or criminal prosecution. See Kraakman, supra note 29, at 70:

> Whenever entry into a gatekeeping market requires significant capital . . . simple legal penalties such as civil damages, fines, or license revocations can be powerful deterrents. . . . [P]rofessionals . . . make attractive legal gatekeepers in part because they have large and vulnerable investments in licenses and reputations.

[168] Clearing firms themselves have claimed the latter would occur. See supra note 26 and accompanying text.

[169] See supra note 26 and accompanying text.

[170] This could be the case if clearing creates large "externalities"—that is, if clearing imposes costs on others that the participants do not take into account. See Jesse Dukeminier & James E. Krier, Property 47-51 (4th ed. 1998) (describing externalities and stating that they tend to lower total societal wealth).

[171] There seems to be good reason for this assumption. See N.Y. Att'y Gen. Rep., supra note 6, at 2 (stating that introducing brokers offering micro-cap stocks, which is area that is heavy with fraudulent activity, nonetheless "serve an important role in the American economy"); Kline & Moss, supra note 27, at 157 ("[T]he clearing business is a thriving one that plays a vital role in the securities markets and one which should be preserved and perpetuated."); Minnerop, supra note 9, at 841 ("Clearing brokers play a vital role behind the scenes and headlines of Wall Street.").

[172] See supra note 26 and accompanying text.

make sense if an expansion of clearing brokers' liability entailed absolute liability for introducing brokers' misdeeds—i.e., some form of strict liability for introducing broker fraud.[173] But a strict liability regime is really a kind of straw man. Partial liability imposed on clearing brokers within a clearly circumscribed domain could retain profitability for the clearing brokers while increasing the overall efficiency of the market and greatly expanding protections for customers.[174] This Section will support that claim by first describing the different types of costs that gatekeeping liability can impose, and then arguing that the right level of gatekeeping duty can retain the profitability of the clearing business by keeping those costs low.

In making their arguments against liability, the clearing firms focus only on their own costs of bearing gatekeeper responsibilities.[175] But in weighing whether the costs of gatekeeper liability are reasonable, it is important here to consider *all* of the costs to society. Professor Kraakman notes three types of costs that can be incurred by gatekeeper liability: administrative (the cost of policing gatekeepers), private (the cost of the burdens imposed on the transactions between the gatekeepers and the regulatory targets—i.e., the prospective wrongdoers), and tertiary (the cost of the burdens imposed on third parties affected by these transactions).[176] While administrative costs are not important for present purposes,[177] the latter two costs are important to consider carefully because of their hidden nature. Private costs include both the gatekeepers' costs of over- or undermonitoring, as well as the costs of bearing and shifting unknown legal risks.[178] The tertiary costs are those borne by third parties when gatekeepers refuse to associate with regulatory targets on the basis of certain characteristics.[179]

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173 Perhaps this liability could be modeled after respondeat superior.

174 See generally Kraakman, supra note 29, at 75-76 (describing how clearly circumscribed duties minimize liability costs).

175 See supra note 26 and accompanying text.

176 See Kraakman, supra note 29, at 75.

177 Kraakman states that administrative costs are the "least important" of the three costs because they are highly visible and easily regulated. Id. at 75 & n.67.

178 See id. at 75-76 (describing private costs). These are the costs about which clearing firms worry.

179 See id. at 75, 77 (describing tertiary costs). Tertiary costs are more likely to occur when there are high private costs since gatekeepers would then be more likely to discriminate among the regulatory targets with whom they associate. See id. at 77. An example of tertiary costs is clearing brokers refusing to clear for introducing brokers specializing in micro-cap stocks (stocks that trade for just above five dollars) because these brokers commit a high incidence of fraud. Micro-cap stocks have been the preferred type of stock for fraud-committing brokers since the enactment in 1990 of new federal "penny-stock" requirements that set certain strict rules for the public selling of stocks priced at five dollars or below. See N.Y. Att'y Gen. Rep., supra note 6, at 11 n.8, 13. Even though much fraud

The liability rules covering gatekeepers' duties affect these costs in the following way: The greater the ambiguity and complexity in these rules, the greater the likelihood that either courts will err and thus impose unexpected liability, or that gatekeepers will err and be overcautious.[180] The possibility of unexpected liability raises gatekeepers' costs of determining their monitoring and legal strategies, and increases the likelihood that gatekeepers will make mistakes in the strategies they choose.[181] If the cost of these mistakes coupled with the higher costs of determining monitoring and legal strategies is too high, then gatekeeper liability will not be an efficient means of counteracting wrongdoing. Clearing firms have already anticipated that those costs would be so high that they would be forced to abandon the clearing business rather than shoulder the costs.[182]

Both the private and tertiary costs can be contained by clearly defining and limiting the duties of the gatekeeper.[183] One way to keep these duties simple is to make them, in Professor Kraakman's terms, "simple operational monitoring rules."[184] Another way to keep the duties simple is to prescribe a scienter standard that requires actual knowledge or intent on the part of the gatekeepers for liability.[185] On the other end of the spectrum, vague and complex duties include a duty to engage in "reasonable" monitoring (i.e., a duty of "due care"),[186] as well as "the limiting case of a diffuse monitoring 'duty'—a strict liability standard."[187] Imposing a vague duty on gatekeepers is likely to lead to high private and tertiary costs,[188] although a vague duty can be more clearly defined (and thus, overall costs reduced) by developing specific, informed criteria that determine what "due care" means.[189]

Recognition of the different levels of gatekeeping costs undermines the clearing brokers' assertion that imposing liability on them

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occurs in this micro-cap area, "[m]icro-cap stock offerings can serve an important role in the American economy." Id. at 2. If these introducing brokers have no one that will clear for them, this important part of the American economy will be lost.

180 See Kraakman, supra note 29, at 76 (noting relationship of ambiguity in law to liability assessment).

181 See id. (discussing costs of unexpected liability).

182 See supra note 26.

183 See Kraakman, supra note 29, at 75-77 (noting that sharply focused and simple duties reduce costs arising from gatekeepers' and courts' lack of knowledge).

184 Id. at 79. An example of such a rule is mandatory identification checks at a bar. The bar bouncer is a gatekeeper who performs his duty by performing a simple ID check.

185 See id. at 76 (stating that duty based on scienter standard imposes lowest cost).

186 Id.

187 Id.

188 Id. (describing relationship between costs and vague duties of care).

189 See id. at 80 (describing sharpening of vague duties of care); infra Part III.C (describing ways to sharpen vague duty of care, particularly in securities clearing context).

will necessarily make the clearing business too costly. The diverse standards of gatekeeper liability impose different levels of costs, and the possibility that the costliest could very well lead to the end of the clearing industry is not a good reason to avoid imposing *any* form of gatekeeper liability on clearing brokers. Legal rules can be fashioned to induce clearing brokers to detect introducing broker fraud at a reasonable cost. A set of such legal rules is proposed below.[190]

This Part has presented an argument for why imposing gatekeeper liability on clearing brokers would be a superior way of maximizing wealth, as compared to direct regulatory oversight or private insurance. Since there is a range of possible gatekeeper liability regimes corresponding to the type of duty imposed on the gatekeeper, it is still necessary to determine the appropriate level of gatekeeper liability. The final part of this Note will make some general suggestions about the determination of the level of clearing broker liability, while also providing a structure that regulators or the courts can use in making this determination.[191]

III

A Proposed Rule Covering the Liability of Clearing Brokers for the Misdeeds of Introducing Brokers

The SEC recently adopted changes to the NYSE and NASD rules governing the introducing-clearing relationship.[192] These rule changes, however, are not sufficient to address adequately the problem of introducing broker fraud. The changes are set forth in Table 1 below.

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190 See infra Part III (suggesting rule of liability for clearing brokers that falls on less costly side of spectrum of gatekeepers' duties).

191 Ultimately, the final determinations of whether and at what level gatekeeping liability should be imposed are empirical determinations rather than broadly theoretical, and thus they cannot be determined a priori. The arguments put forth in this Note are meant as a structure for developing such determinations. Cf. Fiflis, supra note 29, at 516 (stating that it is up to courts to "fine tune[ ]" weighing of costs and benefits in imposing gatekeeper liability on investment bankers); Jackson, supra note 29, at 1054 ("Whether the prerequisites for gatekeeper liability are satisfied is largely an empirical question. A priori, one cannot predict with confidence the interaction of market forces on this kind of issue.").

192 See NASD Order, supra note 17; NYSE Order, supra note 17; see also supra Part I.A for a discussion of the rules currently governing this relationship, and of the process that led to the NYSE delivering these proposed changes to the SEC. The NASD has proposed similar amendments. See Kline & Moss, supra note 27, at 155 (describing NYSE and NASD proposals).

TABLE 1

	Previous Regulation	Newly Passed Regulation
Customer Complaints	Clearing broker need only notify introducing broker of customer complaints.	Clearing broker must also notify introducing broker's overseeing organization.
Surveillance Tools	No regulation covering the surveillance tools for monitoring customers' account activity (known as "exception reports").	Clearing broker must notify regulators as to which exception reports it offers, and which its introducing brokers choose to use.[193]

The NASD and the NYSE have been careful to say that the rule changes are not intended to increase clearing brokers' liability to investors,[194] and the SEC has accepted this interpretation, as it was the NYSE that originally proposed the changes to the SEC.[195] This position, however, naturally leads to the question of what sanction will be imposed on clearing brokers that violate these new regulations.[196] Limiting a sanction to the imposition of a fine by an administrative

[193] The intent of this rule change is to encourage introducing firms to make greater use of the tools available for monitoring customer accounts. See Operations Clarified, Operations Mgmt., Mar. 9, 1998, available in 1998 WL 10891273.

[194] See Kline & Moss, supra note 27, at 155 (stating that "[i]n their rule proposals to the SEC, both the New York Stock Exchange and NASD Regulation, Inc. undertook to state with clarity and specificity that the proposed amendments were not intended to change or . . . otherwise affect the [clearing] firms' respective rights, responsibilities or liabilities under law"); Operations Clarified, supra note 192 (interviewing Sal Pallante, senior vice president of member firm regulations for NYSE, who states that proposed rule changes "are not intended to address or alter the liability of the clearing broker").

[195] See NYSE Order, supra note 17, at 31,339 (espousing NYSE position that rule changes would not increase clearing firm liability); see also Beckett, supra note 16, at A3 (stating that SEC chairman Arthur Levitt does not intend to impose greater responsibility on clearing firms through SEC rules).

[196] The U.S. Supreme Court has recognized repeatedly that private rights of action serve an important and effective role in deterring fraud, over and above the effectiveness of actions by administrative agencies. See, e.g., Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) (stating that private actions under section 10(b) "constitute[ ] an essential tool for enforcement of the 1934 Act's requirements"); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) ("[W]e repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964))).

The current Court, however, has refused to find an implied private right of action where one is not specifically provided for in the securities laws. See Central Bank v. First Interstate Bank, 511 U.S. 164, 175-76 (holding that private plaintiff may not maintain aiding and abetting claim under section 10(b) because text of Act does not specifically allow for such claim). While this Note does argue for expanding clearing brokers' liability under section 10(b), it does not do so by arguing for recognition of a new cause of action under section 10(b). Instead, the argument is that courts or regulators should impose a wider duty on clearing brokers under SRO rules; if a clearing broker breaches this duty, it would be directly liable under section 10(b).

agency seems to make little sense. First, if the fine were a set amount and the reward from violating the rules exceeded that amount, rational clearing brokers would choose to commit the rules violation and pay the fine.[197] The fine would in effect become a "fraud fee." Second, presumably the fine would go to the government and not to the defrauded investors. Yet it was the investors, not the government, who were harmed financially.[198] If the rules were changed to accommodate these concerns, the penalty imposed on clearing brokers for violating the proposed new regulations would be tied to the amount of the fraud and would be paid to the defrauded customers. This, however, would produce the same result as imposing liability on the clearing brokers in the first place.[199]

Instead of a fine, the penalty could be the revocation of the clearing broker's license. This sanction, however, could very well lead to the following undesirable situation: The defrauded customers do not get their money back, the clearing broker is out of business, and the brokers who worked for the introducing firm—the individuals who actually committed the fraud—move on to new firms, keeping the money they made from the fraud.[200] Since introducing firms are unlikely to be able to pay large judgments to defrauded customers,[201] rational investors would prefer that the clearing broker stay in business and pay the investors the money they lost to fraud, rather than be put out of business. Thus, it seems that if the sanctions for violating

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197 See supra Part II.A.

198 See Richard H. Walker & J. Gordon Seymour, Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action, 40 Ariz. L. Rev. 1003, 1003 ("Private actions under the antifraud provisions of the securities laws . . . provide perhaps the quickest way for defrauded investors to attempt to recoup their losses.").

199 There would be one difference between these two outcomes: Making clearing brokers liable to investors involves giving defrauded customers a private right of action, while sanctions imposed by an overseeing organization would probably not involve such a right. This could lead to two differences in incentives. First, if introducing broker customers lose money, they will likely have more incentive to institute a court action against the clearing broker than a presumably objective regulator would have to impose sanctions against the clearer. Second, customers would only institute such an action if they lost money; thus, some violations by clearing brokers would likely go unpunished. The first problem can be ameliorated by the heightened pleading requirements for fraud in Fed. R. Civ. P. 9(a) and sanctions for frivolous lawsuits, while the second problem can be neutralized by the ability of regulators to impose sanctions. Further, the first type of customer incentive can make the market more efficient because it is natural to be more vigilant in protecting one's own interests than in protecting others' interests.

200 See N.Y. Att'y Gen. Rep., supra note 6, at 15-16 (describing how individual brokers are usually not prosecuted when regulators shut down firm, enabling those individuals to move to new introducing firm after old firm is shut down).

201 See Kline & Moss, supra note 27, at 143 (stating that defrauded investors often seek to hold clearing brokers liable because their introducing brokers are frequently financially distressed or defunct).

the proposed new rules do not involve making the clearing broker liable to the defrauded investor, the sanctions would inadequately deter fraud and/or fail to compensate those defrauded.[202]

An alternative proposal for determining the liability of clearing brokers must address two issues. First, what is the liability threshold? That is, what is the point after which, if clearing brokers do nothing, they can be held liable for introducing brokers' wrongdoing? Second, what actions must clearing brokers perform to avoid liability once the liability threshold has been reached?

A. *The Boundaries of Clearing Broker Liability*

Part II.D discussed different levels of liability in the context of Professor Kraakman's analytical structure of gatekeeper liability. These different levels of liability impose different costs on both the gatekeeper and society in general.[203] Since the argument put forth in this Note centers on the claim that imposing expanded liability on clearing brokers would maximize total societal wealth,[204] the cost to society of the level of liability imposed on clearing brokers is a central consideration in the proposed liability scheme. This proposal must weigh, on the one hand, the savings from deterred fraud brought about by imposing liability on clearing brokers and, on the other hand, the total costs incurred by this liability.

The different levels of liability that could be imposed on clearing brokers can be broken down into three categories: a scienter/actual knowledge standard, a strict liability standard, and a duty of care standard. The first two lie on opposite extremes of the liability spectrum. Neither of these two standards would be the proper one for clearing brokers; strict liability makes clearing brokers liable for too much,[205]

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[202] See Walker & Seymour, supra note 198, at 1003. Another possible sanction that could be imposed on clearing brokers for violating these proposed rules is criminal sanctions. While this may go a long way towards effectively deterring clearing brokers from violating the rules, it would do nothing to compensate the defrauded customers. Further, there may be a general reluctance to impose criminal sanctions on a clearing broker for someone else's wrongdoing.

[203] See supra notes 180-90 and accompanying text.

[204] See supra Part II.

[205] Under strict liability, clearing brokers would be liable for the fraud committed by the introducing brokers while acting within the scope of their role as introducing brokers; it would be similar to respondeat superior. See Restatement (Second) of Agency § 219 (1958). This standard would effectively insure investors against fraud, at least to the extent of the clearing broker's resources. It would also, however, impose high monitoring and legal risk bearing costs on clearing brokers. See Kraakman, supra note 29, at 76 (detailing costs to gatekeepers under strict liability standard). Therefore, clearing brokers would likely either severely restrict their clearing business to brokers with whom they have very close ties (akin to employment), or abandon the clearing business entirely. See supra note 26 (describing clearing firms' arguments to this effect). Since it would most likely bring

and scienter makes them liable for too little.[206] The third category of liability is much more complex because a "duty of care" can mean a number of different things, entailing a whole range of effectiveness and comparative costs.[207] The general claim of this section is that some form of "duty of care" liability will provide the best balance of reducing fraud at a reasonable cost. The specific duty of care that this Note advocates imposing on clearing brokers is described in Part III.C.

One end of the range of different duties of care is closer to the actual knowledge standard; the duty is met by undergoing simple operational procedures.[208] For example, Professor Kraakman cites the simple "ID check" as satisfying this standard.[209] On the other end of the range is a diffuse monitoring duty, which is determined ex post by the courts.

A duty of care requiring the performance of simple operational procedures works best if introducing brokers engaged in fraud emit certain telltale signs,[210] and if the introducing brokers cannot avoid emitting these signs by simply changing their methods of fraud.[211] Courts or regulators[212] can determine these simple operational proce-

about the end of introducing brokers' independence from clearing brokers, it would likely be the end of the introducing-clearing business as it now exists. There is good reason to think that this consequence would involve a net loss to society. See supra note 171.

206 Under an actual knowledge standard, clearing brokers' possible liability would arise when either they gained actual knowledge of an introducing broker's fraud, or they formed an intent to help an introducing broker perpetuate fraud. The advantage of this standard is that it is a very inexpensive level of liability, as it does not require any monitoring by clearing brokers nor any real change in their normal operations. See Kraakman, supra note 29, at 76 (discussing scienter standard of gatekeeper liability). It has the disadvantage, however, of encouraging clearing brokers to bury their heads in the sand in order to avoid gaining knowledge of fraud and thus becoming potentially liable. For this reason, the standard would probably only prevent the most egregious cases of fraud, the ones that clearing brokers cannot help but notice. Further, this standard would make it very difficult for plaintiffs to hold clearing brokers liable, as actual knowledge is more difficult to prove than negligence in performing a duty of care.

207 Here, "duty of care" means the duty owed under a negligence standard. The range of different possible duties of care corresponds with different ways of setting the negligence standard.

208 It is important to note that, as defined by this Note, a broader standard of liability encompasses lesser ones. So, if a narrow duty of care standard is imposed, this standard would include the scienter/actual knowledge standard. This avoids the situation in which a clearing firm knows that fraud is being perpetrated, but avoids liability by performing some simple operational duties, the outcome of which do not indicate fraud.

209 See Kraakman, supra note 29, at 79.

210 See infra notes 237-41 and accompanying text.

211 See Kraakman, supra note 29, at 79 (stating that simple operational monitoring rules are not as effective in complex situations).

212 The imposition of expanded liability on clearing brokers could be accomplished either by administrative regulators (e.g., the SEC or NYSE) or by the courts interpreting the rules governing clearing brokers. See id. at 101 (finding that gatekeeper liability may

dures by examining the types of fraud that introducing brokers usually commit and how this fraud is usually manifested to clearing brokers.

As long as all of the terms used in the operational duties are well-defined ex ante,[213] this standard has the lowest cost of any duty of care, and it would prevent many more cases of fraud than a scienter/actual knowledge standard of liability.[214] The standard also has the advantage of actually looking at how fraud is committed in order to combat it. On the other hand, this standard of liability would probably miss some cases of fraud that a higher duty of care would prevent.[215] Introducing brokers would try to be one step ahead of the regulators by knowing the signs for which clearing brokers are looking and tailoring their fraud so as to avoid giving those signals.

The other kind of duty of care is a diffuse monitoring duty that courts determine ex post. This standard of liability would cast a much wider net than the previous one because courts would determine, after the fraud has come to light, whether the clearing broker's monitoring of the introducing broker was "reasonable" or not.[216] This does not mean, however, that the courts would necessarily be left with only their own notions of what is "reasonable" when making this determination; there are ways that a diffuse duty of reasonable care can be focused so as to reduce uncertainty, and thus costs.[217]

One way courts can focus a diffuse duty of care is by looking to the gatekeepers themselves. The courts could ask a group of responsible clearing brokers to develop a set of informed criteria to determine their duty of care,[218] or the courts could determine the duty of care on their own, based upon the widely shared business practices of clearing brokers.[219] The advantage of this approach is that the people who have the most familiarity with a situation define the requirements of due care for that situation. The disadvantage is that these same peo-

be imposed by either alternative). The rest of this Note will focus on courts determining and imposing liability on clearing brokers, but administrative agencies could likely perform this task just as well.

213 See id. at 75-76 (stating that duty based on simple operational procedures imposes lower costs than other, more vague duties of care).

214 See supra note 211.

215 See Kraakman, supra note 29, at 79 (stating that in complex situations "broad culpability standards" must be used as gatekeeper liability standards rather than simple operational duties).

216 See id. at 79-80 (describing diffuse duties of care).

217 See id. at 80 (describing and comparing different means of focusing diffuse duty of care).

218 See id. at 80 & n.76 (citing professional associations of accountants and lawyers that specify minimum standards for audit procedures, legal opinions, and due diligence procedures under section 11 of 1934 Act).

219 See id. at 80 (describing how widely shared business practices can focus diffuse duty of care).

ple have the most vested interest in keeping the costs of this duty to a minimum.

Another option is to have courts estimate a reasonable level of monitoring.[220] This option has the advantage of using disinterested parties to determine the duty of care. This determination, however, would still be a guess based on limited information. Also, this option would probably be applied ex post at trial and would involve the highest costs for monitoring and risk bearing.[221] With a duty of care determined by this option, clearing brokers could not be certain whether or not they discharged their duty, even if they acted conservatively and in good faith.[222]

Overall, a diffuse duty of care would prevent more fraud than one based on simple operational duties. But with this greater prevention comes greater cost, in terms of both costs to the clearing brokers and possible tertiary costs.[223] These costs can be reduced by focusing the duty of care imposed.

B. What Clearing Brokers Must Do to Avoid Liability

This Note's proposal for what clearing brokers must do to avoid liability is quite straightforward: suspend and inform. Once the liability threshold has been reached, a clearing broker has a duty to (1) suspend trading of the fraudulent introducing broker's accounts, and (2) inform the organization overseeing the introducing broker (the NASD, for example) and the introducing broker's customers of the suspension and the reasons for it. If clearing brokers follow this procedure, they can avoid liability for the introducing brokers' fraud.

This "inform and suspend" proposal is a combination of gatekeeping and "whistleblowing"—not only must clearing brokers withhold cooperation from fraudulent introducing brokers, they also must "blow the whistle" by informing victims and proper authorities of the fraud.[224] While whistleblowing liability is a more effective de-

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220 See id. at 80-81 (giving example of courts "guessing" how much misconduct gatekeepers can detect at reasonable cost and citing Connor v. Great W. Sav. and Loan Ass'n, 447 P.2d 609 (Cal. 1968) (Traynor, J., concurring)). One can see another example of focusing a duty of care in the New York State Attorney General's Report on Micro-Cap Fraud, in which the Attorney General looks to the practices of a responsible clearing broker (Merrill Lynch), in order to formulate a proposal as to what should be required of all clearing brokers. See N.Y. Att'y Gen. Rep., supra note 6, at 78-80.

221 See supra Part II.D (discussing why ex ante uncertainty leads to higher monitoring and legal risk bearing costs).

222 See Kraakman, supra note 29, at 76 (stating that under less focused, diffuse duty of care, "even conservative gatekeepers will face legal risks despite their best efforts").

223 See supra Part II.D.

224 See Kraakman, supra note 29, at 53-54, 56 (defining gatekeeping and whistleblowing).

vice for preventing wrongdoing than gatekeeper liability, the latter liability regime is sometimes the preferred alternative because whistleblowing liability imposes extra costs on suspected wrongdoers.[225] These extra costs include the costs of legal defense, reputational loss, and possible penalties or civil damages.[226] If only the fraudulent introducing brokers bear these costs, the costs may be acceptable, but whistleblowers may blow the whistle erroneously and thus impose these costs on law-abiding introducing brokers as well. Therefore, all introducing brokers must bear the risk of these extra costs.[227] Further costs may also arise from the erosion of trust that the threat of whistleblowing might impose on the introducing broker-clearing broker relationship.[228]

There are reasons to think, however, that the extra benefits of deterred fraud that whistleblowing supplies would outweigh the extra costs imposed by whistleblowing. First, the introducing broker-clearing broker relationship does not essentially depend upon a high level of trust (unlike the lawyer-client relationship, for example); thus, a possible erosion of trust is not likely to impose high costs on that relationship.[229] Second, if clearing brokers had a duty to blow the whistle only when receiving very clear signs of fraud,[230] the risk of erroneously accusing a law-abiding introducing broker would be much lower than if a general duty of monitoring care was imposed on clearing brokers.[231] If the extra costs associated with whistleblowing turned out to be too high for introducing brokers to bear, the proposal outlined below could easily be modified to require gatekeeping only.

Another cost associated with the "inform and suspend" proposal is the cost to the investors of having the trading in their accounts sus-

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225 See id. at 58-59 (discussing greater effectiveness and higher costs of whistleblowing liability). Kraakman also finds another reason for preferring gatekeeping over whistleblowing: "our deeply felt aversion to mandatory informing." Id. Kraakman does not explain this aversion further, but presumably it stems from a desire to protect individual liberty. Since this Note focuses almost exclusively on efficiency concerns, the second reason for preferring gatekeeping over whistleblowing will not be addressed. Gatekeeping may also be preferred over whistleblowing for relationships that require the free exchange of information to be effective, like the lawyer-client relationship, for example. See Baxter, supra note 106, at 190 (stating that whistleblowing liability applied to lawyers is "controversial" because it directly conflicts with confidentiality requirements).

226 See Kraakman, supra note 29, at 59 (delineating these costs).

227 See id. at 60 (arguing that all "regulatory targets" should bear extra costs of whistleblowing).

228 See id. (describing costs arising from erosion of trust).

229 Cf. id. at 60 & n.17 (citing relationships such as lawyer-client and doctor-patient, where erosion of trust can impose high costs).

230 See infra Part III.C for such a proposal.

231 See Kraakman, supra note 29, at 79-80 (arguing that circumspect duties of care create lower costs than generalized duties).

pended. Investors could incur substantial costs if they were unable to trade their securities at will. This cost can be lessened, however, by giving these investors the right to move their accounts to another broker (either to the clearing firm or to another introducing broker) when their introducing broker's trading is suspended.[232] Note, however, that this makes the suspension of trading especially costly to the introducing broker because once trading is suspended, the broker could easily lose most of his customers.[233] For this reason, clearing brokers should suspend introducing brokers' trading only when there is fairly clear evidence of fraud. This means that clearing brokers' duty of care should be clearly defined.[234]

C. *The Proposal*

The proposal described in this section utilizes a duty of care based upon simple operational procedures. The SEC should pass regulations that impose a duty on clearing brokers to monitor for certain signs of fraud. The most common type of introducing broker fraud is the illegitimate manipulation of a stock's prices, or "making a market," where the broker and favored investors make money off the inflated stock, while the defrauded customers are harassed or tricked into buying high and selling very low.[235] This general type of fraud is accomplished via particular fraudulent practices: unauthorized trading of customers' accounts, including "parking" of stocks; failure of broker to sell stock when told by customers to do so; "No Net Sales" and "matching" practices; misrepresentation to customers of the quality or risk of a stock; and abuse, harassment, and intimidation of customers.[236] These fraudulent practices are revealed to the clearing broker through the following signs:

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[232] This would accentuate the need for clearing brokers to inform the customers once the liability threshold has been reached. Otherwise a customer would not know to move her account to another broker after trading has been suspended.

[233] These extra costs caused by suspension of trading might lead one to think that "suspend" should be dropped from the "inform and suspend" proposal. But given how adept fraudulent introducing brokers have become at avoiding legal sanctions imposed by regulators, see supra note 114, the suspension of their ability to trade seems to be the best way to stop them from committing fraud.

[234] See Kraakman, supra note 29, at 75-78 (describing how ill-defined gatekeeper duties can cause gatekeeper to overmonitor and thus raise regulatory target's costs).

[235] See N.Y. Att'y Gen. Rep., supra note 6, at 41-42 (describing market manipulation of stock prices).

[236] See id. at 28-32, 35, 39-40 (detailing these practices as usual means of accomplishing securities fraud). A "No Net Sales" policy means that a broker cannot sell a customer's stock until he has gotten an order from that same customer to buy another stock that the brokerage wants to sell. A "matching" policy means that a broker cannot sell a stock unless he finds another customer to buy that stock. This way the brokerage does not have

— a pattern of stock purchases for which the customer does not pay (evidence of unauthorized trading)[237]
— a pattern of cancelled transactions (evidence of "parking")[238]
— complaints from customers about unauthorized trading or about the introducing broker not executing customers' trading orders[239]
— introducing broker loading up on short positions of a stock during early selling periods to the public (evidence of illegitimate marketmaking)[240]
— forged signatures on checks made out to customers[241]

These five signs of fraud can form the basis of simple operational procedures that comprise a clearing broker's duty of care.

If a clearing broker detects one of the above signs of fraud in its interactions with an introducing broker, the clearing broker must immediately suspend clearing trades for that introducing broker, and

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to put that stock into its "house" account. See id. at 35 (describing "No Net Sales" and "matching" policies).

237 See id. at 84-85 (describing how unauthorized trading leads to pattern of unpaid stock purchases). What comprises a "pattern" would need to be defined. The point of stipulating simple operational duties as defining the duty of care is to reduce the costs associated with courts judging clearing brokers' behavior ex post; if terms in the operational duties are left to be defined ex post by the courts, this would again raise these costs. There is some guidance for defining this phrase from the NYSE rules governing extension of credit requests. When a customer does not pay on time for a purchase order in his account, the clearing broker either must get a cancel order from the introducing broker, or must get an OK from its overseeing organization (usually the NYSE) to proceed with the trade. See id. at 82-83. The latter is called an "extension request." See id. at 83. Clearing firms must get the OK from the NYSE because, technically, the trade for which the customer does not pay is an extension of credit to the customer. See id. The NYSE has developed a standard whereby, when the amount of a clearing firm's extension requests exceeds 2% of the clearing firm's total monthly transactions, the expectation of the customers promptly paying for the trades is no longer reasonable. See id. If this ratio exceeds 5% for two out of any three months, the NYSE stops granting extension requests to that clearing broker for 90 days. See id. at 83-84. This 5% ratio over any two of three months is a good standard to use to define "pattern of stock purchases not paid for by the customer." Under the proposal advocated herein, if an introducing broker's orders exceed this ratio, then the clearing broker must "suspend and inform" to avoid liability for the introducing broker's fraud.

238 See id. at 85 (describing how such pattern is evidence of underlying fraud). Once again, "pattern" needs to be precisely defined for the reasons set forth above. See supra note 237. It can be defined as a certain number of canceled transactions within a given time period. Unfortunately, there is no guidance from the NYSE rules on how to define the phrase more precisely. To make this determination, a factual inquiry would be required that is beyond the scope of this Note.

239 See N.Y. Att'y Gen. Rep., supra note 6, at 3 (stating that customers being defrauded often make complaints to clearing brokers, who ignore them).

240 See id. at 134-35 (describing how large acquisition of short positions of stock during selling period can signal introducing broker fraud). "Loading up" is another phrase that would have to be defined more precisely.

241 See In re Lloyd Sec., Inc., 1992 Bankr. LEXIS 1706, at *7-*8 (Bankr. E.D. Pa. Oct. 29, 1992) (detailing how introducing broker forged signatures to carry out fraud, and how clearing broker purposely ignored forgeries).

must inform both the overseeing SRO and the introducing broker's customers that the clearing was suspended, giving the reason for the suspension. From that point forward, the clearing broker cannot continue trading for the introducing broker until the SRO (e.g., the NYSE or NASD) lifts the suspension.[242] If the clearing broker fails to suspend and inform, then it shall be fully liable to the defrauded customer of the introducing broker.[243]

This proposal involves a fairly modest expansion of clearing brokers' liability, without imposing costly monitoring duties on clearing brokers. This Note has argued for a relatively small first step into clearing broker liability in order to make the argument for imposing liability on clearing brokers clearer and more forceful. It is entirely possible that regulators or the courts could perform the calculus of costs in such a way as to conclude that a higher duty of care should be imposed on clearing brokers. Nothing in the argument presented in this Note precludes that determination.

CONCLUSION

Introducing broker fraud is a serious problem for the securities markets. Recent cases of introducing broker fraud of tens and even hundreds of millions of dollars show that the current liability regime is ineffective at preventing such fraud. Introducing brokers who commit fraud believe, accurately, that there is a low likelihood that they will be held individually responsible. "Boiler room" introducing firms go in and out of business with regularity, as the brokers move to a new firm when regulators shut their old firm down. The introducing brokers make money, the firms that clear the trades for the introducing brokers make money, and the only people who lose money are the defrauded investors. These investors then find themselves with no viable legal recourse after they become aware of the fraud; complaints to regulators may lead to the closing of the introducing firm, but de-

[242] In order to limit the costs incurred by a wrongly accused introducing broker, and because of fairness considerations, the SRO should probably be required to take action against the introducing broker within a certain amount of time, or else the suspension will be lifted automatically.

[243] Part II.B supra discusses whether introducing broker customers should have an "opt-out" possibility. That option would allow investors to take on the costs and risks of insuring against introducing broker fraud themselves, via an agreement (separate from the original clearing agreement) that they will not sue the clearing broker in the event of fraud by the introducing broker. Allowing for opt-out may very well raise free rider problems. See supra Part II.B. Thus, the opt-out alternative is not included in the proposal offered herein. If the free rider problems turn out not to arise in this situation (the lack of investing expertise among typical introducing broker customers may mean that they will not recognize the opportunity to free ride), then the opt-out can be added to the proposal in order to reduce costs.

frauded investors are unlikely to get their money back because these firms are so undercapitalized.

Intuitions about equity lead to the conclusion that the liability regime in this area should be changed. Purely economic considerations also support this conclusion. This Note has presented an efficiency argument for expanding clearing brokers' liability for the fraudulent acts of the introducing brokers associated with them. By applying Professor Reinier Kraakman's analytical structure of gatekeeping liability to the introducing broker-clearing broker relationship, this Note has argued that imposing a limited duty on clearing brokers to monitor for signs of fraud would lead to greater wealth maximization than the current liability system.

An expanded liability regime for clearing brokers should not impose too many costs on clearing brokers, however, as this could lead to the end of the introducing-clearing business. For this reason, this Note has sketched a pragmatic proposal for clearing brokers' liability that is meant to keep clearing brokers' costs low by utilizing simple operational duties as the standard for duty of care. An alternative liability regime could impose a more diffuse duty of care on clearing brokers; this alternative could be implemented if the costs associated with it were not too high. In order to evaluate these different liability regimes, the increased costs of the more expansive liability should be weighed against the savings that scheme produces in averted fraud. Ultimately, the final arbiter of this weighing process must be securities regulators and the courts. The proposal offered above is not only meant to be a suggestion for the outcome of this weighing process, but it is also meant to provide a prototype for how this process would proceed.