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Clearing Firms Fear Wall Street Regulator's Data Proposal.

(Reuters) – A proposal by Wall Street's industry-funded watchdog to ramp up oversight of securities brokerages could expose clearing firms to more enforcement actions and lawsuits, lawyers say.

The Financial Industry Regulatory Authority has said it wants to review, on a continuous basis, vast quantities of data from the clearing firms that brokerages hire to settle customers' buy and sell orders.

But some clearing firms are raising concerns that the fledgling plan could ensnare them in legal hassles. As the data flows from brokerages to FINRA, the clearing firms could be held accountable for malfeasance buried in that information, they say. For example, FINRA could question why a clearing firm did not spot that a brokerage customer was laundering money.

"The clearing firm should not become another supervisor," said Ira Hammerman, general counsel for the Securities Industry and Financial Markets Association, a trade group representing clearing firms as well as retail brokerages. SIFMA plans to voice its concerns in a letter this month.

Consumer investor lawyers agree that the proposed system could make clearing firms bear more responsibility for errant behavior. "For decades, clearing firms have buried their heads in the sand, saying they don't have responsibilities for anyone," said Andrew Stoltmann, a Chicago lawyer who represents investors. "I think that defies common sense."

A FINRA spokesman declined to comment.

FINRA announced the plan, known as the Comprehensive Automated Risk Data System, or CARDS, in December, but recently extended the deadline for public input to March 21. The system could take years to put in place, as FINRA would have to develop a more formal proposal and get approval from the U.S. Securities and Exchange Commission.

The watchdog is exploring the idea as financial regulators try to expand their presence by mining data. The SEC, for example, has recently announced efforts to crunch trading data to detect insider trading and other illegal activity.

BIG DATA

FINRA already receives some data from clearing firms for its brokerage examinations, but they provide it voluntarily and often upon request, the regulator has said. For example, examiners may ask for data about trades in a certain security.

CARDS, however, would require clearing firms to be a pipeline for an "unprecedented" combination of data, said Joan Schwartz, chief legal officer of Bank of New York Mellon Corp's Pershing LLC unit.

Clearing firms like Pershing would have to transmit an ongoing stream of data to FINRA about everything from securities transactions and asset movements to customers' risk tolerances and time lines. At Pershing alone, those responsibilities would apply to millions of brokerage accounts.

FINRA recently said it would not require clearing firms to submit details, such as names and Social Security numbers, that would identify specific brokerage customers.

Nor will FINRA hold clearing firms responsible for the accuracy of the data, according to its plan, but that protection is limited, said Irwin Pronin, a New York lawyer who advises clearing firms. More risks could come later if the regulator looks back and says a clearing firm turned a blind eye to brokerage misbehavior revealed in its data, Pronin said.

Daniel Nathan, a Washington lawyer who advises brokerages on regulatory issues, said the plan could make clearing firms vulnerable to fines and other sanctions. The proposed system "will have the effect of dumping into FINRA's lap a treasure trove of potential evidence" that could show what a clearing firm might have known about the brokerage firm's activities, he said.

To be sure, FINRA requires brokerages and clearing firms to sign agreements that lay out which entities are liable for certain responsibilities. For example, retail brokerages are responsible for opening customers' accounts and recommending securities that are in sync with their goals.

But even that may not be an ironclad defense. Pershing's Schwartz, who is also vice chair of SIFMA's clearing firm committee, pointed to a December enforcement case in which FINRA described a clearing firm as a "gatekeeper to the securities markets." The term could signal a change in regulators' expectations for these firms, Schwartz said.

"We're generally concerned about the erosion of this concept that we're 10 steps removed," Schwartz said.

LITIGATION

FINRA's proposal follows a spate of lawsuits and securities arbitration cases against clearing firms by investors.

Some cases were filed when an investor's brokerage goes out of business, often because of a fraud. Others may involve brokerages that cannot make good on losses in a risky security. Pursuing the clearing firm may be the only way for investors to recoup money, lawyers say.

These are tough cases to win, but investors have sometimes prevailed. In 2010, creditors of Bayou Group LLC scored a $20.6 million arbitration award against a Goldman Sachs Group Inc unit that cleared the hedge fund's trades. Bayou, which was bankrupt, turned out to be a Ponzi scheme.

The case hinged on Goldman's ignoring data about the hedge fund's losses, said Ross Intelisano, a New York lawyer who represented the creditors.

Goldman lost two efforts to overturn the ruling. A Goldman spokeswoman declined to comment.

In another case, a group of athletes filed a multimillion-dollar arbitration against Pershing last year, saying the clearing firm should have detected that private investments their adviser recommended in a failed casino project were fraudulent. The case is pending, and Pershing declined to comment.

At least several arbitration cases against other clearing firms were settled last year, according to a FINRA database.

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March 18 Tue Mar 18, 2014 11:09am EDT