

10-5049-cv(L)

11-2446-cv(XAP)

IN THE
United States Court Of Appeals
FOR THE SECOND CIRCUIT



GOLDMAN SACHS EXECUTION & CLEARING, L.P.
FKA SPEARS, LEEDS & KELLOGG, L.P.,

Plaintiff-Appellant-Cross-Appellee,

--against--

THE OFFICIAL UNSECURED CREDITORS' COMMITTEE OF BAYOU GROUP, LLC, et al, on behalf of BAYOU GROUP, LLC, BAYOU MANAGEMENT, LLC, BAYOU ADVISORS, LLC, BAYOU EQUITIES, LLC, BAYOU NO LEVERAGE FUND, LLC, BAYOU AFFILIATES FUND, LLC, BAYOU ACCREDITED FUND, LLC,

Defendant-Appellee-Cross-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF OF *AMICUS CURIAE* SECURITIES INDUSTRY AND FINANCIAL MARKETS
ASSOCIATION IN SUPPORT OF PLAINTIFF-APPELLANT-CROSS-APPELLEE**

Of Counsel:

Ira D. Hammerman
Kevin M. Carroll
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOCIATION
1101 New York Avenue, NW
Washington, DC 20005
(202) 962-7382

Henry F. Minnerop
SIDLEY AUSTIN LLP
787 Seventh Avenue
New York, New York 10019
Telephone: (212) 839-5300
Attorneys for *Amicus Curiae*
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOCIATION

RULE 26.1 STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, the undersigned counsel for proposed amicus Securities Industry and Financial Markets Association (“SIFMA”) states that SIFMA has no parent corporation and no subsidiary corporations.

TABLE OF CONTENTS

Table of Authorities	ii
I. Introduction	1
II. Discussion.....	2
A. Broker-Dealers Do Not Obtain Dominion And Control Over Customer Assets Transferred Into or Between Accounts.....	3
B. Clearing Arrangements – An Overview	6
1. The Clearing Relationship	8
2. Customers	10
3. Introducing Firms	11
C. Regulatory Framework of Clearing Arrangements	11
1. The Elimination of Fixed Commissions.....	13
2. Net Capital and Related Rules.....	14
3. NYSE Rule 382	15
4. Civil Liability	16
III. Policy Considerations	19
IV. Conclusion	21

TABLE OF AUTHORITIES

	Page(s)
CASES	
<i>Antinoph v. Laverell Reynolds Sec., Inc.</i> , 703 F. Supp. 1185 (E.D. Pa. 1989).....	18
<i>Bear Stearns Securities Corp. v. Gredd (In re Manhattan Investment Fund)</i> , 397 B.R.1 (S.D.N.Y. 2007) (“Gredd”).....	5, 6
<i>Bonded Fin. Servs. v. European Am. Bank</i> , 838 F.2d 890 (7th Cir. 1988)	5, 19
<i>Carlson v. Bear, Stearns & Co.</i> , 906 F.2d 315 (7th Cir. 1990)	17
<i>Chase Manhattan Bank, N.A. v. Fidata Corp.</i> , 700 F. Supp. 1252 (S.D.N.Y. 1988)	17
<i>Christy v. Alexander & Alexander of N.Y. Inc. (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)</i> , 130 F.3d 52 (2d Cir. 1997)	5
<i>Connolly v. Havens</i> , 763 F. Supp. 6 (S.D.N.Y. 1991)	18
<i>Cromer Finance v. Berger</i> , 137 F. Supp 2d 452 (S.D.N.Y. 2001)	18
<i>Dillon v. Militano</i> , 731 F. Supp. 634 (S.D.N.Y. 1990)	17
<i>Ferris, Baker Watts Inc. v. Stephenson (In re MJK Clearing, Inc.)</i> , 286 B.R. 109 (Bankr. D. Minn. 2002).....	4
<i>Flickinger v. Harold C. Brown & Co.</i> , 947 F.2d 595 (2d Cir. 1991)	17
<i>Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund, Ltd.)</i> , No. 08-3701-BK(L)	6

<i>Greenberg v. Bear, Stearns & Co.</i> , 220 F.3d 22 (2d Cir. 2000)	18
<i>In re Bear, Stearns Secs. Corp.</i> , Exchange Act Release No. 41,707, 1999 SEC LEXIS 1551, at *15-16 (Aug. 5, 1999).....	10
<i>In re Derivium Capital LLC</i> , 437 B.R. (Bankr. D.S.C. 2010).....	5
<i>Kaiser Steel Resources, Inc. v. Jacobs (In re Kaiser Steel Corp.)</i> , 110 B.R. 514 (D. Colo. 1990), <u>aff'd on other grounds</u> , 913 F.2d 846 (10th Cir. 1990).....	5
<i>Lesavoy v. Lane</i> , 304 F. Supp. 2d 520 (S.D.N.Y. 2004)	17
<i>Mandelblatt v. Devon Stores, Inc.</i> , 521 N.Y.S.2d 672, 676 (N.Y. App. Div. 1987).....	17
<i>Mars v. Wedbush Morgan Sec., Inc.</i> , 283 Cal. Rptr. 238 (Cal. Ct. App. 1991).....	17
<i>Nordberg v. Societe Generale (In re Chase & Sandborn Corp.)</i> , 848 F.2d 1196 (11th Cir. 1988).....	5
<i>Schruefer v. Winthorpe Grant, Inc.</i> , No. 99 Civ. 9365, 2003 WL 1108933 (S.D.N.Y. Mar. 12, 2003).....	5
<i>SEC v. Upton</i> , 75 F.3d 92 (2d Cir. 1996)	4
<i>SFM Holdings v. Banc of America Securities</i> , 600 F.3d 1334. (11th Cir. 2010).....	17
<i>Statement of SEC Div. of Trading & Markets Regarding the Protection of Customer Assets</i> (Sept. 20, 2008)	4
STATUTES	
Exchange Act of 1934.....	11, 12
Section 15(k)(1) of the Securities Exchange Act of 1934	16
Securities Exchange Act of 1934.....	11

Securities Investors Protection Act of 1970 (15 U.S.C. §§ 78aaa et seq)	10
U.C.C. § 8-102(a) cmt. 10.....	19
U.C.C. § 8-503 cmt.1	5
U.C.C. § 8-503 cmt. 3	19
OTHER AUTHORITIES	
17 C.F.R. § 240.15c3-1(a)(2) (1992).....	10, 14
1975 Fed. Sec. L. Rep. (CCH) ¶ 80,212	14
David M. Weiss, <i>After The Trade is Made: Processing Securities Transactions</i>	8
Henry F. Minnerop, <i>Clearing Arrangements</i> , 58 Bus. Law 917, 936-37 956-58 (May 2003).....	2, 16
Henry F. Minnerop, “ <i>The Role and Regulation of Clearing Brokers</i> ,” 48 Bus. Law 841, 843 846-851 (May 1993).....	8, 15
LOSS & SELIGMAN, VI SECURITIES REGULATION 2897-907.....	12
Louis Loss & Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION 745 (2001).....	13
NYSE Information Memo No. 82-18 (Mar. 5, 1982).....	15
Federal Rules of Appellate Procedure Rule 29(c)(5)	1
Federal Rules of Appellate Procedure Rule 29.1(b).....	1
FINRA Rule 4311	9, 15
NYSE Rule 382.....	passim
NYSE Rules 382 and 405	15
NYSE Rule 382/02	9
NYSE Rule 405.....	13, 15
NASD Rule 3230	16

Securities Exchange Act Rule 15c3-3	4, 12, 14
<u>The Wall Street Journal</u> , October 20, 2011, p. C-5	13
www.sifma.org.....	1

I. Introduction

This brief is respectfully submitted on behalf of the Securities Industry and Financial Markets Association (“SIFMA”)¹ as amicus curiae in connection with appellant’s appeal from the judgment of the district court confirming an arbitration award that has industry-wide implications. In submitting this brief, SIFMA underscores that it believes strongly in the principle of finality of arbitration awards and does not urge any deviation from the limited grounds for vacatur recognized under the Federal Arbitration Act. Moreover, SIFMA takes no position on whether this case is a proper case for vacatur. Rather, SIFMA submits this brief (i) to inform the Court of the regulatory context in which clearing brokers, like appellant, operate and (ii) to note that the arbitration award in question, by implicitly characterizing a clearing broker as an “initial transferee” under the Bankruptcy Code, places substantial economic and quasi regulatory burdens on all clearing brokers, burdens which the SEC and industry regulations as well as the courts have specifically rejected.

¹

Description of SIFMA/Interest of Amicus

SIFMA brings together the shared interests of hundreds of securities firms, clearing and prime brokers, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

Local Rule 29.1(b) Disclosure Statement

In accordance with FRAP Rule 29(c)(5) and Local Rule 29.1(b), SIFMA represents that (1) no party’s counsel authored this brief in whole or in part; (ii) no party or its counsel contributed money that was intended to fund preparing or submitting this brief; and (iii) no person -- other than the amicus -- contributed money that was intended to fund preparing or submitting this brief.

II. Discussion

The arbitrators awarded appellees (“Creditors’ Committee”) \$20,580,514.52, a sum that represents two sets of deposits and journal movements within made by Bayou Group hedge funds into and between their own accounts carried by Goldman Sachs Execution & Clearing, L.P. (“Goldman”), as clearing broker. The accounts were introduced to Goldman by Bayou Securities, LLC, the hedge funds’ brokerage firm, which had entered into a clearing agreement with Goldman to settle and clear transactions for the hedge funds’ accounts. The award reflected the Creditors’ Committee’s claims that these deposits and journal movements were fraudulent transfers under New York law and the Bankruptcy Code and that Goldman was an “initial transferee” of the funds, rather than simply a “conduit” without “dominion and control” over the funds. In reaching that conclusion, the award implicitly disregarded specific SEC rules to the effect that broker-dealers, such as Goldman, are forbidden from exercising “dominion and control” over customer assets in their custody. Regrettably, the award signals² that Goldman --

² While SIFMA recognized that arbitration awards -- unlike judicial decisions -- have no precedential value, SIFMA is aware of the common practice in arbitration proceedings for the parties to cite to arbitration awards as if they were precedents. This de facto practice is among SIFMA’s motivations to inform this Court of the regulatory and legal principles bearing on the underlying dispute in this case. SIFMA respectfully suggests that any opinion that may be issued by this Court on this appeal should stress the non-precedential value of arbitration awards and make it clear that, in the event that the Court affirms the award, such affirmance does not represent the court’s endorsement of the legal theories implicit or articulated in an award or advocated by the successful party in the arbitration. See, Henry F. Minnerop, Clearing Arrangements, 58 Bus. Law., 917, 956-58 (May 2003). (“By confirming awards that are contrary to legal precedent, but which do not qualify for vacatur under the doctrine of manifest disregard, courts risk

and all clearing firms similarly situated -- must change their SEC-approved business model, and, henceforth, investigate the facts surrounding customer deposits and transfers in order to benefit from the affirmative defense of “good faith” in accepting such deposits and transfers without knowledge of the fraud and to avoid liability under the Bankruptcy Code. To impose “know-your-customer” responsibilities on clearing brokers -- responsibilities that clearing firms do not now have under SEC and industry regulations -- would not only add an extra layer of costs and regulatory compliance, but, more important, would divert the focus of clearing firms from their public policy-mandated task to clear and settle transactions expeditiously to minimize the systemic risk of open unsettled transactions in the securities markets. The significance of this shift in compliance functions and additional liability exposure signaled by the arbitration award must be gauged in the context of today’s markets in which literally billions of shares are traded daily and millions of trades and related fund transfers are processed by clearing brokers every business day.³

A. Broker-Dealers Do Not Obtain Dominion And Control Over Customer Assets Transferred Into or Between Accounts.

Under federal law, customer funds deposited with broker-dealers or moved between the customer’s accounts remain the customer’s property. As discussed in

becoming unwitting accomplices in the development of a body of case law that bears no resemblance to a correct statement of the law.”)

³ See notes 8 and 16, *infra*.

more detail below, SEC Rule 15c3-3, referred to as the Customer Protection Rule, dates back to 1972 and requires broker-dealers to hold reserves sufficient to ensure the return of customer funds upon demand. It was designed, among other things, to “prevent broker-dealers from using funds or securities held on behalf of customers to finance proprietary and other non-customer transactions.” *SEC v. Upton*, 75 F.3d 92, 93 (2d Cir. 1996); *see also Ferris, Baker Watts Inc. v. Stephenson (In re MJK Clearing, Inc.)*, 286 B.R. 109, 130 (Bankr. D. Minn. 2002) (“The amount of funds to be deposited in the Reserve Account is computed on a weekly basis pursuant to [the] Formula For Determination for Reserve Requirements for Brokers and Dealers. The Reserve Formula is designed to eliminate the use of customers’ funds and securities by broker-dealers in financing firm overhead and such dealer activities as market making, proprietary trading, and underwriting.”) (citation omitted). One reason for this segregation of customer funds is “[t]o facilitate the liquidations of insolvent broker-dealers and to protect customer assets in the event of a SIPC liquidation through a clear delineation in Rule 15c3-3 of specifically identifiable property of customers.” SEC Release No. 34-9856 (Nov. 17, 1972); *see also MJK Clearing*, 286 B.R. at 130 (“The purpose of the Customer Protection Rule is also to ensure that customer property in a failed brokerage firm is available to satisfy the claims of customers . . .”).⁴ In other

⁴ *See also Statement of SEC Div. of Trading & Markets Regarding the Protection of Customer Assets* (Sept.

words, in the event of a brokerage firm's failure, customers are entitled to the return of their property.⁵ Under this customer protection framework, a customer's deposits to, or the journal movement of customer funds between its own brokerage accounts, remain the customer's property.

The Creditors Committee's claim in arbitration relied entirely on *Bear Stearns Securities Corp. v. Gredd (In re Manhattan Investment Fund)*, 397 B.R.1 (S.D.N.Y. 2007) ("*Gredd*"). In *Gredd*, the district court deviated from an unbroken line of cases that had found financial institutions did not have dominion and control over customer accounts.⁶ The district court attributed its decision to its conclusion that Bear Stearns, unlike the financial institutions in the other cases, had extended margin credit to its customer and had used the customer's funds as collateral for existing margin loans. In the instant case, it was undisputed that

20, 2008) ("Customers of U.S. registered broker-dealers benefit from the extensive protections provided by the Commission rules, including the Customer Protection Rule, as well as protection by the Securities Investor Protection Corporation (SIPC). The Commission's Customer Protection Rule requires a broker-dealer to segregate customer cash and securities from a broker-dealer's own proprietary assets.").

⁵ State law generally is to the same effect. See, e.g., U.C.C. § 8-503 cmt.1 ("[S]ecurities that a firm holds for its customers are not general assets of the firm subject to the claims of creditors."). Broker-dealers that do use customer funds for their own purposes can be held liable for conversion. See, e.g., *Schruefer v. Winthorpe Grant, Inc.*, No. 99 Civ. 9365, 2003 WL 1108933, at *5 (S.D.N.Y. Mar. 12, 2003) (granting plaintiff judgment on conversion claim where defendant broker-dealer and its personnel, instead of investing money as instructed, withdrew and redirected funds from plaintiff's account for defendants' use).

⁶ *Christy v. Alexander & Alexander of N.Y. Inc. (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)*, 130 F.3d 52, 57 (2d Cir. 1997), *Bonded Fin. Servs. v. European Am. Bank*, 838 F.2d 890, 893 (7th Cir. 1988), *Kaiser Steel Resources, Inc. v. Jacobs (In re Kaiser Steel Corp.)*, 110 B.R. 514, 520-21 (D. Colo. 1990), aff'd on other grounds, 913 F.2d 846, 521 (10th Cir. 1990), *Nordberg v. Societe Generale (In re Chase & Sandborn Corp.)*, 848 F.2d 1196, 1200 (11th Cir. 1988). Since *Gredd*, another court had occasion to address the matter, stating that the "minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes." *In re Derivium Capital LLC*, 437 B.R., 798, 808 (Bankr. D.S.C. 2010). There, even a clearing firm's ability to debit certain ministerial clearing fees from the end customer account (with the end customer's consent) is insufficient to establish "dominion or control" over those accounts and insufficient to confer "transferee" status on the clearing firm. *In re Derivium Capital LLC*, 437 B.R. at 808.

Goldman (with one minor *de minimis* exception) had no credit extended to the Bayou Funds at the time of the deposits and transfers in question. Thus, Goldman contended before the arbitrators -- as it does on this appeal -- that *Gredd* was categorically different from -- and should not be extended to -- the Bayou Fund claims before the arbitrators.

While SIFMA believes that *Gredd* was incorrectly decided on the law and facts (a position also taken by the SEC in an amicus curiae brief filed in this Court in that matter),⁷ SIFMA understands this issue is not before this Court on this appeal. The issue before the Court is only whether the arbitrators manifestly disregarded the law by extending *Gredd* to the Bayou Fund claims. The resolution of that issue does not require this Court to address whether *Gredd* was correctly decided. That matter is for another day and SIFMA respectfully requests that this Court should not, by *dicta* or otherwise, foreclose a full consideration of *Gredd* in a proper case in the future.

B. Clearing Arrangements – An Overview⁸

The contention that clearing brokers, such as Goldman, are not “initial transferees” in accepting customer deposits and processing transfers, is

⁷ See, *Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund, Ltd.)*, No. 08-3701-BK(L), Brief of the Securities and Exchange Commission, Amicus Curiae, in Support of Defendant-Cross-Appellant, at 2 (2d Cir. Apr. 2009) (broker-dealer does not have “dominion and control” over customer funds regardless of whether margin loans are outstanding or not).

⁸ The discussion relies on “Clearing Arrangements,” 58 Bus. Law 917 (May 2003) and “The Role and Regulation of Clearing Brokers,” 48 Bus. Law 841 (May 1993), both authored by undersigned counsel.

underscored by the limited role they play in the context of securities transactions. While that role is critical to the overall functioning of the securities markets, it belies the notion that they exercise “dominion and control” over customer assets in their custody. The following brief history of the role and regulation of clearing broker emphasizes this point.

Clearing firms play a vital role behind the scenes of Wall Street. It is their unheralded role to process and clear transactions originated by other securities firms and their customers. In “carrying” the customer accounts of other broker-dealers, clearing firms provide their clients, the “introducing brokers,” with a variety of services. These services include the maintenance of books and records; the receipt, custody, and delivery of customer securities and funds; and the extension of credit to finance customer transactions in margin accounts. Most important, clearing firms “clear” transactions – paying for securities purchased and delivering securities sold. Clearing firms perform this function as members of clearing houses that are organized in conjunction with the securities markets where the underlying transactions are executed. Clearing arrangements are integral parts of the securities industry. Approximately 90% of all broker-dealers registered with the SEC utilize clearing arrangements.⁹ Without the availability of the capital,

⁹ According to the SEC Office of Economic Analysis, there were a total of 5,218 broker-dealers doing business with the public and registered with the SEC, 573 of which were self-clearing and the balance, 4,645, utilized clearing brokers, as of January 31, 2004, the most recent date available.

technology, and expertise of clearing brokers, the reliable functioning of modern securities markets would be impossible.

1. The Clearing Relationship

Bayou Securities, LLC (“Bayou Securities”), an SEC registered broker-dealer, retained Goldman as its clearing broker pursuant to a standard fully disclosed clearing agreement approved by the New York Stock Exchange (“NYSE”) under NYSE Rule 382.¹⁰ In accordance with that agreement, Bayou Securities “introduced” its customers to Goldman for clearance service. Among its introduced customers were the Bayou Hedge Funds, which utilized Goldman’s prime brokerage services.¹¹

To understand the nature of a typical clearing arrangement, it is useful to list the key functions involved in the operation of customer accounts and the settlement and clearance of transactions in such accounts:

1. opening, approving, and monitoring customer accounts;
2. providing investment recommendations or accepting customer orders;
3. executing customer orders;

¹⁰ In a “fully disclosed clearing agreement,” the introducing firm identifies the names of its customers to the clearing firm. This is in contrast to “omnibus” clearing agreement where the clearing firm is not advised of the identity of the customers. For further details, see Henry F. Minnerop, “*The Role and Regulation of Clearing Brokers*,” 48 Bus. Law 841, 843 (May 1993).

¹¹ “*Prime brokers* act as a central custodial facility for institutions that utilize the services of many broker/dealers [to execute their trades]. Institutions get investment ideas from many broker/dealers that they do business with. They compensate these broker/dealers by executing trades through them. These trades are flipped to the prime broker, who maintains the institution’s portfolio. The institution receives one statement at the end of the month from the prime broker detailing all of their activity, which is preferable to receiving statements from many broker/dealers, each with a piece of the monthly activity.” David M. Weiss, *After The Trade is Made: Processing Securities Transactions*, Penguin Group (USA) Inc., 2006, p. 8.

4. extending credit in margin accounts;
5. providing written confirmations of executed orders to customers;
6. receiving or delivering funds or securities from or to customers;
7. maintaining books and records that reflect transactions, including rendering monthly or periodic statements of account to customers;
8. providing custody of funds and securities in customer accounts; and
9. clearing and settling transactions effected in customer accounts.¹²

A brokerage firm that performs all of these functions within its own organization is a “self-clearing” firm (e.g., full-service firms). Other brokerage firms, typically smaller in size, frequently become introducing firms by hiring clearing brokers to perform some of these functions for them. While the allocation of functions is a matter of contract, introducing firms uniformly retain all customer contact functions (Functions 1 and 2) and generally execute their customers’ orders themselves (Function 3), while out-sourcing the financing of trades (Function 4) as well as the balance of functions (Functions 5-9) to a clearing broker. Functions 5-9 are referred to generally as “back office” functions to distinguish them from the customer-contact “front-office” functions (Functions 1 and 2) performed by the introducing firm. This division of labor enables introducing firms to pay for clearing and back office services out of their current revenues in line with current

¹² See New York Stock Exchange (“NYSE”) Rule 382, 2 NYSE Guide (Walters Kluwer Financial Services) ¶ 2382, NYSE INTERPRETATION HANDBOOK, Rule 382/02 (Basic Functions). Effective August 1, 2011, NYSE Rule 382 became FINRA Rule 4311 as a result of the NYSE/NASD merger, forming FINRA.

business conditions and avoiding the fixed overhead expenses associated with back office technology and infrastructure. The limited functions of clearing firms have been summarized by the SEC as follows:

In the typical fully disclosed [clearing] relationship between a customer, an introducing firm and a clearing firm, the clearing firm's contact with the customer is limited to transmitting confirmations, account statements and other correspondence such as proxy statements or Regulation T notifications. The introducing firm is responsible for accepting customer orders and other trading instructions. Under these circumstances, the clearing firm's primary (and frequently only) source of information about the customer is the introducing firm. Typically, the customer agreement between the clearing firm and the customer will authorize the clearing firm to accept instructions and orders from the introducing firm for the customer's account without inquiry or investigation, unless the clearing firm receives prior written notice from the customer to the contrary.

In re Bear, Stearns Secs. Corp., Exchange Act Release No. 41,707, 1999 SEC LEXIS 1551, at *15-16 (Aug. 5, 1999).

2. Customers

Introduced customers are the customers of the introducing firm.¹³ Their accounts are serviced by brokers employed by the introducing firm. Among

¹³ There are two technical statutory exceptions to this proposition. First, introduced customers are customers of the clearing firm for purposes of the Securities Investors Protection Act of 1970 (15 U.S.C. §§ 78aaa et seq), which provides insurance (the brokerage equivalent of the FDIC) for customer accounts against the risk of insolvency of the broker-dealer carrying their accounts. Second, introduced customers are customers of the clearing firm under related SEC financial responsibility and net capital rules. 17 C.F.R. § 240.15c3-1 (1992). Under those rules, all broker-dealers that carry customer accounts are required to (1) maintain minimum levels of net capital for all accounts carried by them and (2) provide custody of the funds and securities in all such accounts, including introduced accounts.

introduced customers may be those that utilize the clearing firm's prime brokerage services. In the instant case, Bayou Securities introduced its customers, the Bayou Funds, as prime brokerage customers.

3. Introducing Firms

Introducing firms come in many shapes and sizes, covering a wide spectrum of business activities. These activities extend from retail brokerage to underwriting of newly-issued securities to making of markets in such and other securities. Introducing firms solicit prospective customers, approve the opening of new accounts, and monitor their customers' transactions, and determine their customers' investment objectives and the suitability of recommendations made to their customers by their brokers. Introducing firms are legally independent broker-dealers, registered with the SEC. As independent firms, they are required to maintain written compliance procedures and compliance staff to, among other things, monitor their customers and generally "know" their customers' financial circumstances.

C. Regulatory Framework of Clearing Arrangements

In 1975, Congress amended the Securities Exchange Act of 1934, finding that "[t]he prompt and accurate clearance and settlement of securities transactions. . . are necessary for the protection of investors. . . ." Exchange Act of 1934, § 17A(a)(i). Congress directed the SEC "[t]o facilitate the establishment of a

national system for the prompt and accurate clearance and settlement of securities. . . .” Exchange Act of 1934, § 17A(a)(2)(A)(i).

The 1975 Amendments to the Exchange Act were among a number of Congressional responses to the “paper crunch” crisis of 1967-1970, a period of “the most prolonged and severe crisis in the securities industry in forty years.”¹⁴ During the height of the crisis, the exchanges curtailed their trading hours and closed their markets entirely on Wednesdays to permit brokerage firms to catch-up with their paperwork as Wall Street struggled with trading volumes of 14 to 15 million shares per day in the context of a five day settlement cycle. The severity of the crisis, now only a distant memory, is hard to exaggerate. Approximately 160 NYSE member firms closed their doors, 80 through merger and the other 80 permanently.¹⁵ The Congress created the Securities Investors Protection Corporation (“SIPC”) in 1970 to afford some protections against loss by investors resulting from broker-dealer failures.¹⁶

Responding to this crisis, the SEC took a number of steps, including the creation of a new regulatory framework that governs clearing arrangements to this day. This framework successfully encouraged the development of a highly efficient

¹⁴ William J. Casey, SEC Chairman, Letter of Transmittal, H.R. Doc. No. 92-231, at 1 (1972) (transmitting and summarizing the SEC’s Study of Unsafe and Unsound Practices of Brokers and Dealers).

¹⁵ See LOSS & SELIGMAN, VI SECURITIES REGULATION 2897-907 (3d ed. 1999).

¹⁶ The SEC also adopted the so-called Customer Protection Rule, Rule 15c3-3, in 1972. See discussion supra at pp. 2-3.

clearance and settlement system which currently processes and clears over three (3) *billion* shares per day on NASDQ and the NYSE alone without operational difficulties¹⁷ and does so during a shorter three (3) day settlement cycle. This is a far cry from the 14 to 15 *million* shares per day during a five (5) day settlement cycle that brought Wall Street to its knees during the 1967 “paper crunch” crisis.

The new regulatory framework, commenced in 1975, consists of three key planks:

- the elimination of fixed commissions on May 1, 1975;
- the adoption of the first industry-wide Net Capital Rule on June 26, 1975; and
- the approval of amendments to NYSE Rule 382 and NYSE Rule 405 on February 19, 1982.

1. The Elimination of Fixed Commissions

The modern era of securities clearing started on May 1, 1975, when the SEC outlawed fixed brokerage commissions.¹⁸ To underscore the revolutionary nature of the occasion, the date was immediately called “May Day.”¹⁹ Prior to May Day, members of the NYSE and other national exchanges, including members acting as clearing brokers, were required by exchange rules to charge fixed minimum commissions for all but the largest transactions with non-members. This requirement placed introducing firms – which were usually not NYSE members –

¹⁷ The composite trading volume of all American securities markets was over 4.3 billion shares on October 19, 2011. See *The Wall Street Journal*, October 20, 2011, p. C-5.

¹⁸ (Exchange Act Release No. 11,203 (Jan. 23, 1975)).

¹⁹ Louis Loss & Joel Seligman, *FUNDAMENTALS OF SECURITIES REGULATION* 745 (2001).

at a competitive disadvantage. To realize a profit, introducing firms were forced to add an extra commission to the exchange-mandated minimum charged by their clearing firms. The elimination of fixed commissions enabled clearing and introducing firms to negotiate clearing fees that reflected the economic value of only the services provided by the clearing firm. This allowed introducing firms to compete more effectively for customers with NYSE member firms and lowered transaction costs for introduced customers generally.

2. Net Capital and Related Rules

On June 26, 1975 – shortly after outlawing fixed commissions on May 1 – the SEC adopted its first uniform Net Capital Rule.²⁰ The new Net Capital Rule required only modest net capital for brokerage firms that introduced their accounts to clearing firms.²¹ The new Rule encouraged the protection of customer funds and securities by motivating small brokerage firms to place these assets into the custody of well-capitalized clearing firms, subject to SEC’s financial responsibility rules (see, e.g., Rule 15c3-3.).

²⁰ Exchange Act Release No. 11,497, 1975 Fed. Sec. L. Rep. (CCH) ¶ 80,212 (June 26, 1975) (codified at 17 C.F.R. § 240.15c3-1).

²¹ The original Net Capital Rule has been amended, but even today provides for lenient net capital treatment of introducing firms. 17 C.F.R. § 240.15c3-1(a)(2). The current regulatory minimum net capital of introducing firms is, effectively, \$50,000 although it is still possible to operate as an introducing firm with only \$5,000 in net capital if the firm has no involvement with the receipt or delivery of customer assets at any point. By contrast, virtually all clearing firms have well in excess of the required minimum of \$250,000 in net capital.

3. NYSE Rule 382

On February 19, 1982, the SEC approved amendments to NYSE Rule 382.²²

This was a landmark development that shaped the regulatory regime governing clearing brokers. Rule 382, as amended, permitted clearing and introducing firms to contractually allocate between themselves responsibility for the performance and supervision of specific functions related to transactions in customer accounts. Equally important, amended Rule 382 relieved clearing firms from their prior regulatory duty under NYSE Rule 405 to supervise introducing firms.²³ The continuation of that duty could no longer be economically justified after May Day as clearing firms were no longer receiving generous fixed commissions, which had permitted them to maintain legal and compliance staff and systems to police introducing firms. Under amended Rule 382, “know your customer” responsibilities became solely those of the introducing firm. In brief, under amended Rule 382, clearing brokers became responsible for the performance of only those functions allocated to them under the clearing agreement and eliminated

²² Order Approving Proposed Rule Change, Exchange Act Release No. 18,497 (Feb. 19, 1982). As the result of the merger of the NYSE and the NASD, NYSE Rule 382 became FINRA Rule 4311 effective, August 1, 2011.

²³ NYSE Information Memo No. 82-18 (Mar. 5, 1982), which announced the SEC’s approval of the amendments to Rule 382, made it clear that Rule 405 had no further application to clearing brokers. Prior to 1982, NYSE Rule 405 was interpreted by the Exchange as requiring its member clearing firms to treat their introducing firms as one of their own branch offices. *See also In Adler Coleman Clearing Corp.*, 198 B.R. 70, 73 n.4 (Bankr. S.D.N.Y. 1996) (summarizing the history of the 1982 Amendments to NYSE Rules 382 and 405); Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 Bus. Law 841, 846-851 (May 1993) (same).

heretofore duplicative responsibilities of clearing firms, *e.g.*, to “know the customers” of introducing firms.

Amended Rule 382 encouraged the rational and efficient division of labor. The savings realized from this division of labor benefited, not only introducing and clearing firms, but also introduced customers in the form of lower commissions. Most importantly, Rule 382, as amended, advanced significant regulatory objectives of the SEC for the benefit of investors by encouraging minimally-capitalized brokerage firms to place investor assets into the custody of well-capitalized clearing firms, firms that possessed the operational capacity to process and clear transactions promptly and accurately and maintain timely and accurate brokerage records.²⁴ Each of these objectives addressed a substantial concern of Congress and the SEC in the aftermath of the “paper crunch” of 1967-1970.²⁵

4. Civil Liability

Civil liability rules have similarly strictly limited the role and obligations of clearing brokers. For example, courts have repeatedly held under state law that clearing brokers have no fiduciary duty vis-à-vis introduced customers.²⁶ The

²⁴ NYSE Rule 382 was further amended in 1999. Those amendments did not change the relationship between clearing and introducing firm as contemplated in Rule 382. See, Henry F. Minnerop, *Clearing Arrangements*, 58 Bus. Law 917, 936-37 (May 2003).

²⁵ The NASD formulated its own clearing agreement rule, NASD Rule 3230, which is substantially identical to NYSE Rule 382. Since the formation of FINRA, merging the SRO functions of the NYSE and the NASD, the two rules are in the process of being harmonized along the line of their existing provisions.

²⁶ Federal law likewise does not impose any such duty. See “Dodd-Frank” Amendments to Section 15(k)(1) of the Securities Exchange Act of 1934, mandating the SEC to study, among other things, adoption of a fiduciary standard for broker-dealers when providing personalized investment advice about securities to

Second Circuit in *Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595 (2d Cir. 1991), applied New York law to the breach of fiduciary duty claims of an introduced customer: “no such [fiduciary] relationship existed between . . . the clearing agent and . . . the investor.” *Id.* at 599 (quoting *Mandelblatt v. Devon Stores, Inc.*, 521 N.Y.S.2d 672, 676 (N.Y. App. Div. 1987)). Other courts before and since have reached identical conclusions.²⁷ Nor does a clearing firm owe a continuing duty of disclosure to convey warnings to successor clearing firms.²⁸ As Judge Milton Pollock explained, regarding a federal securities claim against a clearing broker:

Clearing firms . . . relieve brokerage firms . . . of the huge costs associated with ‘back-office’ operations. . . . In no way, shape or form does the complaint plead that [the clearing firm] was making decisions regarding the accounts. The pleading indicates that [the clearing firm] simply executed the . . . transactions along with the other transactions sent to it by [the introducing firm]. [*The clearing firm*] was not in a fiduciary relationship with [*the introducing firm’s*] customers. This being so, no primary liability may attach to [the clearing firm] (Emphasis added.).

Dillon v. Militano, 731 F. Supp. 634, 636 (S.D.N.Y. 1990).

retail customers. This prospective fiduciary standard, however, would obviously not apply to a clearing broker.

²⁷ See, e.g., *Lesavoy v. Lane*, 304 F. Supp. 2d 520, 525, 526 (S.D.N.Y. 2004) (clearing firms owed no duty to accountholders’ beneficiaries, as a broker “‘has no duty to monitor a nondiscretionary account’” (quoting *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002)), *aff’d in part and rev’d in part* on other grounds, 170 Fed. Appx. 721 (2d Cir. 2006). *Carlson v. Bear, Stearns & Co.*, 906 F.2d 315 (7th Cir. 1990) (clearing broker not a fiduciary under Illinois’ blue sky law); *Mars v. Wedbush Morgan Sec., Inc.*, 283 Cal. Rptr. 238 (Cal. Ct. App. 1991) (clearing broker not a fiduciary of the customer under California law).

²⁸ See *Chase Manhattan Bank, N.A. v. Fidata Corp.*, 700 F. Supp. 1252 (S.D.N.Y. 1988) (clearing firm allegedly knew that its introducing firm had committed fraud, but failed to warn its successor clearing firm). See also, *SFM Holdings v. Banc of America Securities*, 600 F.3d 1334, 1339-40. (11th Cir. 2010) (clearing firm offering prime brokerage service is not a fiduciary).

Courts have been similarly uniform in holding that clearing firms, performing routine functions, do not give the “substantial assistance” to a fraud or breach of duty necessary to sustain an aiding and abetting claim.²⁹ In *Cromer Finance v. Berger*, 137 F. Supp 2d 452 (S.D.N.Y. 2001), the district court granted a motion to dismiss a complaint alleging that the clearing and prime broker had enabled a Ponzi scheme by continuing to clear trades in spite of red flags. In dismissing the claims brought by the hedge fund’s investors, the district court, citing Second Circuit case law, held: “The simple providing of normal clearing services to a [introducing] broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker.”³⁰ The *Cromer* court further stated that “[t]he plaintiffs [were] unable to cure the defect in their pleading of substantial assistance by emphasizing that the alleged fraud included a Ponzi scheme that could not have functioned but for the extension of credit and margin violations.” *Cromer* concluded its analysis by noting that: “[w]hile the Ponzi scheme may only have been possible because of [the clearing broker’s] actions, or inaction, [the clearing broker’s] conduct was not a proximate cause of the Ponzi scheme.”

²⁹ See *Connolly v. Havens*, 763 F. Supp. 6, 11 (S.D.N.Y. 1991) (having no fiduciary relationship with introduced customers, “clearing broker’s failure to disclose cannot constitute the requisite ‘substantial assistance’”); *Antinoph v. Laverell Reynolds Sec., Inc.*, 703 F. Supp. 1185, 1189 (E.D. Pa. 1989) (“mere inaction or silence does not amount to substantial assistance”).

³⁰ *Greenberg v. Bear, Stearns & Co.*, 220 F.3d 22, 29 (2d Cir. 2000).

III. Policy Considerations

In imposing liability on Goldman, the arbitrators disregarded the long-recognized principle that a clearing firm cannot be liable for merely processing transactions received from an authorized source. Commercial law recognizes the firmly established principle that a clearing broker has no duty to inquire into the honesty and finances of its accountholders. “Rather than imposing duties to investigate, the general policy of the commercial law of the securities holding and transfer system has been to eliminate legal rules that might induce participants to conduct investigations of the authority of persons transferring securities on behalf of others for fear that they might be held liable for participating in a wrongful transfer.” U.C.C. § 8-503 cmt. 3. Such firms do not exercise investment discretion, but instead provide incidental financing and – for just fractions of a penny per share – perform the ministerial “back office” functions necessary to clear and settle the trades. Given this carefully limited role, “it would impair rather than advance the interest of investors in having a sound and efficient securities clearance and settlement system to require intermediaries to investigate the propriety of the transactions they are processing.” U.C.C. § 8-102(a) cmt. 10. Any other rule, whether under the Bankruptcy Code or otherwise, would increase system-wide costs, to no useful purpose. *See Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988) (“Exposing financial

intermediaries . . . to the risk of disgorging a ‘fraudulent conveyance’ . . . would lead them to take precautions, the costs of which would fall on solvent customers without significantly increasing the protection of creditors.”).

These principles have allowed the nation’s securities clearance and settlement systems to function effectively for decades. Major clearing firms, such as Goldman, clear millions of trades daily and process hundreds of thousands of related deposits and transfer of funds into and out of customer accounts. They perform these routine functions on behalf of the customers of hundreds of introducing firms, including those that use their prime brokerage services. They do so in an environment of extremely large trading volumes, averaging billions of shares a day, and ever shorter settlement cycles.³¹ If clearing firms were to be deemed “initial transferees” and, as such, required to analyze the huge volume of trading they process along with daily transfers of funds to determine if customers are engaged in wrong-doing, then the speed and efficiency demanded in clearing and settling open securities transactions would be undermined.

³¹ See generally: SEC’s Concept Release: Securities Transactions Settlements. Securities Exchange Act Release No. 49405 (March 11, 2004) (Discussing the shortening of the settlement cycle from 5 to 3 days and the prospect of same day settlements in the future).

IV. Conclusion

SIFMA respectfully requests that the Court's decision and opinion on the pending appeal reflect the applicable law and regulations governing clearing brokers.

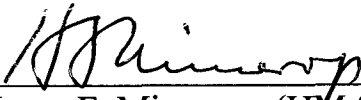
Dated: October 20, 2011

Of Counsel:

Ira D. Hammerman
Kevin M. Carroll
SECURITIES INDUSTRY AND
FINANCIAL MARKETS
ASSOCIATION
1101 New York Avenue, NW
Washington, DC 20005
(202) 962-7382

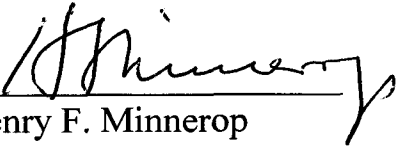
Respectfully submitted,

SIDLEY AUSTIN LLP

By: 
Henry F. Minnerop (HM 0013)
787 Seventh Avenue
New York, New York 10019
Telephone: (212) 839-5300
Attorneys for *Amicus Curiae*
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOCIATION

CERTIFICATE OF COMPLIANCE

I hereby certify that, pursuant to Federal Rules of Appellate Procedure 29(d) and 32(a)(7)(B) and (C), the foregoing brief contains 5,761 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii), according to the Word Count feature of Microsoft Word. This brief has been prepared in 14 point Times New Roman font.


Henry F. Minnerop

Dated: New York, New York
October 20, 2011