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SUPERVISION OF THIRD-PARTY/ POWER OF ATTORNEY ACCOUNTS

Douglas J. Schulz & Tracy Pride Stoneman

Introduction

Third-party/power of attorney accounts[1] have been a problem for broker-dealers (BDs) for decades, but an alarming new problem has raised its ugly head: third party/power of attorney accounts at online/internet brokerage firms such as Schwab, E-Trade, TD Ameritrade (Ameritrade) and Scottrade. Whatever problems brick-and mortar-BDs have with these types of accounts doesn't compare to the dangerous situation and fraud being perpetrated on thousands of American investors in their brokerage accounts at online firms. Sadly, the regulators have once again been asleep at the wheel as to these issues. The hope of the authors Douglas Schulz and Tracy Stoneman[2] is that this article will prompt the SEC, FINRA and the state regulators to wake up.

Definition of a Third-Party/Power of Attorney Brokerage Account

A power of attorney (POA) account can arise in three distinctly different situations. One is where an investor gives trading authority to his or her broker or investment adviser who is employed by the broker-dealer where the

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1. Third-party trading authority, power of attorney, and discretionary trading authority are used synonymously throughout this article.

2. Mr. Schulz, of Invest Securities Consulting, Inc., has traded securities for over 45 years and has been in the securities business professionally for 36 years. He has held numerous securities licenses and positions. He has been hired over 1,100 times as a securities expert and has given sworn testimony approximately 630 times. He is a Certified Regulatory Compliance Professional (CRCP), a title bestowed on him by FINRA and The Wharton School of Business. He co-authored with attorney Tracy Stoneman a popular book: DOUGLAS SCHULZ & TRACY STONEMAN, BROKERAGE FRAUD – WHAT WALL STREET DOESN'T WANT YOU TO KNOW (2002). Tracy Pride Stoneman has over 24 years of experience representing investors in investment disputes with brokerage firms and stockbrokers in firm disputes. She served on the PIABA Board of Directors from 1999 – 2005 and has several reported cases on the six-year eligibility rule. She has obtained for her clients some of the largest arbitration awards against Raymond James and Paine Webber.

investor's account is held. These are also called discretionary accounts. The second is where an investor gives trading authority to a third party who is a licensed investment adviser, but the adviser is not affiliated with the BD where the account is being held. The third situation is where an investor gives a POA to a spouse, family member or friend. Each of these situations has its own unique requirements and problems, but first let's address the general requirements of a POA.

Perhaps the most sacrosanct requirement of broker-dealers is to establish in writing at the opening of any brokerage account who will have authority to perform certain tasks associated with the account. Fulfilling this requirement is generally pretty straightforward when an account is a basic, individual account and there is only one named owner. Without further documentation, it is assumed that the named account holder is in the sole position to make any and all decisions regarding trading in the account. The same is true when an account is opened by a married couple, that is, each spouse has the same rights when it comes to making decisions for the account. But that is where the simplicity ends.

The following are just a few of the types of accounts that create questions as to who does or does not have authority in an account:

- A spouse trading in the account of the other spouse, when the account is titled in only one spouse's name
- A spouse trading in the account of a son, daughter, parent or grandparent
- Corporate and business accounts
- Pension and other retirement accounts
- Trust and estate accounts
- Investment adviser accounts

In each of these types of accounts, the BD must have in writing a legal document making it clear who has authority to make certain decisions. The regulations and internal policies of the BDs require that this written authority be in place before any transaction of any kind takes place.[3]

3. *See* FINRA, RULE 408 (2008) and FINRA, RULE 4512 (2011) ("the member shall maintain a record of the dated, manual signature of each named, natural person authorized to exercise discretion in the account.")

Types of Authority

In something close to 90% of accounts where there exists a POA, it is in the form of a limited power of attorney. The limitation most often is that the person with the POA can only make investment decisions and enter buy and sell orders. Even though, as we will discuss in detail later, this person can harm an account through unsuitable investments, the higher risk is when authority is given to a third party to withdraw money or securities from the account.

The second type of authority is a full power of attorney. This authority goes beyond the mere management of investments and allows the withdrawal of funds from the account. Most firms require that any request for withdrawals/disbursements be sent to the only person that has been pre-approved by the account owner.

Licensed Versus Unlicensed

There is no securities regulation that forbids a BD from giving a POA to an individual who is not licensed in the securities industry. How the various BDs deal with this issue is quite a hodgepodge. We found some smaller BDs that will not allow a person to be a POA if they are unlicensed, unless they are a family member. The brick-and-mortar BDs generally have stricter policies in this area.

Although licensing is not a complete safeguard against wrongdoing, the authors strongly believe that unless the POA is a family member or there are special, legal circumstances, that anyone with a POA should be licensed. Nor should a POA holder's status as a family member indicate a lesser level of supervision. The authors have been involved in multiple cases where the son ripped off his parents' accounts, a husband abused his wife's account, and just about every combination that you can imagine. BDs should scrutinize both the authority and the accounts when a POA is given to a family member, as in other circumstances.

The Institutional Game

The institutional game is a new, unethical defense tactic being used extensively by the internet/online broker-dealers. FINRA regulations have carved out exceptions for the broker-dealers if the investment account is an institutional account. If the account meets the criteria for being an institutional account, there are certain duties and obligations that are lessened on the part of the broker-dealer. The following is the definition of an institutional account:

> (c) For purposes of this Rule, the term "institutional account" shall mean the account of:
>
> > (1) a bank, savings and loan association, insurance company or registered investment company;
> > (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or
> > (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.[4]

One specific area where this institutional coding changes the requirements is suitability. The following is FINRA 2111, the suitability rule:

> 2111. Suitability
>
> (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.
>
> (b) A member or associated person fulfills the customer-specific suitability obligation **for an institutional account**, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision-making authority to an agent, such as

4. FINRA, RULE 4512 (2011).

> an investment adviser or a bank trust department, these factors shall be applied to the agent.[5] [emphasis added]

Yet online firms routinely code individual retail accounts, whose owners have provided third-party trading authority to an independent agent, as institutional. The practice of online firms coding individual accounts as institutional is not only wrong, it does not comport with the language and definition of what an institutional account is. The definition is clear – it's three categories of individuals/entities. The first definition is an actual entity, like a bank or a pension plan or an insurance company. In other words, an actual institution is the account holder. The second definition is very specific – it includes only investment advisers registered at the state or federal level. When third-party investment advisers manage the accounts of multiple investors, it is not uncommon for the investment adviser to open up a master account. The account of that adviser, under the institutional customer definition, would be an institutional account. The third definition is any other person or entity with assets of $50 million or more.

Regular people who hire independent investment advisers and who then have accounts opened for them at online broker-dealers where they provide the adviser a limited trading authorization do not meet the definition of an institutional account. Yet, the online firms are ignoring the definition. An example, from one of Tracy's cases, is the account application from Ameritrade[6]. The top of the form states "TD Ameritrade Institutional" and the top box identifies the investment adviser. Box number two identifies the Account Owner - this is the individual who Tracy represents. Tracy's client is Ameritrade's customer, client, and the account owner, yet Tracy's client fits none of the three definitions of an institutional account! And note that this account application form contains none of the "customer profile" data required by FINRA Rule 2111(a). By coding the account " institutional," a firm can essentially ignore its clients.[7]

Another game being played by particularly the online broker-dealers is with their manipulation of the "factors" that are to be applied to the agent pursuant to FINRA Rule 2111. Paragraph (b) references "these factors" to be

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5. FINRA, RULE 2111(a)-(b) (2014).

6. https://www.advisorservices.com/content/advisor/pdfs/onlineforms/TDINST 1468.pdf

7. All broker-dealers have policies, even if for their own protection, that dictate that they obtain enough financial information to make sure that any client opening a margin account has the financial wherewithal to handle the complexity of margin trading.

applied to the agent, however, the identification of "these factors" isn't found only in paragraph (b) but also in paragraph (a). What the broker-dealer must obtain from the power of attorney/agent is some of the customer profile information that would otherwise be obtained from the customer. This would include such information as the agent's investment knowledge and investment experience. We are aware that Schwab's Power of Attorney form requests this and other detailed information about the agent, such as date of birth, employment, address, email address, driver's license number, marital status, and number of dependents of the agent.

Admittedly, it is rather confusing and it is FINRA's fault. In 2012, the Securities Industry and Financial Markets Association (SIFMA), the brokerage industry's lobby, prepared for distribution a form for broker-dealers to use in order to comply with FINRA Rule 2111 and the institutional exemption. SIFMA's announcement read:

SIFMA Develops New Institutional Suitability
Certificate to Facilitate Compliance with New
FINRA Suitability Requirements[8]

However, a copy of its Institutional Suitability Certificate contains no information other than the two items in FINRA Rule 2111(b) concerning "evaluating investment risks independently" and "exercising independent judgment."[9] FINRA could do a much better job in clarifying what information broker-dealers must obtain from the power of attorney/agent.

Yet another consequence of coding individual, retail accounts who have hired independent investment advisers as institutional is that firms can then rely on FINRA's Margin Disclosure Statement rule to not provide disclosure statements to such customers:

> 2264. Margin Disclosure Statement
> (a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a **non-institutional customer**, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in paper or electronic form, and in a separate document (or contained by itself on a separate page as part of another document),

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8. Press Release, Securities Industry and Financial Markets Association, SIFMA Develops New Institutional Suitability Certificate to Facilitate Compliance with New FINRA Suitability Requirements (Feb. 23, 2012) *available at* http://www.sifma.org/news/news.aspx?id=8589937525.

9. http://www.sifma.org/services/standard-forms-and-documentation/cross-product/#isc (search for "Suitability" to find the certificate on this page).

> the margin disclosure statement specified in this paragraph (a). In addition, any member that permits **non-institutional customers** either to open accounts online or to engage in transactions in securities online must post such margin disclosure statement on the member's Web site in a clear and conspicuous manner. [emphasis added][10]

If the account is "institutional," FINRA Rule 2264 is not triggered, which means that firms that improperly code individual, retail accounts as "institutional" are not required to provide those clients with the Margin Disclosure Statement.[11]

It is our strong opinion that when the account owner is an individual (with less than $50 million in assets), that account is a retail, individual brokerage account, not an institutional account. And it should benefit fully, as any other individual retail account would, from all of the regulations and policies that might protect it from abuses of any kind. We've seen this institutional game by the internet brokerage firms used regularly. The worst part is that where we have seen this improper coding/titling of the account most often is in some of the cases where the largest numbers of investors are defrauded.

The Risks and Problems of POA Accounts

Far too many individuals in the brokerage industry are unaware of the most basic risks associated with POA accounts. And to some degree, we can say the same for the regulators. Unfortunately, the regulators have allowed the brokerage industry, mainly the internet, discount broker-dealers,[12] to create dangerous situations in millions of accounts where there exists a POA.

When a power of attorney is in place, by definition, the account owner is less involved in the management and investment decisions of the account. Indeed, it is far more typical that when a POA is granted, the account owner is not involved at all in day-to-day investing decisions or active monitoring of account activity.

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10. FINRA, RULE 2264 (2011).

11. FINRA, RULE 2360 (2014) (Options) does not have an "institutional" exemption and the Option Disclosure Statement must be provided to any customer who is approved for option trading.

12. This is not the first time Mr. Schulz has expressed criticism of internet brokerage firms. Douglas J. Schulz, Invest Securities Consulting Inc., No Duty - Does Suitability Apply to Internet Brokerage Firms?, Presentation at the Annual Meeting of the Public Investor's Arbitration Bar Association, (Oct. 2000).

Partly for these reasons, discretionary accounts, that is, accounts where someone other than the account owner is making all the investment decisions for the account, have always been considered by the brokerage industry to be the most potentially problematic accounts. There is an inherent safeguard in the normal broker-client relationship where each and every investment decision is discussed in advance, because although a naïve investor might not fully understand every single investment the broker recommends, he or she at least is fully aware of what's taking place with respect to every single trade.

Contrast this with a discretionary account, where somebody with a POA is making every single investment decision without any communication whatsoever with the account owner. The investor can be completely in the dark. At the majority of brick-and-mortar brokerage firms, management and compliance is aware of that fact. And they have policies and monitoring practices that make sure that they give special attention and conduct detailed due diligence into how managed, discretionary accounts are being invested and traded. Yet, at the online/internet brokerage firms, POA accounts often receive little or no supervisory attention, and regulators have done little to require such firms to conduct adequate supervision.

The overriding potential problem with POA accounts is the fact that the account owner is not making the day-to-day decisions for the account and often pays very little attention to the account. Considering that this is the circumstance in the vast majority of all POA accounts, the regulators, BD compliance departments, and local branch office managers should have both a heightened awareness and a policy to regularly conduct extensive due diligence to ensure that each and every POA account is not being abused.

Know Your Customer *and* The Power of Attorney!!

Perhaps no regulation other than suitability has been written about as much as the "Know Your Customer" rule. Our main focus here is to address how the "Know Your Customer" rule relates to the issue of third-party authority. But before we do so, there are some side issues we must first put in perspective.

When testifying in arbitration, Douglas often likes to describe the regulation on suitability as an A, B, C process. First, the stockbroker/adviser is required to exercise diligence in learning the essential facts relating to the investor. This includes such things as age, employment, investment experience, investment knowledge, financial needs, investment goals, and risk tolerance.[13] But under the regulations, there is no complete list. Instead, it is all the "essential" facts that need to be learned about each investor. Specifically, FINRA Rule 2090 states the following:

> 2090. Know Your Customer
>
> Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.
>
> • • • Supplementary Material: --------------
>
> .01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.[14]

The "B" part of the process is the requirement that the broker/adviser conduct reasonable diligence to learn the essential facts about the particular investment that he is thinking of recommending to his client.[15] That would include such items as the nature of the investment, the industry or sector of the investment, the history of the investment, profitability, the management, the

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13. FINRA, RULE 2111 (2014). Suitability (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. *Id.* A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. *Id.*

14. FINRA, RULE 2090 (2012).

15. "FINRA notes that it replaced the term 'due diligence' used in former NYSE Rule 405(1) with the term 'reasonable diligence' in new FINRA Rule 2090 for consistency with the language used in new FINRA Rule 2111. FINRA did not intend by such action to impair or adversely affect established case law and other interpretations discussing the diligence that is required to comply with know-your-customer or suitability obligations." FINRA, REGULATORY NOTICE 11-02 (2011).

goals, and most importantly the associated risks.[16] Again, this list is by no means complete. The broker/adviser is required to learn all the essential facts so he can properly determine if the investment is suitable based on what he knows about his client. Finally, there is the "C" part of the process. The broker is now required to take what he knows about the client and compare it to what he now knows about the investment and make a determination if he should even recommend the investment to the client, that is, is the investment suitable for the client.

For those of us who have been in the securities industry for decades, we often referred to the "Know Your Customer" rule as New York Stock Exchange Rule 405:

> Rule 405. Diligence as to Accounts
>
> Every member organization is required through a principal executive or a person or persons designated under the provisions of Rule 342(b)(1) to:
>
> ***(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.*[17]

Over the last decade, it's been a challenge for those in compliance and supervision. First, we had the regulatory authority for the NYSE rolled into the NASD. Then we had the NASD rules renumbered for FINRA. The net result is going forward (depending on the exact years relating to the potential securities violations), we don't find ourselves quoting NYSE Rule 405, but instead the new FINRA Rule 2090. Below is a section from FINRA Regulatory Notice 11-02 on the Know Your Customer rule and NYSE Rule 405:

> Know Your Customer
>
> In general, new FINRA Rule 2090 (Know Your Customer) is modeled after former NYSE Rule 405(1) and requires firms to use "reasonable diligence,"4 in regard to the opening and maintenance of every account, to know the "essential facts" concerning every customer. The rule explains that "essential facts" are "those required to (a) effectively service the customer's account, (b) act in accordance with any special

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16. For additional information on the requirements for due diligence *see* Douglas Schulz, *Due Diligence: Securities Applications and Regulatory Requirements*, 17 PIABA B.J., 4 (2010). This article addresses the due diligence obligations of financial professionals such as brokers, broker-dealers, investment advisers, hedge fund managers, and private placements.

17. NYSE, RULE 405 (2010) [emphasis added].

> handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."7 *The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation*. Unlike former NYSE Rule 405, the new rule does not specifically address orders, supervision or account opening—areas that are explicitly covered by other rules.[18]

The regulators have made it clear that despite the fact that there is no broker making a recommendation, as is the case at online/internet firms, the "Know Your Customer" obligation still applies. That is why the account applications/new account forms at some online firms ask many of the same litany of questions as if the account were being opened at a full service, brick-and-mortar firm.

The landscape changes dramatically, however, with the introduction of an independent third-party adviser. We have already described how online firms are miscategorizing accounts with third-party advisers as institutional and how firms use this categorization to *not* know their customers as they should.

The main thrust of this article, however, is that the brokerage industry and more specifically the internet/online discount brokerage firms such as Schwab, Ameritrade, E*Trade, and Scottrade are failing to conduct due diligence to obtain the essential facts about individuals that they are giving trading authority to and who manage thousands of accounts worth hundreds of millions of dollars.

It is our opinion that the "Know Your Customer" rule is sacrosanct. And it is our opinion that the current regulations in fact require all broker-dealers to apply the "Know Your Customer" rule to include anyone with power of attorney over the account. The following is the support for our opinion.

> NYSE Rule 405: *(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.*[19]

Although the words are slightly different in the new FINRA Rule 2090, there was no intent to change the original meaning of NYSE Rule 405:

> FINRA Rule 2090

18. FINRA, REGULATORY NOTICE 11-02 (2011).

19. NYSE, RULE 405 (2010) [emphasis added].

> Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and *concerning the authority of each person acting on behalf of such customer.*01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) *understand the authority of each person acting on behalf of the customer*, and (d) comply with applicable laws, regulations, and rules.[20]

Since firms are required to learn the essential facts concerning "the authority" of each person acting on behalf of the customer, it is reasonable that the diligence exercised would include uncovering facts that might compromise such authority. For example, if the independent adviser had a record of customer complaints, regulatory actions, bankruptcies, or inexperience, these are essential facts that concern the authority of the independent adviser.[21] And, as FINRA stated in Regulatory Notice 11-02, the "reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case."[22]

FINRA clarified that obtaining the essential facts from the customer or power of attorney is not static and is to take place beyond just the opening of the account:

> *A broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts.* Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information. As with a customer's investment profile under the suitability rule, *a firm should verify the "essential facts" about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's*

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20. FINRA, RULE 2090 (2012).

21. FINRA's Option Rule 2360(b)16(B)(ii)(b) requires firms to obtain the "Discretionary authorization agreement on file, name, relationship to customer and experience of person holding trading authority." Such experience would include option experience specifically. FINRA, RULE 2360(b)(16)(B)(ii)(b) (2014).

22. FINRA, REGULATORY NOTICE 11-02 (2011).

> *account* that might result from the customer's change in circumstances. *The reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case.* Firms should note, however, that SEA Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations.[23]

Another important point are the words "mishandling of a customer's account." By definition, preventing mishandling of a customer's account is the primary obligation of the securities industry's self-regulatory organization, FINRA. Note the following language from FINRA's website and its description of "What We Do":

> 1. Deter misconduct by enforcing the rules
>
> FINRA's mission is to safeguard the investing public against fraud and bad practices. We pursue that mission by writing and enforcing rules and regulations for every single brokerage firm and broker in the United States, and by examining broker-dealers for compliance with our own rules, federal securities laws and rules of the Municipal Securities Rulemaking Board.[24]

One of the more interesting aspects of what the broker-dealers are required to know about anyone with a POA is seen by looking at the hodgepodge of what some of the BDs require currently about anyone with a POA. We have heard arguments from the internet brokerage firms that the new "Know Your Customer" Rule 2090 does not have the same requirements as the old NYSE Rule 405. They argue that instead of previously needing to know all the "essential facts" relating to someone with power of attorney, now they only need to 'understand the authority'. However, seemingly contrary to this argument, numerous BDs currently require quite a lot of information about a POA.

One particular internet brokerage firm's POA form starts with the words, "Securities industry regulations require that we collect the following information" before asking for information about the POA. Interesting, because other internet brokerage firms request very limited information from the POA. The firm with better policies asked the following about the POA:

- how the individual is employed;
- marital status and number of dependents;

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23. FINRA, REGULATORY NOTICE 11-02 n.5 (2011) [emphasis added].

24. Financial Industry Regulatory Authority, *What We Do*, http://www.finra.org/about/what-we-do.

- investment experience;
- annual income;
- liquid net worth;
- if the individual is being compensated and how; and
- investment adviser registration ID (IARD).

Merrill Lynch, in addition to a lot of other information, requires that when a third-party, POA account is opened for an outside investment adviser that the firm document "the relationship to the designated owner."

It is our strong opinion that the obligation of the broker-dealer to diligently uncover essential facts on anyone holding a POA on an account is more paramount than the basic Know Your Customer rule as it applies to the account owner. There is even more of a reason for heightened due diligence as relates to third-party accounts based on the actions, or inactions, of the broker-dealers.

Here is a list of the minimum all brokerage firms (especially internet and online BDs) should obtain and document about the POA:

- name, address, date of birth, Social Security number, email, phone number;[25]
- business name, business affiliates, details of employment, DBAs, sources of income;
- verify the registration status and history of not just the RIA entity but all individuals who have authority on the account;
- copies of the last three years' ADV forms which should be reviewed in detail to address any material issues. Additionally, require and scrutinize the RIA's updated annual ADV;
- obtain the RIA's current and past CRD, FINRA filings, review and address any material issues, including all information on prior complaints;
- Obtain the RIA's U-4s and U-5s to review questionable employment history or any history of customer complaints. Address any material issues;
- full, prior work history and note any frequency in changing firms (a red flag);
- a separate questionnaire asking if any complaints have been expunged;
- information from broad databases on any litigation or bankruptcies;
- a comprehensive credit check;
- contact various state securities boards as to any past or pending investigations or litigation;

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25. Under the Bank Secrecy Act and the Patriot Act, broker-dealers are required to obtain basic information from anybody having a POA on an account.

- direct phone contact with prior employer or BD he was clearing through;
- a separate questionnaire documenting how the relationship with the account holder was formed and when; and
- review of the POA's website and review of all marketing materials.

The due diligence to obtain this information should be updated no less than every three years, which is the basic regulatory requirements for other accounts.[26]

Monitoring

At the very heart of the securities regulations and firm policies on compliance and supervision is the practice of monitoring the firm's brokers and advisers and the monitoring of the brokerage accounts themselves. Almost every broker-dealer in the country now has sophisticated, computerized screening systems that, on any given day, can spit out volumes of detailed analysis on such things as:

- broker's monthly commissions;
- broker's commissions broken down by product;
- percentage of brokers' commissions in any one account;
- commissions as a percentage of account equity;
- number of trades in an account for the month;
- percentage of trades that are profitable;
- profit and loss for the month;
- profit and loss year-to-date;
- account performance when compared to various indexes;
- percentage of trades that are short-term;
- concentration in a particular security;
- concentration in type of security or sector;
- unusual withdrawals and disbursements;
- frequency and size of margin calls; and
- number of margin calls met through liquidations.

FINRA's supervision Rule 3110 to some degree can be broken into three parts: a) firms are required to have written policies and procedures addressing a myriad of brokerage activities; b) firms are required to monitor their brokers

26. The Securities Exchange Act of 1934 Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations. 17 C.F.R. § 240.17a–3 (2008).

and their accounts to make sure these policies and all securities regulations are being adhered to; and c) firms are required to document all supervisory and compliance activity.

Internet brokerage firms far too often fail miserably in their obligation to know their customers and anyone holding power of attorney over the account and exacerbate this problem by failing to monitor accounts for any potential conflicts or abuses.

Transfers & Withdrawals

As we discussed earlier, it is rare for the authority given to a third party to include the ability to effectuate transfers and withdrawals, thus the term "limited" authority /power of attorney. Even when a broker-dealer does allow an account owner to give an individual "full" authority, which includes transfer and withdrawal authority, there are almost always restrictions on those withdrawals and transfers. For example, most all broker-dealers require that the POA's request for funds to be distributed must be mailed to an address that is pre-designated and signed by the account owner.

Even with a limited power of attorney, though, investors grant their advisers the authority to communicate with the BD about disbursements from the accounts. For example, Ameritrade's Advisor Service Account Application states:

> Authorization to Direct Disbursement or Funds. By providing my signature on this Fee Payment and Trading Authorization I am providing authorization for the Clearing Firm to remit checks wire funds, and otherwise to make disbursements of funds held in the Clearing Firm Account to banks, broker/dealers, investment companies or other financial institutions for my benefit, upon Advisor's verbal, written, or electronically transmitted instructions.[27]

Based on this authorization, an unscrupulous independent adviser could authorize the firm to transfer funds to his brokerage account held at another firm, and verbally at that! We doubt that investors and even the regulators are aware of this loophole language in a limited power of attorney. Scottrade's Investment Advisor Limited Trading and Fee Authorization has something similar:

> My Investment Advisor is permitted to request the disbursement of funds from the account(s) listed below, provided the funds are sent to the registered name and address on file for the account(s). To disperse

27. Ameritrade, *Advisor Service Account Application,* (on file with author).

> funds from the account(s) to an alternate payee or address, I must submit a written request to Scottrade. I must also submit a written request to Scottrade for asset or wire transfers.[28]

The problem, again, is that a corrupt investment adviser could simply forge the disbursement request. It happens more than you might imagine.

In 2005, the NYSE found that Schwab failed to prevent independent investment advisers from forging checks and letters of authorization to move its customers' assets and slapped the broker-dealer with a $1 million fine.[29] The non-employee advisers took advantage of Schwab's ineffective procedures to commit the fraud.[30] Schwab allowed the fraud to take place by failing to compare client signatures to original account documents on letters of authorization and wire requests to third-parties and failed to send confirmations directly to the customer when assets were transferred to parties other than the person on the account.[31]

More recently, in March 2016, the Texas State Securities Board reprimanded Scottrade and fined the firm $100,000 for supervisory violations of its independent investment advisers through the Scottrade Advisory Services platform.[32] The Board noted that: "[a]t all relevant times, broker-dealers such as Respondent were subject to securities regulations requiring firms to establish procedures designed to review and monitor the transmittal of customer funds by wire to third-party accounts."[33] However, the Board found that Scottrade "did not provide customers with a contemporaneous notification that customer funds had been transferred via wire from the customer's account to a third-party."[34] A copy of the Texas Disciplinary Order against Scottrade is attached as Appendix A. Obviously, wire transfer protocol should be heightened when firms deal with independent investment advisers

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28. Scottrade, *Investment Advisor Limited Trading and Fee Authorization,*(2009) *available at* http://avondaleam.com/wp-content/uploads/2013/11/4-Investment-Advisor-Authorization.pdf.

29. *See* Div. of Enforcement v. Charles Schwab & Co., NYSE Decision 05-110 (Oct. 17, 2005), *available at* https://www.nyse.com/publicdocs/nyse/markets/nyse/disciplinary-actions/2005/05-110.pdf.

30. *Id.*

31. *Id.*

32. *See In re* Scottrade, Inc., Tex. St. Sec. Bd. Order No. IC16-CAF-04, *available at* https://www.ssb.texas.gov/sites/default/files/files/news/Scottrade_IC16-CAF-04.pdf.

33. *Id.*

34. *Id.*

for the simple reason that the requests emanate not from the investors themselves but from the investment advisers, thereby allowing for the opportunity of forgery. Forgery of client signatures is a particular problem when the clients have no notice that a disbursement of funds has taken place.

Management and Performance Fees

Invariably, when a third-party advisory account is opened at an online firm, the agreements between the adviser and the firm and the firm and the investor authorize the payment of management or performance fees directly out of the investor's account.

The firms are adept at attempting to protect themselves by inserting language in their agreements to protect themselves. Scottrade's Investment Adviser Limited Trading and Advisory Fee Authorization states as follows:

> I acknowledge that Scottrade is not responsible for monitoring or enforcing any advisory fee agreement between me and my Adviser. I also acknowledge that Scottrade is not involved in determining the amount of any fees and is not liable for any errors or miscalculations in the fee amount represented on the invoice.

The majority of third-party, individual accounts these days are managed on an annual fee based contractual arrangement. Generally speaking, those fees range from 1% to 2% based on the annual or quarterly net asset value of the account. Rarely do these arrangements cause problems.

Where the problems often do arise is in the performance fees. Some of the larger and more successful money managers charge a management fee as mentioned above and also charge a performance or incentive fee. This is the standard practice in hedge funds. The fee's methodology of calculation is spelled out in the various customer agreements, but the calculations of performance fees can be complicated and confusing. For example, the fulcrum fee is based on the asset value of the funds over a "specified period" and must increase or decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices."[35] The inherent complexity of calculating performance fees can provide an opportunity for fraud by the dishonest investment manager who is the only one performing these complicated calculations on the accounts, without any supervision by the broker-dealer.

Our suggestion is that firms not be permitted to distribute funds directly to investment advisers, especially when the fee is either a performance fee or not

35. Investment Adviser's Act, 15 U.S.C. § 80b-5(b) (2012).

monitored by the firm. Most all brokerage firms, including online firms, have separate departments that allow their brokers to become fee-based investment advisers. The NASD, now FINRA, has been regulating brokerage firms who allow their brokers to become registered investment advisers since 1994 when it clarified that firms must supervise securities transactions conducted by RR/IAs away from the NASD members with which they are associated.[36] Accordingly, firms already have systems in place to monitor their in-house investment advisers. You can bet that in those fee-based accounts, the firm is monitoring, calculating and double checking the management and performance fees of those accounts. It is not a huge leap to bring under the supervision umbrella the accounts of third party investment advisers.

Moreover, firms should have policies and procedures to monitor the management and performance fees charged by investment advisers to a) ensure that the charges comport with the agreement with the clients, and b) ensure that the charges do not exceed industry standards. That was the finding of the Texas State Securities Board's Order against Ameritrade in 2007, attached as Appendix B, wherein the Board was critical of the firm for failing to have written procedures to address the monitoring of independent third-party adviser fees:

> Until on or about April 4, 2006, Respondent had not established a system or any procedures reasonably designed to monitor for, and address, management fee transfer requests that could be in excess of the industry standards for management fees or otherwise indicative of improper conduct by an IIA on Respondent's trading platform.[37]

Texas recognized in the above finding that the charging of improper fees could be indicative of other improper conduct, prompting further investigation by the firm.

Supervision

It is significant that what the Texas State Securities Board used to find liability on the part of Ameritrade in the attached Appendix B was its own regulation which states that "a dealer shall establish, maintain, and enforce written procedures to supervise the activities of its agents that are reasonably

36. FINRA, NOTICE TO MEMBERS 94-44 (1994).

37. *See In re* Ameritrade, Inc., Tex. St. Sec. Bd. Order No. IC07-CAF-03, *available at* https://www.ssb.texas.gov/sites/default/files/files/news/IC07-03.pdf.

designed to achieve compliance with the Texas Securities Act and Board Rules."[38] This rule is not so very different from FINRA Rule 3110, the Supervision Rule, which requires each member to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages…."[39] FINRA's supervision rule is actually broader than the Texas supervision rule, because it does not use the phrase "its agents," thereby allowing firms to argue that the independent investment advisors trading on their platform are not agents of the firm. The Texas State Securities Board didn't buy that argument if Ameritrade made it. The language of the FINRA Supervision Rule is perfectly worded so as to capture all of the wrongdoing that we are critical of in this article.

The broker-dealers, in particular the online firms, realized years ago that offering a trading platform to independent investment advisers was big business. So much so that each firm established divisions within their firms to handle this new business they often call "Advisor Services." The firms market these independent advisers with claims of name recognition of the firm, sophisticated trading platforms, etc.

While it would be great if FINRA issued a Regulatory Notice called "FINRA Clarifies Firm Duties with Respect to Independent Investment Adviser Accounts," it is not necessary. By virtue of having created platforms designed for use by investments advisers, broker-dealers have triggered the application of FINRA Rule 3110. Online/internet firms have already been sanctioned by state regulators for failing to have the proper procedures in place to protect the clients of these independent investment advisers. FINRA needs to follow suit; it has the ability to reign in the misconduct occurring in accounts managed by third-party investment advisers by simply enforcing Rule 3110. Broker-dealers, both brick-and-mortar and online/internet firms, must have in place policies to supervise the advisory businesses that they have embraced as a new business platform.

It must be remembered that when an independent, third-party adviser approaches an online broker-dealer, or even a brick-and-mortar broker-dealer, and seeks to open multiple accounts and manage them as the agent for those clients, the firm enters into a contractual relationship with that third-party investment adviser. That contractual relationship gives rise to supervisory responsibilities.

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38. Citing § 115.10(b)(1) of the Rules and Regulations of the Texas State Securities Board, 7 TEX. ADMIN. CODE § 115.10(b)(1) (2007).

39. FINRA, RULE 3110(b)(1) (2015).

The New, New Account Forms, Hear No Evil See No Evil

Discussed earlier is the regulatory requirement of the broker-dealers to "Know Your Customer." This regulation, in combination with the regulations relating to books and records, requires broker-dealers to not only know the essential facts about their clients, but they are required to document what they know. This information is classically put on what we often refer to as the "new account form."

A number of the internet broker-dealers in just the last few years have changed their new account forms to no longer ask some of the basic, rudimentary information about the client, like investment experience, investment objectives, and risk tolerance. Surprisingly, we have seen this not only in the improperly coded "institutional" accounts, but also in regular accounts. The authors are not aware of any regulation or NTM or Regulatory Notice that states that internet broker-dealers are no longer required to obtain this information. In our minds, it is a direct violation of the "Know Your Customer" rule, and there is no "institutional" exception to the "Know Your Customer" FINRA Rule 2090.

But the argument in defense of the internet broker-dealers is merely, "under Notice to Members 01-23, we have no suitability obligations for unsolicited trades, so why do we need information that pertains purely to suitability?" This argument may have more resonance when there is a third party POA who (it may be argued) should obtain that information, not the firm.

However, specific circumstances give rise to specific "Know Your Customer" information-gathering requirements that are not so easily evaded:

Margin – The "No Duty" and the "Know Your Customer" defenses by the internet brokerage firms fail when it comes to the issue of margin. Even if you buy the argument that the margin rules were written to protect the brokerage firms, instead of protecting the clients, the regulations still require that BDs obtain and document certain financial information before they can allow an investor to use margin in their account.[40] Since each firm may have

40. "Purchasing securities on margin in customer accounts without customer approval violates the anti-fraud provisions of the securities laws." *In re* J. Stephen Stout, Exchange Act Release No. 43410, 12 (Oct. 4, 2000). Margin is "a sophisticated tool" which may be wholly inappropriate for an account; *see* Timoleon Nicholaou v. S.E.C., Fed. Sec. L. Rep. (CCH) ¶ 99,204, 51 S.E.C. 1215, 1217 (1994) (salesperson's improper use of margin in customer's account violated just and

different financial requirements, the authority for this requirement is found in each firm's operations and compliance manuals.

Options – When it comes to options, the online brokerage firms' defenses fail even more so than with margin. FINRA's Option Rule 2360 states, "[i]n approving a customer's account for options trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives."[41] Another reason FINRA should revert back to "due diligence" instead of the watered-down "reasonable diligence" in the current suitability rule is so that it will be consistent with the options rule. The option rule makes no distinction for unsolicited trades and no distinction for online/internet broker-dealers. Additionally, the Chicago Board of Options Exchange (CBOE) has its own detailed set of regulations that apply to each and every BD (a point that internet/online broker-dealers love to ignore) dealing with options. It includes strict requirements as to knowing the customer, including detailed documentation of option experience and knowledge, as well as compliance and supervision which specifically includes monitoring the accounts.[42] And again, these regulations are not watered-down if the account is going to be managed by a POA.

Recommendations for Regulators

The following are some of our recommendations to fix the problems we have outlined in this article in power of attorney accounts:

- Annual renewal of all power of attorney agreements;
- Ban any use of "standing letters of authority" in POA accounts;
- Ban the use of "negative consent letters" in POA accounts;
- Provide contemporaneous confirmation to account owner of all disbursements out of the account;
- Require that opening account documents to be signed by the account owner be witnessed or notarized;
- Option risk disclosure brochure and margin disclosure documents be sent directly to account owners and require a written signed acknowledgment of receipt by account owner;

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equitable principles of trade), *aff'd*, No. 94-3990, 1996 WL 140339 (6th Cir. Mar. 27, 1996).

41. FINRA, RULE 2360 (2014).

42. *See* CBOE, RULES 9.1-9.25(2010) (Doing Business with the Public).

- Require a notarized signature on any document granting limited trading authority;
- Require a bank medallion signature on any document granting full power of attorney;
- Disallow policies that allow broker-dealers to not send confirmations and monthly statements to the account owner;
- Stop the "Institutional Game" and do not allow BDs to designate an account institutional when an individual with less than $50 million in assets is the account owner;
- Wherever FINRA replaced the words "due diligence" with "reasonable diligence," put back the words "due diligence." "Due diligence" is a better defined legal and regulatory term, whereas "reasonable diligence" is too amorphous a term. Also, reverting back to "due diligence" will be consistent with FINRA Rule 2360's use of the term "due diligence" (FINRA's option rule);
- Require all BDs to conduct due diligence to know their customer and to document this knowledge on account forms which should be updated every three years. And even if it is anticipated that all of the trading and investment activity is going to be unsolicited, or managed by a third-party/POA, to document the client's age, profession, investment knowledge, investment experience, investment objectives and risk tolerance;
- Require documented, extensive due diligence on any person holding a POA;
- Require BDs, when dealing with an independent investment adviser, to obtain and document the information that we list in the section of this article titled, "Know Your Customer *and* The Power of Attorney";
- BDs should be required to make account holders aware of the results of the firm's due diligence and all material facts regarding the POA;
- Require that the due diligence on any person with a POA be updated at least every three years;
- Require special attention to the account where the adviser is getting a percentage of profits, because the incentive for abuse is so much higher;
- Require BDs to use the same screens and monitoring systems for POAs that are used for other supervised accounts;
- Create and require special screening and monitoring systems for POA accounts that would include such things as numerous accounts losing equity, contrary to a general bull market;

- Forbid BDs from allowing advisers to take their fees of any kind directly from the accounts at the brokerage firms. Advisers should submit their bills directly to their clients, and be paid directly by their clients and not through their brokerage accounts. An exception could be that if the BD is going to allow account withdrawals by the adviser, the BD must have a written, approved document stating specifically the details of how any fees or performance fees will be charged and it must monitor the account to make sure that the specifics of the fee-based arrangement are being met and complied with;
- Require BDs to send a copy to the account owner of every single document related to the account. Electronic format is acceptable. Do not allow any document of any kind to go only to the POA;
- Restrict BDs from granting POAs to non-family individuals who are not licensed (exceptions may apply to court appointed conservators or guardians). Additionally, friends should not be granted a POA unless they are licensed;
- Require BDs to notify account owners of all margin calls, margin call extensions, margin call forced liquidations. And require a direct phone call communication verifying that the account owner has received and understands the seriousness of margin calls; and
- Require BDs to notify the account owner in writing of any red flags or material issues that the BD uncovers in its due diligence investigation of the POA throughout the life of the account.

In addition, broker-dealers should be required to quarterly or annually send an activity letter to the account owner of a POA account that in plain language spells out a few facts:

1. The performance in dollars and percentages;
2. The performance in comparison to certain bench marks and indexes;
3. The activity in number of trades, dollars in and out, and the disclosure that active trading causes higher costs and taxes;
4. If options are used, a disclosure that options have higher costs and higher risks;
5. If margin is used, provide a full explanation in easy to read language of the conflicts, costs and higher risks; and
6. Total cost in commissions, fees, performance fees annualized and as a percentage of assets.

JOHN MORGAN
SECURITIES COMMISSIONER

RONAK V. PATEL
DEPUTY SECURITIES COMMISSIONER

Mail: P.O. BOX 13167
AUSTIN, TEXAS 78711-3167

Phone: (512) 305-8300
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Texas State Securities Board

208 E. 10th Street, 5th Floor
Austin, Texas 78701-2407
www.ssb.texas.gov

IN THE MATTER OF THE DEALER REGISTRATION OF SCOTTRADE, INC.	§ § §	**Order No. IC16-CAF-04**

TO: Ryan T. Barke, AVP, Associate GC
Scottrade, Inc. (CRD #8206)
700 Maryville Centre Drive
St. Louis, MO 63141-5824

DISCIPLINARY ORDER

Be it remembered that Scottrade, Inc. (“Respondent”) appeared before the Securities Commissioner of the State of Texas ("Securities Commissioner") and consented to the entry of this order (“Order”) and the Findings of Fact and Conclusions of Law contained herein.

FINDINGS OF FACT

1. Respondent has waived (a) Respondent’s rights to notice and hearing in this matter; (b) Respondent’s rights to appear and present evidence in this matter; (c) Respondent’s rights to appeal this Order; and (d) all other procedural rights granted to the Respondent by The Securities Act, Tex. Rev. Civ. Stat. Ann. arts. 581-1 to 581-43 (West 2010 & Supp. 2015)("Texas Securities Act"), and the Administrative Procedure Act, Tex. Gov’t Code Ann. §§ 2001.001 to 2001.902 (West 2010 & Supp. 2015)("Administrative Procedure Act").

2. On May 23, 1989, Respondent registered with the Securities Commissioner as a dealer. This registration is currently effective.

3. In April 2014, the staff of the Texas State Securities Board (the “Staff”) initiated an investigation into Respondent’s written supervisory procedures regarding third-party wire transfers for clients of independent investment advisers utilizing the Firm’s institutional platform from January 2011 through July 2015 (the “Investigation Period”).

4. In June 2015 Respondent submitted to the Financial Industry Regulatory Authority ("FINRA") a Letter of Acceptance, Waiver and Consent ("AWC"), No. 2013035000501, in connection with Respondent's supervision of third-party wire transfers and agreed to pay a fine to FINRA.

5. Respondent provides brokerage and custody services to self-directed retail customers and to customers receiving investment advisory services from independent investment advisers through the Scottrade Advisory Services platform.

6. The retail customers and the customers utilizing independent investment advisers use the Respondent's platform to wire transfer funds from customer accounts.

7. Respondent's retail customers and customers utilizing independent investment advisers request wire transfers by submitting a Letter of Authorization ("LOA") to Respondent. The LOA lists the customer's account information, the recipient's financial institution information, and the amount of the wire transfer.

8. Respondent's retail customers and customers utilizing independent investment advisers must sign the LOA.

Third-Party Wire Transfers

9. From at least July 2012 to the present, Respondent's written supervisory procedures relating to the processing of third-party wire transfer requests have required Respondent to review the LOA for completeness and accuracy, ensure that customer funds are available for payout, verify the customer's signature, and confirm that Respondent's Fraud and Loss department reviewed the applicable requests.

10. At all relevant times, broker-dealers such as Respondent were subject to securities regulations requiring firms to establish procedures designed to review and monitor the transmittal of customer funds by wire to third-party accounts.

11. Further, from January 2011 to October 2013, Respondent did not provide customers with a contemporaneous notification that customer funds had been transferred via wire from the customer's account to a third-party.

12. During the Investigation Period, Respondent received one reported instance of fraud related to the processing of third-party wire transfers from a Texas resident's account. Respondent and the Texas customer resolved the matter after Scottrade detected the fraud.

13. In October 2013, Respondent implemented an automated procedure whereby customers are provided with a contemporaneous notification when customer funds are transferred via wire from the customer's account to a third-party.

CONCLUSIONS OF LAW

1. From January 2011 to October 2013, Respondent's written supervisory procedures were not reasonably designed to achieve compliance with applicable securities laws because Respondent's procedures did not require that a contemporaneous confirmation notice be sent to the customer after funds were transferred from the customer's account to the account of a third-party.

2. Respondent's failure to establish written supervisory procedures reasonably designed to achieve compliance with applicable securities laws in connection with the wire transfer of funds to the account of a third-party is a violation of §115.10(b)(1) of the Rules and Regulations of the Texas State Securities Board ("Board Rules").

3. Respondent's violation of a Board Rule provides a basis for the issuance of an Order reprimanding Respondent pursuant to Section 14.A(6) of the Texas Securities Act.

4. Respondent's violation of a Board Rule also provides a basis for the assessment of an administrative fine against Respondent pursuant to Section 23-1 of the Texas Securities Act.

ORDER

1. It is therefore ORDERED that Scottrade, Inc. is hereby REPRIMANDED.

2. It is further ORDERED that Scottrade, Inc. shall pay an ADMINISTRATIVE FINE in the amount of Fifty Thousand Dollars ($50,000.00) to the general fund of the State of Texas within ten (10) days of the entry of this Order.

3. Respondent further agrees to contribute Fifty Thousand Dollars ($50,000.00) within ten (10) days of the entry of this Order to be used for investor education efforts in Texas to the Investor Education Fund of the Investor Protection Trust, 1020 Nineteenth Street NW, Suite 890, Washington, D.C., 20036-6123.

SIGNED AND ENTERED BY THE SECURITIES COMMISSIONER this 7th day of March, 2016.

John Morgan

JOHN MORGAN
Securities Commissioner

Respondent:

Scottrade, Inc.

Ryan Barke

By: Ryan T. Barke
AVP, Associate General Counsel

Approved as to Form:

Ronak V. Patel
Deputy Securities Commissioner

John Kincade

John Kincade
Winstead PC

ACKNOWLEDGMENT

On the 4th day of MARCH, 2016, Scottrade, Inc. ("Respondent"), by and through Ryan T. Barke, appeared before me, executed the foregoing Order, and acknowledged that:

1. Ryan T. Barke is duly authorized to enter into the foregoing Order on behalf of Respondent;

2. Ryan T. Barke has read the foregoing Order;

3. Respondent has been fully advised of its rights under the Texas Securities Act and the Administrative Procedure Act;

4. Respondent knowingly and voluntarily consents to the entry of the foregoing Order and the Findings of Fact and Conclusions of Law contained therein; and

5. Respondent, by consenting to the entry of the foregoing Order, has knowingly and voluntarily waived its rights as set forth therein.

KRISTA M. KIRK
Notary Public - Notary Seal
State of Missouri, Saint Louis City
Commission # 12415533
My Commission Expires Jan 28, 2020

Krista M Kirk
Notary Public in and for
the State of Missouri
My commission expires on: 1/28/20

DENISE VOIGT CRAWFORD
SECURITIES COMMISSIONER

JOHN R. MORGAN
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Texas State Securities Board

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IN THE MATTER OF
THE DEALER REGISTRATION
OF AMERITRADE, INC. § § § **Order No.** IC07-CAF-03

TO: Bryce Bradley Engel, President
Ameritrade, Inc. (CRD No. 5633)
1005 North AmeritradePlace
Bellevue, NE 68005

DISCIPLINARY ORDER AND UNDERTAKING

Be it remembered that Ameritrade, Inc. ("Respondent"), by and through Bryce Bradley Engel, its President, appeared before the Securities Commissioner of the State of Texas ("Securities Commissioner") and consented to the entry of this order ("Order") and Undertaking and the Findings of Fact and Conclusions of Law contained herein.

FINDINGS OF FACT

1. Respondent has waived (a) Respondent's right to notice and hearing in this matter; (b) Respondent's right to appear and present evidence in this matter; (c) Respondent's right to appeal this Order; and (d) all other procedural rights granted to the Respondent by The Securities Act, TEX. REV. CIV. STAT. ANN. art. 581-1 et seq. (Vernon 1964 & Supp. 2006)("Texas Securities Act"), and the Administrative Procedure Act, TEX. GOV'T CODE ANN. § 2001.001 et seq. (Vernon 2000 & Supp. 2006)("Administrative Procedure Act").

2. On or about July 22, 1983, Respondent registered with the Securities Commissioneras a securities dealer, which is currently effective.

3. Since 2002, Respondent has maintained a trading platform that may be utilized by persons acting as an independent investment adviser ("IIA") for customers holding accounts with Respondent. In order to utilize the platform, each IIA must open a "master account" with the Respondent and obtain trading authorization from the customers.

4. In or about June 2003, Respondent contracted with a third party ("Contractor") to perform registration verifications on each IIA seeking to utilize the trading platform. Respondent's written policies and procedures state that the Respondent will not enter into a relationship with an IIA seeking to use the trading platform until the Contractor has been able to verify the registration status of the IIA.

5. In or about April 2004 and in or about October 2004, Respondent received notifications from the Contractor that multiple IIAs (the "Advisers") located in Texas and utilizing Respondent's trading platform were not appropriately registered and/or notice-filed with the State of Texas.

6. Respondent did not immediately prohibit the Advisers from utilizing Respondent's trading platform. Furthermore, Respondent did not direct its employees to immediately follow-up on the registration status of each of the Advisers.

7. Pursuant to § 115.10(b)(1) of the Rules and Regulations of the Texas State Securities Board ("Board Rules"), a dealer shall establish, maintain, and enforce written procedures to supervise the activities of its agents that are reasonably designed to achieve compliance with the Texas Securities Act and Board Rules.

8. Respondent continued to allow the Advisers to utilize Respondent's trading platform until on or about December 7, 2005.

9. Each IIA utilizing Respondent's trading platform is generally able to, with prior consent from its clients, directly transfer management fees from Respondent's customer accounts to the IIA's master account. In order to effect a management fee transfer, an IIA must submit a management fee transfer request directly to the Respondent.

10. Until on or about April 4, 2006, Respondent had not established a system or any procedures reasonably designed to monitor for, and address, management fee transfer requests that could be in excess of the industry standards for management fees or otherwise indicative of improper conduct by an IIA on Respondent's trading platform.

CONCLUSIONS OF LAW

1. Respondent's failures to direct its employees to immediately follow-up on the registration status of each of the Advisers and/or immediately prevent the Advisers from continuing to utilize Respondent's trading platform constitute failures to enforce Respondent's written procedures, and are violations of § 115.10(b)(1) of the Board Rules.

2. Pursuant to Section 14.A(6) of the Texas Securities Act, the foregoing violations of a Board Rule constitute bases for the issuance of an order reprimanding a registered dealer.

3. Pursuant to Section 23-1 of the Texas Securities Act, the foregoing violations of a Board Rule constitute bases for the assessment of an administrative fine against a dealer.

UNDERTAKING

1. Respondent hereby undertakes and agrees to continue to utilize the services of the independent outside consultant it has retained, as of April 4, 2006, to monitor for management fee transfer requests by an IIA that could be in excess of industry standards for management fees on a going forward basis and until such time that the computer systems of Respondent and/or any successor are able to conduct reasonable monitoring.

2. Respondent further undertakes and agrees to develop written procedures that are reasonably designed to monitor for, and address, management fee transfer requests that could be in excess of the industry standards for management fees. Respondent further undertakes and agrees to submit these written procedures and policies to the Director of the Inspections & Compliance Division of the Texas State Securities Board within sixty (60) days of the Order being signed by the Securities Commissioner.

3. Respondent further undertakes and agrees to take reasonable steps to enforce its written procedures and policies with respect to its trading platform by IIAs.

ORDER

1. It is therefore ORDERED that Ameritrade, Inc. is hereby REPRIMANDED.

2. It is further ORDERED that Ameritrade, Inc. is hereby ASSESSED AN ADMINISTRATIVE FINE in the amount of Two Hundred Thousand Dollars ($200,000.00). Payment shall be made by delivery of a cashier's check to the Securities Commissioner in the amount of Two Hundred Thousand Dollars ($200,000.00), payable to the State of Texas, contemporaneously with the delivery of this Order.

3. It is further ORDERED that Ameritrade, Inc. hereby COMPLY with the terms of the Undertaking contained herein.

SIGNED AND ENTERED BY THE SECURITIES COMMISSIONER this 7th day of February, 2007.

Denise Voigt Crawford

DENISE VOIGT CRAWFORD
Securities Commissioner

Respondent:

Ameritrade, Inc.

By: Bryce Bradley Engel, President

Approved as to Form:

Benette L. Zivley
Director
Inspections and Compliance Division

Richard D. Marshall
Attorney for Respondent

Ronak V. Patel
Attorney
Inspections and Compliance Division

Lee Polson
Attorney for Respondent

ACKNOWLEDGMENT

On the 29th day of January, 2007, Ameritrade, Inc. ("Respondent"), by and through, Bryce Bradley Engel, its President, personally appeared before me, executed the foregoing Order and Undertaking, and acknowledges that:

1. Bryce Bradley Engel is duly authorized to enter into the foregoing Order and Undertaking on behalf of Respondent;

2. Bryce Bradley Engel has read the foregoing Order and Undertaking;

3. Respondent has been fully advised of its rights under the Texas Securities Act and the Administrative Procedure Act;

4. Respondent knowingly and voluntarily consents to the entry of the foregoing Order and Undertaking and the Findings of Fact and Conclusions of Law contained therein; and,

5. Respondent, by consenting to the entry of the foregoing Order, has knowingly and voluntarily waived its rights as set forth therein.

GENERAL NOTARY-State of Nebraska
DENISE K. RICHARDSON
My Comm. Exp. Nov. 1, 2007

[affix notary seal here]

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CAN BROKERAGE FIRMS ANTICIPATE BROKER MALFEASANCE?

Edward S. O'Neal, Ph.D.[1]

Three recent research studies have analyzed the information in FINRA's BrokerCheck database concerning the likelihood of repeat broker malfeasance.[2] These three studies all conclude that BrokerCheck information can be helpful in identifying which brokers are more likely to commit fraud on clients. One drawback, which is detailed most clearly in McCann, Yan and Chuan (2016), is that realizing the predictive potential of the database requires access to the entire dataset and complex statistical analysis which is well beyond the capabilities of investors.[3] Although the findings of the three studies differ somewhat due to slightly differing time periods and statistical approaches, the over-riding conclusion is that a broker's history of misconduct and the characteristics of the broker's firm coworkers can be combined to help identify which brokers pose the biggest risk to investors.

The extant studies illustrate how BrokerCheck information could be used by investors when investigating brokers if the data was available in bulk and

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2. Craig McCann, Chuan Qin & Mike Yan, *How Widespread and Predictable is Stock Broker Misconduct?* (June 9. 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2768942 ("McCann, Yan and Chuan (2016)" or "McCann et al."); Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct* (Mar. 1, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170 ("Egan, Matvos and Seru (2016)" or "Egan, Matvos and Seru"); Hammond Qureshi & Jonathan S. Sokobin. *Do Investors Have Valuable Information About Brokers?* (FINRA Office of the Chief Economist, Working Paper, Aug. 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2652535 ("Qureshi and Sokobin (2015)" or "Qureshi and Sokobin").

3. *See* McCann, *supra* note 2.

analyzed by firms like *Morningstar* and *US News & World Report*. This paper raises the question of why brokerage firms do not use this and other data ready at their disposal, but not readily available to investors, to better protect their clients from broker harm.

As two of the previous studies demonstrate, some brokerage firms are much more apt than others to have brokers who commit investor harm. These higher-risk firms persist in the industry from year to year. Some firms make a profit-maximizing decision that losses due to investor harm in the form of settlements or FINRA awards are outweighed by the fee or commission income generated by these high-risk brokers given the current regulatory regime. As explained by Brian Kovack, President of Kovack Securities, Inc. – one of the brokerage firms with the highest level of investor harm rates in the industry – and a member of FINRA's Board of Governors, to Wealth Management Magazine:

> If an advisor sold the tainted products to five or fewer clients and has at least $500,000 in gross dealer concessions, he'll consider hiring that person to his firm. The more production an advisor has, the more he can shell out for defense costs if an arbitration or lawsuit does develop, Kovack reasons. Another way to manage the possible risk of litigation is to get the incoming clients to sign a disclosure agreement, he says. "You need to be able to approach clients and have them sign a disclosure agreement recognizing that the new broker/dealer had no part in the sale of a tainted security at the prior firm," says Kovack.[4]

FINRA claims that investors should use a sliver of BrokerCheck data to avoid bad brokers. FINRA member firms have far more BrokerCheck data, data excluded from BrokerCheck but on CRDs, and information only known internally at the brokerage firms available to them. If the brokers that ultimately harm investors are hired or continued to be employed by FINRA firms when the firm could easily identify them as high risk brokers, the firm may not have served investors.

Attorneys representing aggrieved investors could also make use of BrokerCheck resources to help arbitration panels understand when the broker involved in a case was such a high-risk broker that the brokerage firm could have known that further investor harm was likely. This evidence might suggest that culpability for the broker's malfeasance rests partially or in large part with

4. Diana Britton, *The Good, the Bad and the Ugly*, WEALTH MANAGEMENT MAGAZINE (June 27, 2011), http://wealthmanagement.com/practice-management/good-bad-and-ugly.

the firm's failure to use information at its disposal to more closely scrutinize or terminate a high-risk broker.

I. What the studies find

FINRA's BrokerCheck database in its current form allows investors to look up one broker at a time to access a subset of the information on the broker's CRD. The researchers in the three studies essentially gathered all data on all brokers in the database. Qureshi and Sokobin (2015),[5] which is a FINRA working paper, find over the period 2000 – 2013 that 1.3% of all brokers in their study are associated with at least one investor "harm event."[6] They define a harm event as a customer-initiated complaint that results in a settlement or arbitration award above $10,000 before 2009 or above $15,000 after 2009.[7] Further, the authors find that broker misconduct is at least partially predictable. Previous settlements or awards, judgments or liens, and previously declared bankruptcy are among the characteristics in a broker's past that help predict future malfeasance. In each year of the study, the authors divide the sample of all brokers in that year into five groups or quintiles.[8] The first quintile is the group predicted to be least likely to commit malfeasance based on his or her characteristics.[9] The fifth quintile is the group most likely to be associated with an investor harm event in that year.[10] The authors find that 55% of the harm events in that year are by brokers in the fifth quintile. If harm events were unpredictable, approximately 20% of the harm events would be in each quintile.[11]

Egan, Matvos and Seru (2016) look at the BrokerCheck database over the period 2005 – 2015 and find that 7.8% of all brokers are associated with at least one harm event.[12] They document that of all brokers in a given year that

5. *See* Qureshi, *supra* note 2.

6. *Id.* at 25.

7. *Id.* Note that this definition of a harm event is somewhat arbitrary. We adopt it here only because the FINRA working paper used this definition.

8. *Id.* at 16.

9. *Id.*

10. *Id.*

11. *Id.*

12. *See* Egan, s*upra* note 2, at 2.

report financial misconduct on their CRD, 38% had a previous financial misconduct event.[13] A broker who has a harm event in a particular year is approximately 20 times more likely than the average broker to have another harm event in the subsequent year.[14] This increased likelihood of a harm event by a broker remains elevated for at least five years after the initial harm event.[15] The authors also document that offending brokers are more likely to be fired and to have longer periods of unemployment than terminated brokers without a harm event.[16] They also find that many of these terminated brokers are re-hired, but at lower compensation rates and at lower quality firms.[17]

McCann, Qin and Yan (2016) provide the most comprehensive study of the predictability of broker misconduct. They find that Qureshi and Sokobin dramatically understate the incidence of harm events by screening from their analysis all brokers registered before the year 2000.[18] The longer a broker is in the industry, the more likely he or she is to have a harm event *in any given year*.[19] Qureshi and Sokobin's screening procedure removes a very large percentage of brokers from the sample, especially in the early years of their analysis (which, incidentally, corresponds to the tech wreck). Once this screening procedure is removed, McCann et al. find that approximately 5% of all brokers are associated with harm events. McCann et al. refine and improve the prediction model of harm events.[20] Their prediction model also groups brokers into quintiles. With the improved estimation technique, the authors' fifth quintile contains 70% of all brokers that commit investor harm in the subsequent year, a significant improvement over the model of Qureshi and Sokobin.[21]

Notably, both Qureshi and Sokobin and McCann et al. find that characteristics of the brokerage firm that employs the broker influence the predictability of broker harm. High-risk coworkers increase the likelihood that

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13. *Id.* at 11.

14. *Id.* (The authors note the probablility of repeat is 11% compared with 0.6% for the average broker who has not already committed investor harm).

15. *Id.*

16. *Id.* at 17-18.

17. *Id.*

18. *See* McCann, *supra* note 2, at 7.

19. *Id.* at 8.

20. *Id.* at 6.

21. *Id.* at 17.

a broker will commit investor harm. This finding is consistent with the finding in Egan, Matvos and Seru that some firms simply hire a greater proportion of bad brokers.[22] Egan, Matvos and Seru find that among the firms with over 1,000 registered representatives, there is a wide dispersion in the frequency of broker misconduct.[23]

II. Analysis of Brokerage Firms

FINRA maintains a database of registration, employment, complaint and disciplinary history for each brokerage firm and broker, the Central Registration Depository, or CRD. The CRD includes each broker's involvement in customer disputes, financial, disciplinary and criminal events, employment history, and qualifications. FINRA makes a portion of the information in the CRD public through its BrokerCheck website. The data employed for the analysis in this paper is the same data used in McCann et al.[24]

McCann et al. show a ranking (Table 22 in their paper) of the top 30 brokerage firms based on investor harm rate as of December 2015.[25] Investor Harm Rate is calculated as the number of currently employed brokers that have committed at least one instance of investor harm divided by the total number of brokers at the firm. Table 1 below shows the worst 10 firms with more than 400 brokers as of December 31, 2015.[26]

22. *See* Egan, *supra* note 2, at 4.

23. *Id.* at 13.

24. See McCann, *supra* note 2, for a more detailed description of the data.

25. *Id.*at 32.

26. *Id.*

Table 1: Worst 10 brokerage firms with more than 400 Brokers as of December 31, 2015[27]

Brokerage Firm	CRD	Number of Brokers Employed	Number of Brokers w/ Investor Harm Event	Percentage of Brokers with Investor Harm Event
Aegis Capital Corp.	15007	444	107	24.1%
Summit Brokerage Services, Inc.	34643	676	129	19.1%
National Securities Corp.	7569	760	137	18.0%
Centaurus Financial, Inc.	30833	602	98	16.3%
Independent Financial Group, LLC	7717	638	90	14.1%
Kovak Securities, Inc.	44848	434	58	13.4%
Oppenheimer & Co., Inc.	249	2217	276	12.4%
Wedbush Securities, Inc.	877	634	77	12.1%
Investors Capital Corp.	30613	641	72	11.2%
Wunderlich Securities, Inc.	2543	459	51	11.1%

The same analysis was used to identify the 10 worst firms as of the end of 2010. Many of the same firms show up in 2010 as in 2015. This finding suggests that brokerage firms with high investor harm percentage persist over time and is consistent with the idea that the business model of certain firms includes the hiring and continued employment of brokers who are more at risk of harming investors. A statistical test was performed to confirm this idea. All brokers with over 400 brokers that exist in 2010 and in 2015 are ranked based on investor harm as of 2010 and are then re-ranked based on investor harm in 2015. A rank order correlation test is conducted to see whether the ranking in 2010 is correlated with the ranking in 2015. In other words, do firms that rank poorly in one period continue to be ranked poorly in the next period? The Spearman's rank correlation statistic delivers a p-value of 2.2×10^{-16}, meaning that one could not be any more certain that there is a strong correlation between a brokerage firm ranked on investor harm events in 2010 and 2015. This test delivers identical results whether the sample is confined to those firms larger than 1,000 brokers or, less restrictively, to firms with more than 400 brokers. Bad firms continue to be bad for years at a time.

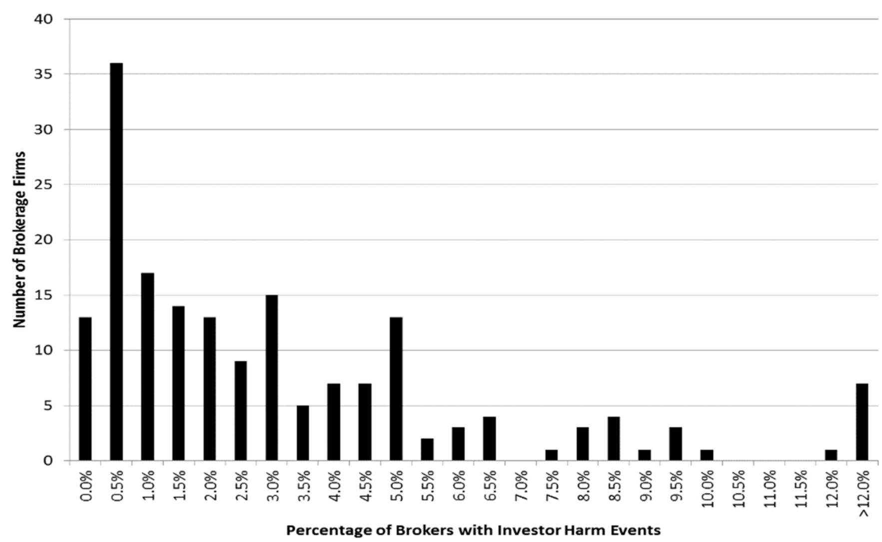
27. *Id.*

The phenomenon is persistent. For the brokerage firms that exist in both 2010 and 2015, the worst 10 in 2010 are also the worst 10 in 2015. The rank order is slightly different, but the fact that those firms all remain in the worst 10 over a five year period when there are over 175 brokerage firms with more than 400 brokers is astounding. These firms at the bottom clearly do not alter their hiring or firing practices to attempt to decrease the rate at which their brokers harm clients.

The brokerage firms in the worst 10 tend, on average, to be smaller firms. These 10 brokerage firms employ only 4% of the brokers in the sample but represent 14% of the brokers with investor harm events.

For the worst 10 firms shown in Table 1, the average investor harm rate is 15.2%. In other words approximately 1 in 7 brokers has at least one instance of investor harm in his employment history. For the median firm over the same period, the investor harm rate is approximately 2.0%. One in 50 brokers at the median firm has committed investor harm. Therefore the worst 10 brokerage firms have chosen to employ a stable of brokers who commit investor harm at 7 or 8 times the rate of the average FINRA firm with 400 or more brokers. Figure 1 below is a histogram showing the number of firms in different bins of percentage investor harm as of 2010. There are firms far out into the right tail of this distribution that have decided to operate with a high percentage of harm-causing brokers.

Figure 1: Histogram of brokerage firms by brokers with investor harm events in 2010



III. Analysis of Individual Brokers

The analysis in the previous section has shown that certain brokerage firms employ brokers that are much more apt to have committed investor harm and, further, that these firms persistently keep brokers on staff with investor harm in their backgrounds. The analysis now turns to individual brokers.

As the academic papers have demonstrated, broker harm is at least partially predictable. In any given year, it is possible to identify which brokers are more likely than other brokers to harm investors. The percentage of brokers employed in 2010 that committed an investor harm event in that year is 0.35%. However, since the harm events are somewhat predictable, it is possible to identify brokers that are more likely to be those that commit investor harm. Although investors would have to be very sophisticated to do this, brokerage firms, with their expertise, resources and access to BrokerCheck information as well as private information could easily identify high-risk brokers. As an example, using the predictive model developed by McCann et al., 10% of all brokers as of 2009 that were predicted to be most likely to commit investor harm in a future period (the "worst decile"), can be identified. Table 2 below shows the percentage of those brokers that committed investor harm by the end of the next several years compared to the average broker.

Table 2: Brokerage Harm Occurrence for Worst Decile Brokers

Year	Worst 2009 Decile: Percent that committed harm	Average 2009 Broker: Percent that committed harm	Times more likely harm caused by worst decile broker
2010	2.16%	0.35%	6.16
2011	3.46%	0.59%	5.85
2012	4.37%	0.77%	5.69
2013	5.10%	0.92%	5.54
2104	5.55%	1.02%	5.42

Though only 0.35% of all brokers committed harm in 2010, the brokers predicted to be in the worst 10% committed harm at about 6 times this frequency. Of the high-risk brokers, 5.55% of them had committed an investor harm event within 5 years, a rate 5.4 times that of the average broker. A brokerage firm, using just the publicly available information in BrokerCheck (not to mention the firm's own plethora of private information), could determine if any firm brokers were in the worst decile. This identification would allow a firm to conclude that such brokers are 5 or 6 times more likely than average to commit an act of investor harm in the near future. It would seem logical that such brokers, at the very least, would be under heightened supervision.

The analysis becomes even more vivid after identifying the worst of the worst brokers. The worst 1% of all brokers based on the predictive model gives a striking result. Using information available in 2009 to predict broker harm in 2010 and beyond results in the findings presented in Table 3 below.

Table 3: Brokerage Harm Occurrence for Worst 1 percent of Brokers

Year	Worst 2009 percentile: Percent that committed harm	Average 2009 Broker: Percent that committed harm	Times more likely harm caused by worst percentile broker
2010	7.58%	0.35%	21.58
2011	11.17%	0.59%	18.89
2012	13.60%	0.77%	17.71
2013	15.26%	0.92%	16.59
2104	16.28%	1.02%	15.89

If a firm employs a broker in the worst percentile, that broker is over 20 times more likely than the average broker to commit investor harm in the next year. The predictive models make it possible to identify high-risk brokers. Because of this predictability, vigilance on the part of brokerage firms could curtail investor harm events. Warning signs exist that could easily be heeded by firms and their compliance or supervision teams. Failure to recognize these signs and to act on them raises the question of accountability for harm events that could possibly have been prevented with stricter scrutiny of such brokers.

Firms that choose to allow high-risk brokers to operate are likely making the profit-maximizing decision that losses due to investor harm in the form of settlements or FINRA awards are outweighed by gains provided by these high-risk brokers in the form of fees or commission income. Arbitration panels may be interested if it can be proven that a firm made such business decisions at the expense of investors resulting in an investor harm event. Even for firms that appear to have low average rates of investor harm events, a wide dispersion in probability of broker harm exists, suggesting that even good firms can identify at risk brokers prior to investor harm occurring.

Table 4 shows an example of the “risk-level” of an actual broker involved in a recent FINRA case. This broker was employed by one of the 10 worst firms identified above. Sorting brokers from low-risk to high-risk using FINRA’s definition of investor harm and statistical tools, this broker would have been worse than 99.9% brokers *every year* from 2003 to 2015 and yet was allowed to engage in a years-long pattern of investor harm.

Table 4: Real World Example Bad Broker

Year	Percentile by Probit	Percentile by GBM
2003	99.970%	99.996%
2004	99.980%	99.997%
2005	99.976%	99.992%
2006	99.968%	99.968%
2007	99.969%	99.981%
2008	99.971%	99.997%
2009	99.973%	99.997%
2010	99.976%	99.996%
2011	99.974%	99.990%
2012	99.973%	99.994%
2013	99.981%	99.993%
2014	99.985%	99.891%
2015	99.984%	99.785%

IV. Within-firm broker analysis

The previous analysis considered brokerage firms as a group and individual brokers ranked on measures of investor harm relative to the industry. Individual brokers can also be analyzed in relation to other brokers at the same brokerage firm. There is a wide spread of individual broker quality within brokerage firms. Based on data that would have been available at the end of 2013, consider two different firms: One firm has a high percentage of brokers with harm events, and the other has a low percentage of brokers with broker harm events. From each firm a broker was selected that committed investor harm in 2014 and who would have been in that firm's worst decile of brokers as of the end of 2013 The offending broker was then compared to the other brokers at their respective firms based on the 2013 prediction model.

Within the bad firm, the dispersion in broker quality is quite high. Brokers in the worst decile of the firm, are 48 times more likely than brokers in the best decile of the same firm to commit investor harm. When compared to the brokers in the median decile, the offending broker was 12 times more likely to commit investor harm. Even at the bad firm, the broker who subsequently commits harm stands out at the end of 2013, not just relative to brokers nationwide, but relative to the firm's other brokers.

The results are similar, although not as strong, for brokers at good firms. The offending broker at the good firm was 6 times more likely than the median broker at his own firm to be involved in an investor harm event and 17 times more likely than the best decile of brokers to commit investor harm. Even firms that have a better record of investor harm have high risk brokers that could be identified prior to harming investors.

V. Conclusion

Published studies by academics and by FINRA demonstrate that Broker-Check information can be used to assess the likelihood of a broker committing investor harm. Authors in the FINRA study suggest that investors can use this information to make more informed choices of which broker to use. FINRA member firms could use exactly the same information (and more) proactively to help protect the investing public from brokers at high risk of committing investor harm events.

RETAIL OIL AND GAS INVESTMENTS[1]

Brian J. Henderson, PhD, CFA, Joshua Mallett, CPA,
Craig J. McCann, PhD, CFA, and Regina Meng, MS

I. Introduction

In recent years, many investors, rather than holding a diversified portfolio of securities, were sold concentrated oil and gas investments and, as a result, lost billions of dollars. In this paper, we catalogue the primary types of oil and gas investments and explain why diversified portfolios – which always makes sense - would have invested only a small percentage in these investments.

First, the devastating numbers. Oil and gas prices have declined sharply over the past two years. The West Texas Intermediate spot price dropped over 75% from $106.07 per barrel on June 30, 2014 to a low of $26.21 on February 11, 2016. After increasing to $48.27 on June 30, 2016, oil prices remain 54% below their 2014 levels. The United States Oil Fund (USO), an ETF tracking daily changes in the price of near term crude oil futures contracts, lost 70.2% in the two years ending June 30, 2016. The S&P Oil and Gas Exploration & Production ETF (XOP), which tracks the performance of companies in the U.S. oil and gas sector, lost 56.5% and the Alerian MLP Index (AMLP), comprised of approximately 24 midstream energy Master Limited Partnerships (MLPs), fell by 21.1% during the same period.[2]

A myriad of investments have significant exposure to oil and gas prices. In addition to investments illustrated in Figure 1, some portfolios were heavily invested in structured products or ETNs linked to indexes of oil and gas companies or to ETFs. Some investors held portfolios heavily concentrated in Master Limited Partnerships (MLPs) or high-yield bonds issued by energy producers, which have experienced severe negative returns or gone bankrupt from the recent decline in oil and gas prices.

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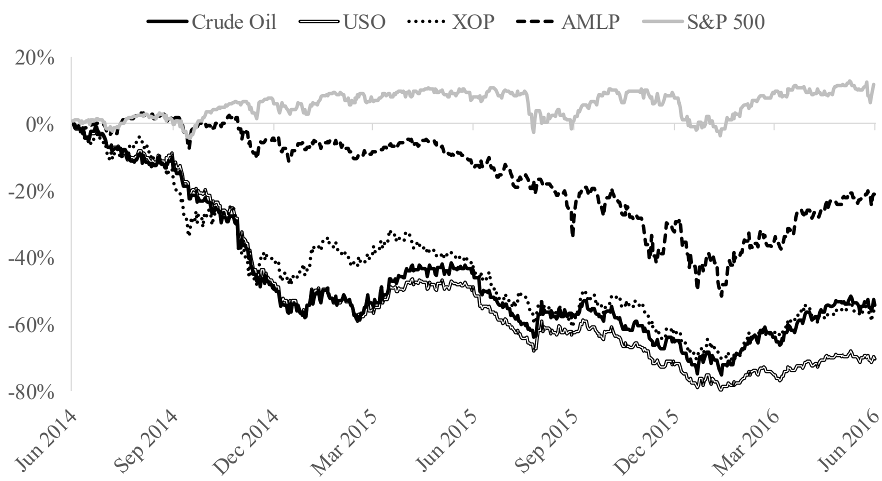
2. *See infra* Figure 1.

Figure 1 WTI Adjusted Spot Price and USO, XOP, AMLP and S&P 500 Total Returns June 2014 - June 2016



Declining oil and gas prices have direct, negative impacts on the revenues, and thus the valuations, of production and exploration companies. Other companies benefit from declines in energy prices. These include those that are heavy consumers of oil like airlines and chemical producers, as well as consumer goods and services companies that benefit from consumers' additional spending power (when energy accounts for less of their budget). A properly constructed investment portfolio will diversify across firms with varying exposures to energy prices and avoid over-concentration in any sector, including the oil and gas sector. To illustrate the importance of diversification, consider that during this same two-year period that the WTI spot price declined by 54%, the S&P 500 total return was 11.7%.

The remainder of the paper is organized as follows.

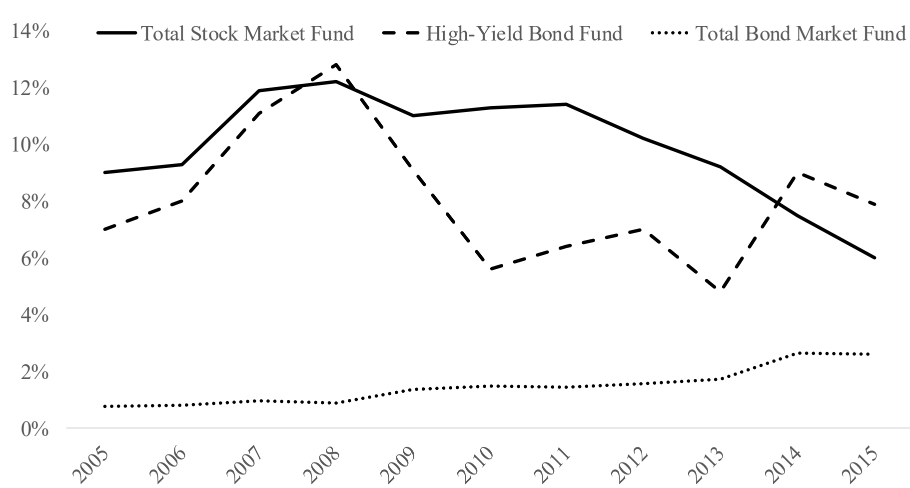
- Section II provides context for assessing whether a portfolio was too heavily invested in oil and gas related investments.
- Section III describes the organization of the oil and gas industry.
- Section IV covers stocks and bonds issued by publicly traded oil and gas companies.
- Section V discusses MLPs.
- Section VI presents investments providing direct exposure to commodity prices.

- Section VII examines structured products linked to oil prices, operating companies and ETFs.
- Section VIII is our conclusion.

II. First, How Much Oil and Gas Exposure is in a *Diversified* Portfolio?

Relative market capitalization of different securities, issues and industries provide useful reference points for evaluating the composition of investment portfolios since they reflect the aggregate portfolio weights of all investors across the economy. As of December 31, 2015, 6.5% of the market value of Vanguard 500 Index Fund (VFINX) and 6.0% of the market value of Vanguard's Total Stock Market Index Fund (VTSMX) were invested in oil and gas stocks. As of December 31, 2015, 2.6% of the market value of Vanguard Total Bond Market Index (VBMFX) and on January 31, 2016 7.9% of Vanguard's High Yield Corporate Fund (VWEHX) were invested in energy bonds. Figure 2 presents the historical energy sector exposure weights of these indexes.

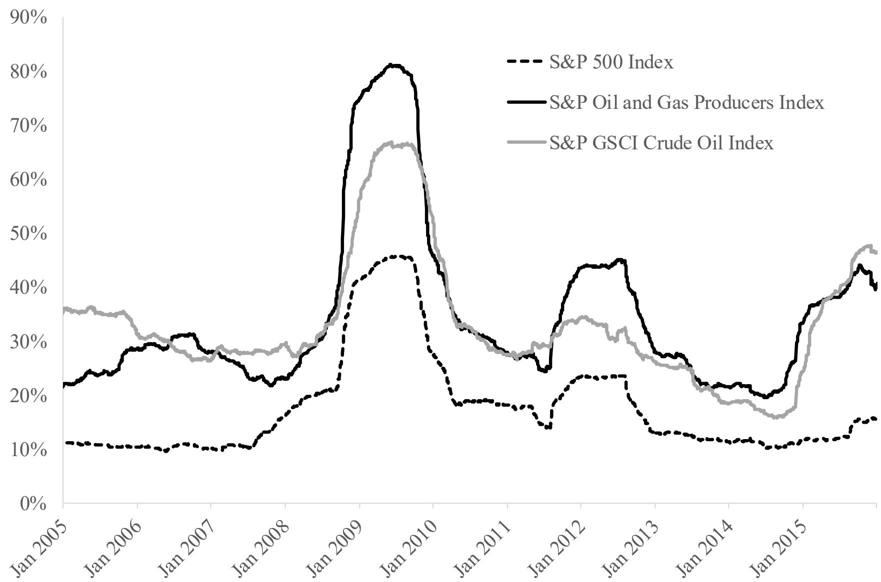
Figure 2 Oil and Gas Companies in S&P 500 and Aggregate Bond Index Funds, 2005 – 2015



These four funds track the U.S. stock market and the U.S. investment grade and high-yield bond markets; they provide a good estimate of how much oil and gas exposure investors hold in diversified portfolios. Based on the composition of these market capitalization-weighted indexes, a balanced portfolio of 60% invested in stock and 40% invested in investment grade bonds would have oil and gas exposure of only about 5%.

Investors should diversify their portfolios because it allows them to reduce risk without reducing their expected return. Portfolios that are concentrated in securities of oil and gas companies are much more volatile than diversified portfolios of stocks invested in firms across multiple sectors. Figure 3 plots the trailing one-year volatility of daily returns to the S&P 500 Index, the S&P Oil & Gas Exploration and Production Select Industry Index, and the S&P GSCI Crude Oil Index. On average, the subset of oil and gas companies is nearly twice as volatile as diversified portfolios of stock.

Figure 3 Volatility of Oil and Gas Companies versus Diversified Stock Portfolios, 2005 – 2015



Some investment professionals have advocated for the addition of commodity investments in asset allocations on the basis of perceived diversification benefits. While the benefits of including commodity investments are debatable, at most 5% of a typical portfolio should be allocated to commodities, with the balance held in traditional stocks and bonds. The weight of energy commodities in major commodity indexes varies based on the specific index weighting scheme. The S&P GSCI commodity index contains a large allocation to energy commodities (63%). Thus, an investor holding a diversified portfolio of 55% stocks, 40% bonds, and 5% commodities would have at most 8.15% exposure to energy, comprised of 5% exposure to energy producers and 3.15% exposure to a diversified complex of energy commodities.

III. The Oil and Gas Industry Structure

Oil and gas companies can be divided into subsectors based on where their primary operations fall in the value chain. We use Bloomberg Industry Classification Systems (BICS) Level 3 code to classify firms. The exploration and production sector focuses on locating and extracting oil and gas. These entities are referred to as the "upstream" subsector. Those exploration and production companies send the extracted oil and gas to refineries through pipelines, which are owned and maintained by companies in the transportation and storage sub-sector, referred to as the "midstream" subsector. Once the oil reaches the refinery, it is processed and sold by companies in the refining and marketing sub-sector. Companies in the equipment and services subsector provide support services.

Figure 4 presents the U.S. listed, exchange traded oil and gas firms, including corporations and master limited partnerships (MLPs), categorized by the primary market segment in which they operate, as well as available ETFs and ETNs for investment exposure to these firms.

Figure 4: Oil and Gas Sector Investments Categorized By Segment.

Number of Active, Listed Entities (5/31/2016)

	Corporations	**MLP/ LP**	**ETFs**	**ETNs**	**Total**
Integrated	3	-	32	13	48
Exploration & Production	315	10	7	-	332
Storage & Transportation	35	70	5	6	116
Refining & Marketing	30	11	1	-	42
Equipment & Services	97	6	4	-	107
Commodity Prices	-	-	14	20	34
Total	**480**	**97**	**63**	**39**	**679**

Average Market Capitalization (5/31/2016)

(in Millions)	**Corporations**	**MLP/ LP**	**ETFs**	**ETNs**	**Total**
Integrated	$186,507		$1,031	$387	$12,449
Exploration & Production	$1,315	$278	$337		$1,263
Storage & Transportation	$3,984	$4,605	$251	$454	$4,015
Refining & Marketing	$4,032	$1,177	$4		$3,189
Equipment & Services	$2,324	$536	$360		$2,151
Commodity Prices			$516	$156	$304
Total	**$3,041**	**$3,519**	**$719**	**$279**	**$2,735**

There are more than 480 publicly traded oil and gas corporations in the U.S. The average oil and gas company has a market capitalization of approximately $3 billion. The majority of those firms (nearly 3 out of 4) are concentrated in the upstream (exploration and production) sector, which is the most sensitive to energy prices since costs are invariant in the short-run and revenues are directly tied to output prices. Although there are only three integrated companies, their size dwarfs that of the single-segment operators, and accounts for a large portion of the market capitalization of the total industry, as illustrated by the average market capitalization of $186 billion.

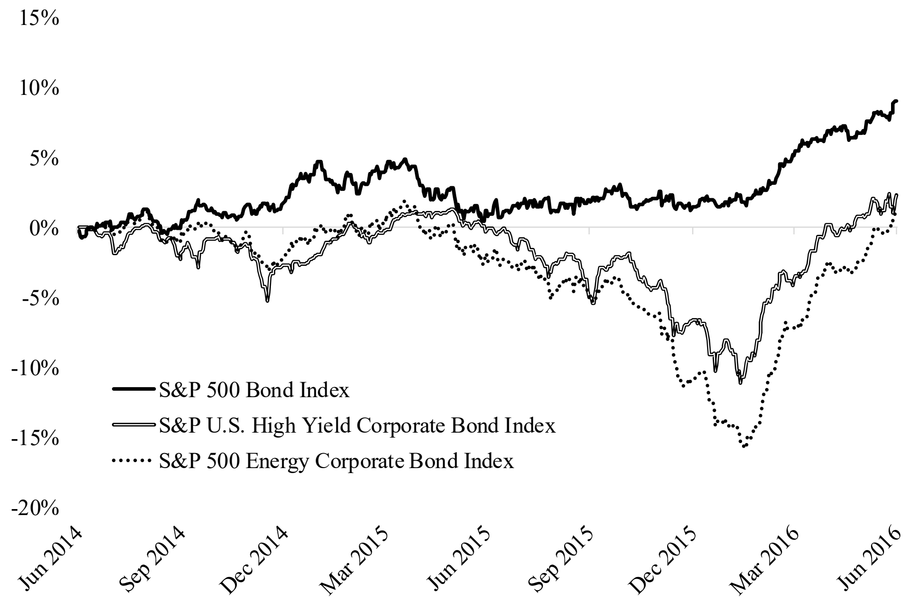
In contrast to public companies, the vast majority of MLPs (70%) are involved in the transportation and storage of oil and gas. The minority of MLPs are involved in exploration and production and oil services. The average size of MLPs is similar to public companies ($3.5 billion), but the value is spread more homogenously across MLPs since there are not any large, fully integrated ones.

IV. Investments in Oil and Gas Operating Companies

Debt and equity securities issued by companies involved in the exploration, production, transport, refining or sales and distribution of oil and gas are common ways that investors are exposed to energy commodities. The revenues of companies in this industry strongly correlate with global energy prices. As a result of the recent decline in oil and gas prices, and thus declines in these firms' revenues and earnings, investors in energy companies have suffered significant losses.

As oil and gas prices remain low, debt securities issued by energy companies have also experienced significant declines. For example, the S&P 500 Energy Corporate Bond Index posted a return of -15.8% from July 2014 to February 16, 2016. See Figure 5. By comparison, the S&P U.S. High Yield Corporate Bond Index and S&P 500 Bond Index returned -10.3% and +1.7%, respectively, during that same period. The high-yield names in the energy bond space have suffered the worst returns, since those are the most heavily indebted upstream companies.

Figure 5: Cumulative Total Returns from S&P Bond Indices (June 2014 - June 2016)

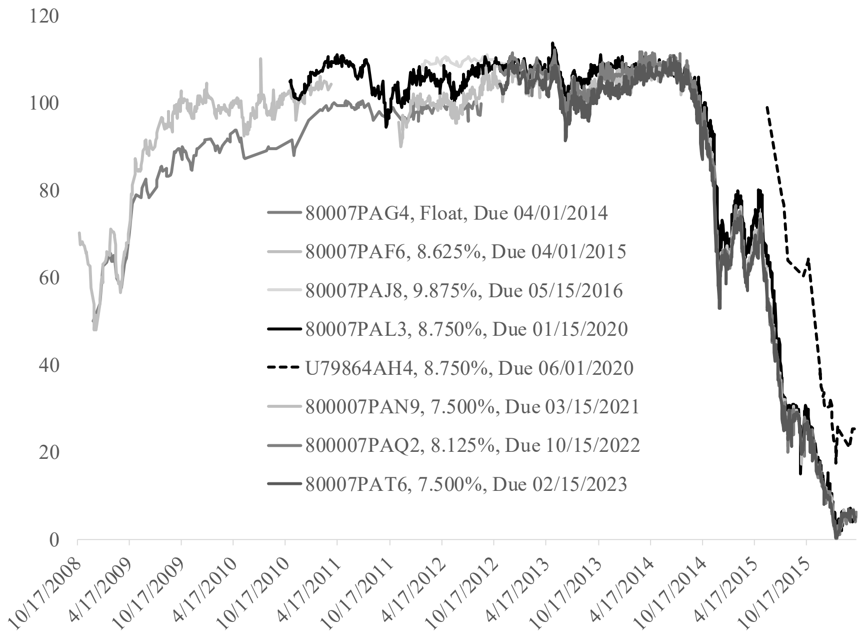


Thirty-five exploration and production companies with a cumulative debt of under $18 billion filed for bankruptcy protection between July 1, 2014 and December 31, 2015.[3] Another 175 companies with a total debt of over $150 billion are at a high risk of bankruptcy. Recent examples of bankruptcies that lead to large losses for noteholders include Linn Energy and SandRidge Energy Inc., where noteholders have lost billions of dollars. Many investment portfolios were over-concentrated in these debt securities, mistakenly underestimating the probability of bankruptcy and the magnitude of losses under a bankruptcy scenario.

3. JOHN ENGLAND ET AL., DELOITTE CENTER FOR ENERGY SOLUTIONS, THE CRUDE DOWNTURN FOR EXPLORATION AND PRODUCTION COMPANIES 2 (2016), *available at* https://www2.deloitte.com/content/dam/Deloitte/ro/Documents/energy-resources/us-er-crude-downturn-2016.pdf.

To illustrate the staggering size of note holder losses, Figure 6 illustrates prices of SandRidge Energy outstanding notes as the company spiraled toward bankruptcy. Despite their seniority to equity holders, all classes of SandRidge Energy note holders have suffered near total losses. Senior Notes (unsecured) trade at roughly 5 to 6 cents on the dollar. At these prices, it is implied that note holders expect to recover virtually nothing through bankruptcy. Even SandRidge Energy's Senior Secured Notes (issued June 10, 2015) plummeted in value virtually right out of the gate. Those Senior Secured Notes, with roughly $1.3 billion principal outstanding, trade at roughly 20 cents on the dollar, an -80% capital loss.

Figure 6: SandRidge Energy Inc. Note Prices

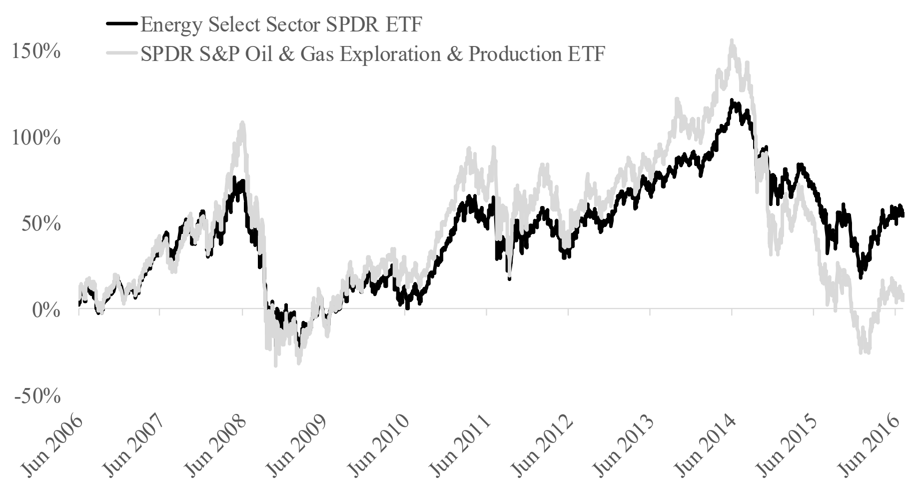


Several indexes track the returns to common stock issued by oil and gas companies. The Energy Select Sector Index (XLI) contains all energy firms in the S&P 500. This market capitalization weighted index is heavily concentrated in the three largest integrated energy companies (Exxon Mobil Corporation, Chevron Corporation and Schlumberger). Collectively, those three companies account for 43% of the index. The Energy Select Sector SPDR Fund (XLE), which tracks the Energy Select Sector Index, is one of the largest sector ETFs.

The S&P Oil & Gas Exploration and Production Select Index includes all exploration and production companies traded on major U.S. exchanges. This index covers smaller capitalization companies than the XLI, which is dominated by large-cap companies. It is also more volatile and more highly correlated with energy prices. The SPDR S&P Oil & Gas Exploration and Production ETF (XOP) track this index.

Figure 7 presents the cumulative returns to energy corporations, as proxied by investments in those two ETFs: XLE and XOP. Both ETFs exhibit significant volatility and sharp price declines during periods of declining energy prices. The XLE, which contains large-cap companies and is dominated by the large integrated firms, exhibits slightly less volatility than the XOP, which is not surprising since the XOP contains only upstream companies and the XLE is more diversified across subsectors.

Figure 7: Cumulative Returns to Energy Company Stocks

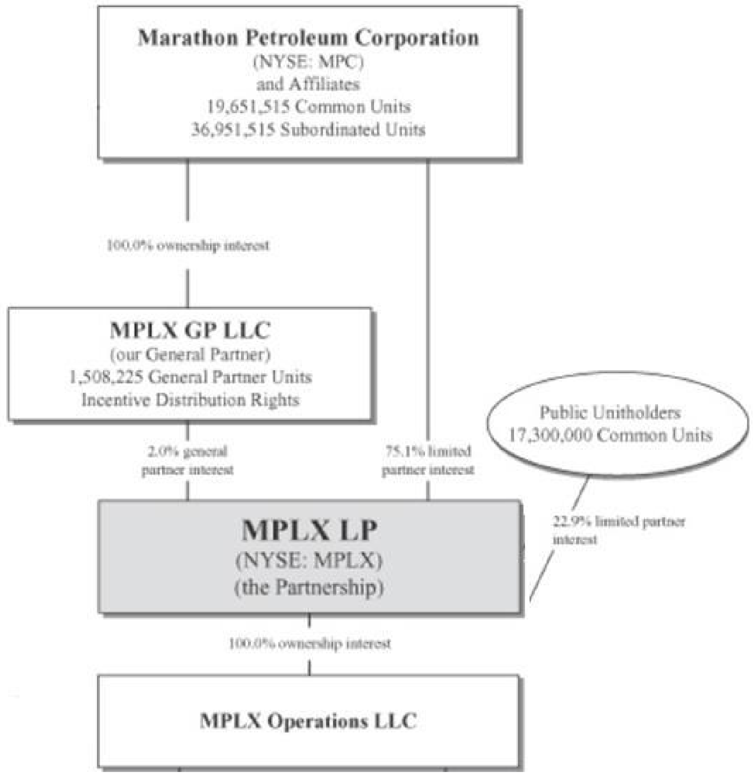


Although many ETFs offer significant diversification within or across asset classes, it is important to remember that these particular ETFs are concentrated in one sector (XLE) or sub-sector (XOP). They are intended to be building blocks of an investment portfolio and to be used in conjunction with other securities to achieve diversification. Appropriate uses of these ETFs include fine-tuning sectors or sub-sector exposures, but they do not themselves represent well diversified portfolios since their holdings are so concentrated.

V. Master Limited Partnerships (MLPs)

Master Limited Partnerships (MLPs) are publicly traded limited partnerships that derive at least 90% of their income from certain activities related to real estate, natural resources and commodities. They are pass-through entities which distribute a majority of their cash flows to investors and do not pay tax at the entity level. Figure 8 illustrates a typical MLP structure.

Figure 8 Organization Structure of MPLX[4]



MLPs are commonly formed with assets spun off from a parent company or "sponsor." The sponsor also forms the general partner, typically organized as a limited partnership or limited liability company, to manage and operate the MLP. Common units of the MLP are then registered and issued to investors through a public offering. Investors who purchase MLP

4. MARATHON PETROLEUM CORPORATION, PROSPECTUS 10 (Oct. 25, 2012).

units become limited partners of the entity, given that they have no voting rights and assume no role in the daily operation. Like other publicly traded companies, MLPs file 10-Ks, 10-Qs and other documents with the Securities Exchange and Commission to communicate operating results and substantial events.

Sponsors of MLPs usually set a Minimum Quarterly Distribution (MQD). Limited partners will receive 100% of distributed cash up to the MQD; the excess amount will then be divided between limited partners and general partners. However, a general partner's share of cash flows is not fixed, but increases with the cash amount available for distribution. The general partner's share of interest is stated in the Incentive Distribution Rights (IDRs) schedule. Figure 9 shows an example of an IDRs schedule.

Figure 9 Example Incentive Distribution Rights Schedule[5]

	Total quarterly distribution per unit target amount		Marginal percentage interest in distributions	
			Unitholders	General Partner
Minimum Quarterly Distribution	$0.2625		98.0%	2.0%
First Target Distribution	above $0.2625	up to $0.301875	98.0%	2.0%
Second Target Distribution	above $0.301875	up to $0.328125	85.0%	15.0%
Third Target Distribution	above $0.328125	up to $0.393750	75.0%	25.0%
Thereafter	above $0.393750		50.0%	50.0%

In addition to units issued to the public, the sponsor often retains a portion of interest in the MLP in forms of both common units and subordinated units. Subordinated units will not be entitled to any distribution until limited partners receive MQD.

In the case of MPLX, Marathon Petroleum Corporation (the sponsor) forms and controls MPXL GP LLC (the general partner), which manages the MPXL LP and owns Incentive Distribution Rights. The Minimum Quarterly Distribution is $0.2625 per unit with higher distribution targets set at 115%, 125% and 150% of the MQD. The general partner's marginal percentage interest in distributions increases if cash distributed to limited partners reach higher targets.

We analyzed 137 oil and gas MLPs, including 37 that have been acquired and two that have been delisted due to bankruptcy. Both from the perspective of quantity or market capitalization, oil and gas MLPs predominately operate in the midstream subsector. As shown in Figure 10, 72% of actively traded oil and gas MLPs operates in the midstream subsector, which represents 94% of the total MLP market capitalization. The midstream subsector's domination of the oil and gas MLP market may be explained by the characteristics of midstream assets and activities. Mainly

5. MARATHON PETROLEUM CORPORATION, PROSPECTUS 84 (Oct. 25, 2012).

engaging in storage and transportation, midstream MLPs generally lack direct commodity exposure, generating mostly stable cash flows supported by fee-based activities.[6] Stable cash flows allow the MLP to support Minimum Quarterly Distributions and are an attractive feature in the MLP structure.

Figure 10 Market Breakdown by Subsector (May 31, 2016)

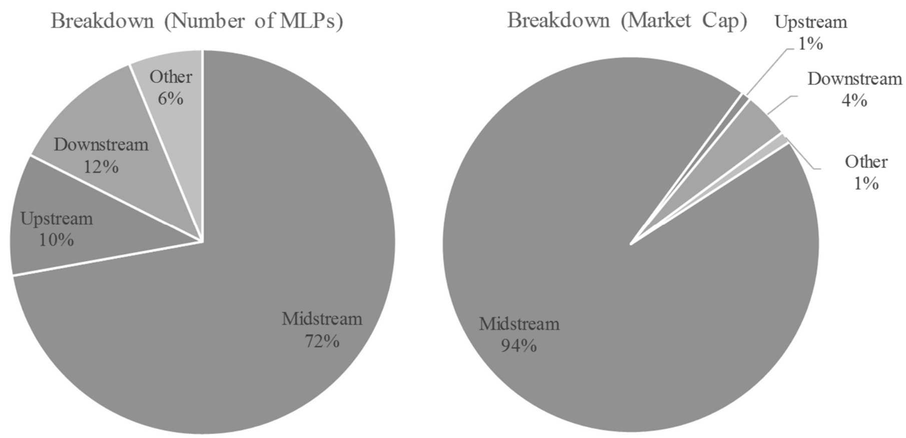


Figure 11 graphs the market growth of oil and gas MLPs since 2000. Since then, the number of oil and gas MLPs has grown from 17 in 2000 to 97, with market capitalization grown from less than $14 billion to over $350 billion. In early years, only a few upstream or downstream entities operated as MLPs. Recently, while more and more non-midstream companies adopt the MLP structure, their size is relatively small. As of May 31, 2016, the average market cap of midstream MLPs is about $4.6 billion, while that of upstream, downstream and other oil and gas MLPs are $0.3 billion, $1.2 billion and $0.5 billion, respectively.

6. BANK OF AMERICA MERRILL LYNCH, MASTER LIMITED PARTNERSHIPS: ENERGY MLP PRIMER 17 (Aug. 2, 2013) *available at* http://www.merrilledge.com/publish/content/application/pdf/gwmol/EnergyMLPPrimer.pdf.

Figure 11. Number of Oil and Gas MLPs and Market Capitalization

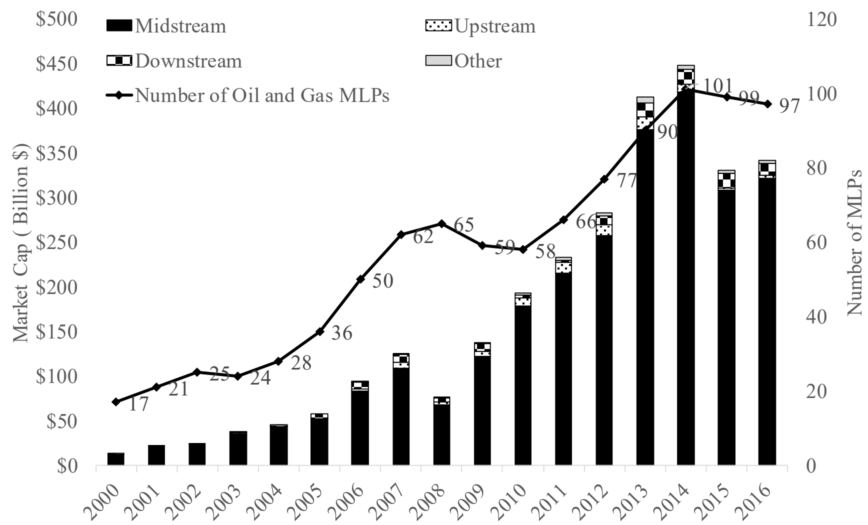
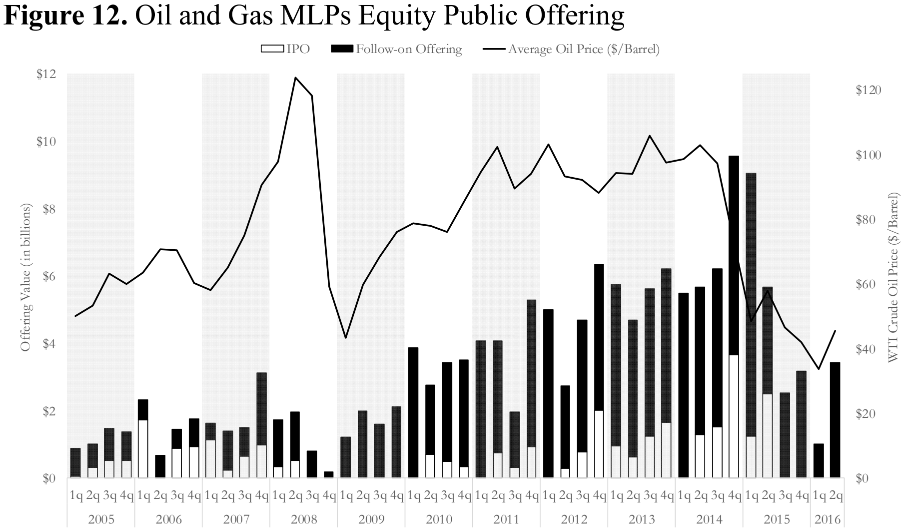


Figure 12 shows capital raised by oil and gas MLPs through public equity offerings during the past decade. In general, oil and gas MLPs tend to raise more equity when energy prices are high. New oil and gas MLPs went public each year except 2009, during the financial crisis and declining global energy prices.

Figure 12. Oil and Gas MLPs Equity Public Offering



Since MLPs pay out nearly all of their earnings, they frequently need to access capital markets for sources of external capital. Even at the height of the financial crisis and global rout of commodity prices, MLPs conducted secondary offerings. In total, MLPs raised more than $150 billion through public equity from 2000 to June 2016.

On a total return basis, oil and gas MLPs as a group outperformed S&P 500 Index and S&P Energy sector over the past decade. Downstream and midstream MLPs performed the best, generating a total return of over 200%. Upstream MLPs performed the worst and reported a loss of 66%. Both upstream and other MLPs underperformed the S&P Energy sector

Income-oriented investors are attracted to oil and gas MLPs because of their relatively large distributions, although significant portions of those distributions are actually returned capital. However, higher returns come with higher risk. The oil price collapse starting from mid-2014 hurts oil and gas MLPs investors across all subsectors. Losses reported by upstream, midstream, downstream and other MLPs from July 2014 to June 2016 are -84.3%, -24.3%, -35.4% and -55.1%, respectively. As a comparison, the S&P 500 gained 11.7% during the same period.

Figure 13. Total Returns (January 2005 to June 2016)

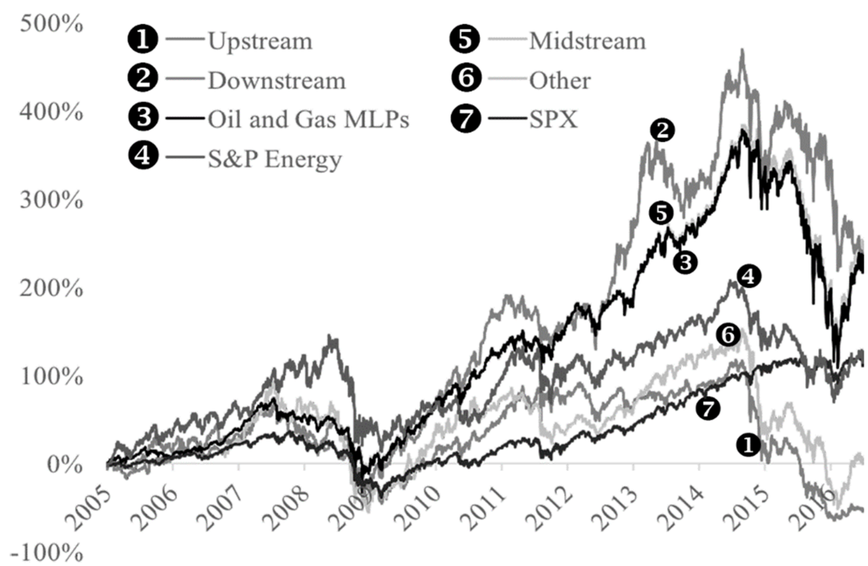


Figure 14 presents 1-year, 3-year and 5-year annualized volatility of MLPs, the S&P 500 index, crude oil futures and S&P energy sector index. Upstream and other MLPs tend to be more volatile than the crude oil futures. Midstream and downstream MLPs have lower volatility compared to upstream and other MLPs, but are still more volatile than energy stocks.

Figure 14. Annualized Volatility

	Upstream	Midstream	Downstream	Other	SPX	WTI	S&P Energy
1 Year	0.55	0.33	0.27	0.66	0.15	0.40	0.24
3 Year	0.41	0.21	0.22	0.44	0.11	0.34	0.18
5 Year	0.34	0.19	0.22	0.36	0.12	0.31	0.19

Figure 15 presents the correlation between MLPs, the S&P 500 index, crude oil futures and the S&P energy sector index. The correlation is calculated with monthly total returns over the past three years. Compared to midstream and downstream MLPs, upstream and other MLPs have higher exposure to oil and are less correlated with the stock market.

Figure 15. Correlation (July 2013 to June 2016)

	Upstream	Midstream	Downstream	Other	SPX	WTI	S&P Energy
Upstream	1.00						
Midstream	0.68	1.00					
Downstream	0.51	0.56	1.00				
Other	0.84	0.79	0.59	1.00			
SPX	0.35	0.61	0.53	0.46	1.00		
WTI	0.78	0.57	0.31	0.76	0.23	1.00	
S&P Energy	0.76	0.72	0.53	0.80	0.64	0.66	1.00

VI. Commodity ETFs

A number of Exchange Traded Funds (ETFs) and Exchange Traded Notes (ETNs) provide investors with investment exposures linked to energy commodity prices. Since most commodities, other than metals, are difficult to store, most ETFs invest in commodity futures contracts instead of the physical commodity. An example is the United States Oil Fund (USO), which invests in the nearest-month West Texas Intermediate (WTI) crude oil futures contract having more than two weeks to expiration. The United States Natural Gas Fund (UNG) is an ETF that provides exposure to natural gas prices through its ownership of natural gas futures contracts. As shown in Figure 4, there are 14 ETFs and 20 ETNs providing direct exposure to an energy commodity or a basket of energy commodities, with a variety of investment exposures, including short exposure and leveraged exposure.

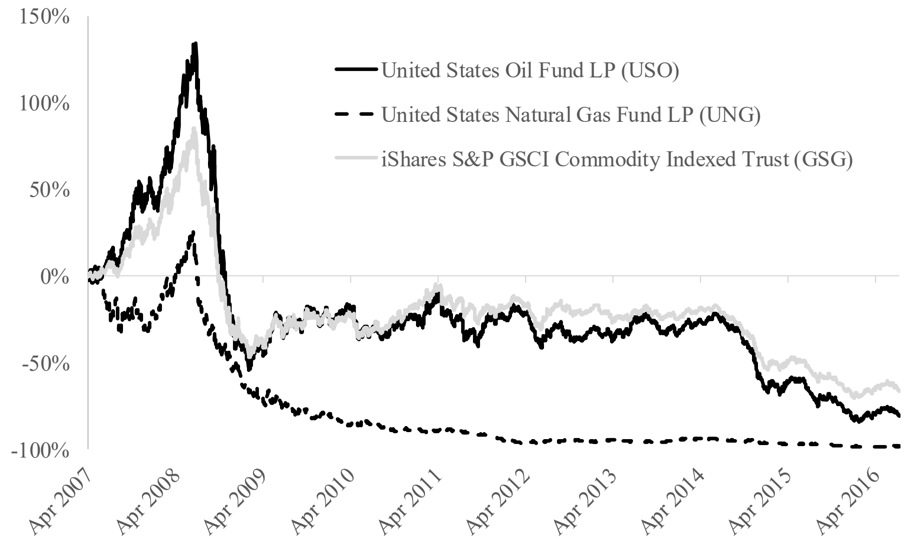
Even commodity indexes diversified across non-energy commodities such as agricultural, industrial metals and precious metals often have heavy allocations of oil and gas. For example, the S&P GSCI Commodity Index includes 11 agricultural, 6 energy, 5 industrial metals and 2 precious metals futures contracts. The Energy sector, however, comprises approximately 63% of the index with crude oil (WTI and Brent) accounting for 43.4%.[7]

Figure 16 illustrates the returns to three representative ETFs tracking oil, natural gas and the energy-heavy S&P GSCI Commodity Index. The figure shows that over the last decade, investors in these products have suffered large losses. Most of those losses are attributable to the decline in energy prices. Portions of those losses stem from their use of futures contracts, which often result in losses when the futures price is higher than the commodity's spot price, as is generally the case of energy commodities given the difficulty and costs associated with storage. Additionally, Figure 16 illustrates that although the S&P GSCI Commodity Index includes a diversified basket of commodities across multiple sectors, its heave energy concentration, in particular to crude oil, results in a strong correlation between its returns and returns to crude oil futures (as measured by USO in the figure).

Overall, energy commodities prices are highly volatile, which lead to large investor losses when energy prices decline. Investors with these exchange traded vehicles in their portfolios have, in recent years, incurred significant losses and endured much volatility.

7. Press Release, S&P Dow Jones Indices, WTI Crude Oil Overtakes Brent Crude Oil as S&P Dow Jones Indices Announces 2016 Weights for the S&P GSCI (Nov. 5, 2015), *available at* http://us.spindices.com/documents/index-news-and-announcements/20151105-sp-gsci-2016-cpw-announcement.pdf?force_download =true.

Figure 16: Cumulative Returns to Commodity ETFs



VII. Structured Products

Investing in oil-linked structured notes is one of several ways in which investors can obtain energy investment exposure. Unlike conventional debt securities, these structured notes do not guarantee a fixed amount of principal payment at maturity. Their performance, instead, is derived from the underlying asset(s).

We have collected issuances of structured notes tied to eight oil and gas ETFs and indices prior June 2016 from their 424B2 filings with the Securities and Exchange Commission. After removing preliminary filings and products that are linked to a basket of reference assets, we come up with a list of over 600 oil-linked structured notes. Figures 17 and 18 present the issuance proceeds and number of issuances from 2011 to June 2016 and underlying references.

Over the past five and a half years, at least 574 oil-linked structured notes totaling $3.6 billion were issued by investment banks. Top issuers include Credit Suisse, Bank of America, J.P. Morgan Chase & Co., Barclays Bank PLC, Morgan Stanley and HSBC USA. The $3.6 billion is 30% linked to ETFs and 70% linked to indices, but there were 398 structured notes linked to the ETFs and only 176 linked to the indices. Thus, the average size of the ETF linked products ($2.6 million) is small compared to the index-linked products ($14.5 million).

Of the eight underlying assets, S&P GSCI Crude Oil Index Excess Return (SPGCCLP) and United States Oil Fund LP (USO) track changes in oil futures prices, while the others track the performance of oil operating companies.

Figure 17. Oil-Linked Structured Notes Issuance Amount: 2011 to June 2016

($ in thousands)	**2011**	**2012**	**2013**	**2014**	**2015**	**January to June 2016**	**Total**
Index Linked							
SPSIOP	$0	$0	$69,572	$705,985	$537,488	$16,178	**$1,329,223**
SPGCCLP	$156,919	$0	$0	$27,548	$246,780	$22,975	**$454,222**
IXE	$204,418	$103,664	$34,620	$45,115	$30,026	$46,741	**$464,584**
OSX	$219,788	$21,280	$25,306	$28,174	$6,849	$0	**$301,398**
Total Index Linked	**$581,126**	**$124,944**	**$129,498**	**$806,822**	**$821,143**	**$85,894**	**$2,549,427**
ETF Linked							
XLE	$14,487	$7,295	$0	$120,872	$346,039	$90,011	**$578,704**
XOP	$0	$6,941	$17,885	$47,278	$210,130	$49,356	**$331,590**
OIH	$0	$5,104	$100	$33,727	$60,422	$2,597	**$101,950**
USO	$1,212	$8,475	$0	$0	$12,199	$2,560	**$24,446**
Total ETF Linked	**$15,699**	**$27,815**	**$17,985**	**$201,877**	**$628,790**	**$144,525**	**$1,036,690**
Grand Total	**$596,824**	**$152,759**	**$147,483**	**$1,008,699**	**$1,449,933**	**$230,419**	**$3,586,117**

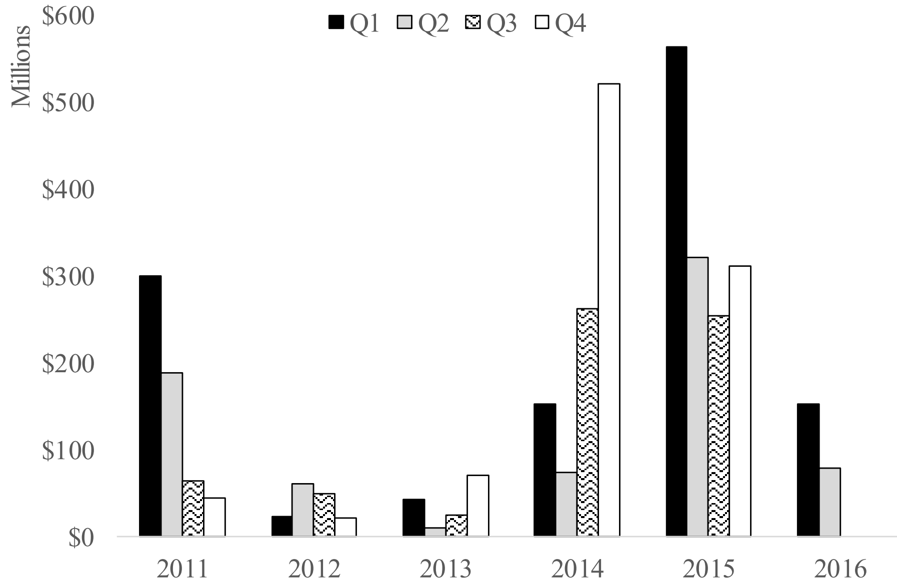
Figure 18. Oil-Linked Structured Notes Number of Issuance: 2011 to June 2016

	2011	2012	2013	2014	2015	January to June 2016	Total
Index Linked							
SPSIOP	0	0	2	15	12	1	**30**
SPGCCLP	6	0	0	11	72	17	**106**
IXE	5	6	2	2	1	3	**19**
OSX	13	3	2	1	2	0	**21**
Total Index Linked	**24**	**9**	**6**	**29**	**87**	**21**	**176**
ETF Linked							
XLE	7	6	0	22	106	46	**187**
XOP	0	1	5	8	80	31	**125**
OIH	0	9	1	14	40	5	**69**
USO	2	2	0	0	9	4	**17**
Total ETF Linked	**9**	**18**	**6**	**44**	**235**	**86**	**398**
Grand Total	**3**	**27**	**12**	**73**	**322**	**107**	**574**

Close to 40% of the notes are linked to S&P Oil and Gas Exploration & Production Select Industry Index (SPSIOP), an index designed to measure the performance of the GICS oil and gas exploration and production sub-industry. Energy Select Sector Index (IXE), another popular underlying index, is intended to track the movements of companies in the S&P 500 energy sector. These are the same indexes tracked by the ETFs XLE and XOP. The market for structured notes linked to oil and gas ETFs has been growing rapidly. Over half of the oil ETF linked notes are tied to Energy Select Sector SPDR Fund (XLE) and SPDR S&P Oil & Gas Exploration & Production ETF (XOP).

Figure 19 shows note issuances from 2011 to June 2015 by quarter. Sales of the notes surged in the last two quarters of 2014. Demand remained high in 2015, with more than $1.3 billion of the notes offered in over 300 transactions. However, note sales plummet 60% in the first six months of 2016, compared to the same period last year.

Figure 19. Oil-linked Structured Notes Issuance by Quarter

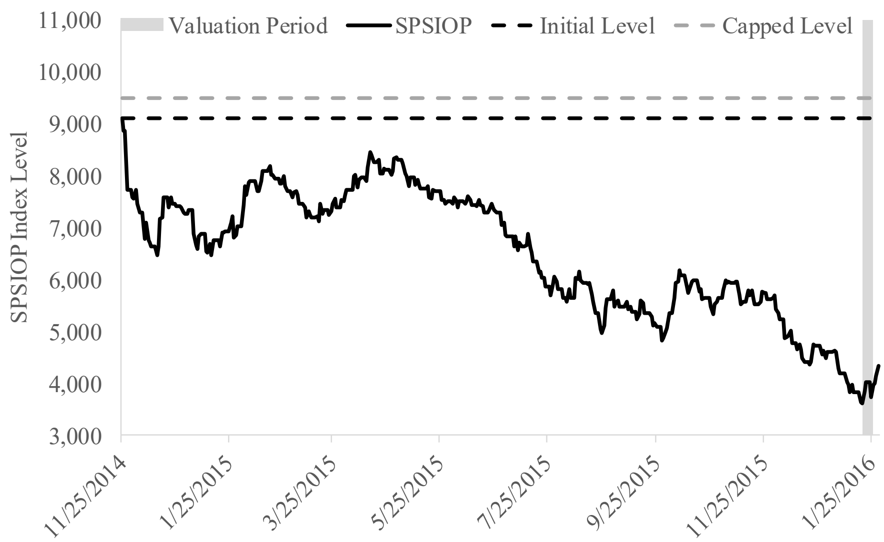


About $303 million oil-linked structured notes expired between January and June 2016. These notes were issued between October 2014 and December 2015. While 67% of the expired notes offer 10% to 40% protection against a price drop in the underlying ETF or index, all but one matured *above* the barrier. In total, note holders lost about $110.3 million or 41.5% in principal in these recent matured notes.

The largest offering of such securities is the Accelerated Return Notes (CUSIP 06742Y618) issued by Barclays Bank PLC. These notes, totaling $72.4 million, are linked to S&P Oil & Gas Exploration and Production Select Industry Index (SPSIOP Index). According to the prospectus, the notes offer 3-to-1 upside exposure to increases in the index, but only up to a capped return of 24.15%. On the other hand, the notes do not provide any buffer if the index goes down: investors will lose 1% of their investment for every 1% decreases in the index. Also, the notes do not bear any interest payment.

When the notes came out on November 25, 2014, the S&P Oil and Gas Producer Index level was 9,104.07, down more than 27% from mid-2014. Oil prices did not recover before the maturity date, as the average index level during the maturity valuation period was 3,845.38, which is 57.8% lower than the initial level. Thus, investors lost 57.8% ($41.8 million) in principal in this single notes issuance. Figure 20 presents the index level from the note's pricing date to its maturity date. In fact, the index dropped substantially right after the issuance. Unfortunately, without a liquid secondary market, it is not easy for the noteholders to exit their investments and mitigate their losses before maturity.

Figure 20. S&P Oil and Gas Exploration & Production Select Industry Index



About $1.6 million oil-linked structured notes issued in 2014 and 2015 are currently outstanding. The underlying reference assets have decreased by 17% on average since their issuances. While some notes offer principal protection to a certain point, many of them are still underwater, meaning investors are on track for the realization of significant losses when the notes mature.

VIII. Conclusions

Investors are exposed to oil and gas prices as a result of their investments in stocks and bonds. Securities issued by publicly traded companies in the oil and gas industry are approximately 5% of U.S. stocks and bonds. Investors holding well-diversified portfolios of stocks and bonds thus have about 5% of their portfolios invested in securities issued by companies in the oil and gas industry. Focused oil and gas investments - common stock, bonds including high-yield bonds, MLPs, ETFs, structured products and ETNs linked to indexes of oil and gas companies – only belong in well diversified portfolios to the extent they compensate for what would otherwise be an underrepresentation of the oil and gas industry in an investor's portfolio.

Investors who were invested in poorly diversified portfolios of oil and gas have lost billions of dollars in recent years. A properly constructed investment portfolio will diversify across securities with varying exposures to energy prices and avoid over-concentration in any sector, including the oil and gas sector. Most strikingly, during the past two years, while the WTI spot price declined by 54%, the S&P 500 total return was 11.7%.

REASONABLE DUE DILIGENCE FOR OIL AND GAS DRILLING PROGRAMS

Frederick Rosenberg and Lawrence Elkus

Introduction

Before oil and gas related securities can be solicited to investors, financial advisors and their clients need to appreciate how hydrocarbons are extracted from the earth and how many levels of investment promotions exist before investors receive a cut of the revenues, a "drop" on their returns.

Hydrocarbons are compounds derived from organic decay trapped in subterranean strata at depths ranging from a few hundred to tens of thousands of feet below the surface of the earth. Extraction of those hydrocarbons is accomplished by drilling wells into the formation whereupon the subterranean pressure forces the oil or gas into the well bore where it flows to the surface into tanks or pipelines. Recovery depends on several factors principal of which is the porosity and permeability of the rocks within the formation and the viscosity and chemistry of the oil.

"Porosity" describes spaces in the rock capable of accumulating oil or gas while "***permeability"*** describes the level of communication between pores that allows the hydrocarbon to flow into the well bore. For example, typically an unglazed earthenware brick is 5-7% porous and permeable. Submerging the brick in water will result in water being drawn into the pores. Water flows easily and under pressure much of it can be recovered. But, if the water were replaced by viscous, sticky, crude oil, recovering more than a small fraction of the oil becomes an impossibility. As so it is with oil-bearing rock. There are no pools filled with crude oil below ground sloshing around as if in a swimming pool, only strata of porous and permeable rocks squeezed between impermeable zones that trap the hydrocarbon.

Gas typically flows easily through most formations allowing for recoveries in excess of 50-60%. Oil, however, is a viscous fluid comprised of various chemistries including paraffin, asphalt, naphtha, and Sulphur to name a few. This means that, depending on the porosity and permeability of the production zones, primary recovery can be a minuscule 2% of the oil in place (in areas like the Bakken Shale in North Dakota) to 10% - 15% of the oil (in places like the Permian formations in West Texas and New Mexico) before wells become uneconomic. In fact, even the best U.S. wells leave 80% - 85% of their oil in the ground unless secondary or tertiary recovery methods are utilized to extract perhaps an additional 10% - 25% of the oil in place.

Production rates always decline over a well's economic life, often precipitously in the early months when pressure drops throughout the initial flush production period. "***Flush Production***" is the initial production, typically the highest volume of production in a well's economic life occurring in the first 3 - 6 months. It is the period when the well's reservoir has the most pressure to push the hydrocarbons to the surface. Fracking, water flooding, steam injection and chemical treatments all enhance recovery but add substantial production costs and environmental liability just to boost production for a limited period of time. Those treatments can be repeated at regular intervals to squeeze out more hydrocarbons depending on the formation and type of treatment.

The oil and gas exploration business is built upon risk sharing and joint ventures with over a century of history. Risk is measured by potential losses realized by drilling dry holes or uneconomic wells. The common method for defraying that risk is through "***Promotions***." At each stage of the promotions, someone is attempting to profit for their activities. The first promotion occurs when a production company leases the mineral rights from a landowner and takes on the financial responsibility for drilling and producing the well. The landowner receives a negotiated "***Bonus Payment***" for signing the oil and gas lease and, more importantly, receives a "***Royalty Interest***" in the well's production. The oil company's lessee interest is called the "***Working Interest***" because, while the royalty interest owner waits for the check in the mail box, the working interest owner must pay for the drilling, completion, operation and plugging of the well. But the promotions do not end there. The Landman who acquires the leases from the landowners and others who originate and engineer a drilling prospect may also take an interest in the well. These interests are typically in the form of an "***overriding royalty***" that is carved out of the working interest's revenue stream. In low risk drilling programs, royalties and overrides commonly exceed 30%, meaning that 70% of the revenues is responsible to pay 100% of all costs.

The production company, the "Working Interest" owner, also defrays its risk by shifting the drilling costs to joint venture partners, typically in an arrangement whereby the production company (the promoter) retains 25% of the working interest without having to pay its proportionate share. In this arrangement, the promoted joint venture companies agree to pay 100% of drilling costs and possibly the completion costs in exchange for 75% of the net revenues after royalties. The Operating Company is said to get a ***"¼ Carried Interest***." For example, the landowner and overriding royalty interests amount to 30% of the revenues, leaving 70% for the working interest owners.

The promoted joint venture partner(s) agrees to pays 100% of the costs for 75% of the 70%, or 52.5 % of the production revenues. The oil company that promoted the deal to the venture partners pays 0% of the drilling and possibly completion costs and receives 17.5% of the revenues. Carried interests may be "***carried through the tanks***" - meaning through well completion and after costs. Typically, with exploratory drilling the carried interest will pay its proportionate share: 25% of completion and production costs as well as 25% of all costs on subsequent wells. Once the well begins production, the Carried Interest begins to pay its share of operating costs, in this case 25% unless "carried through the tanks."

Important Terms in the Extraction of Hydrocarbons:

1. *Prospect Geology*: Typically oil and gas programs identify the type of geology and production anticipated from a particular area of the oil patch. This is important because West Texas operating costs may be 7% - 10% while tight sands and secondary drilling projects often suffer from operating costs of 30%+ of gross production, leaving the working interest owners with barely a profit or a possible loss if costs get out of hand, complications develop, or oil prices drop.
2. *Spacing*: Spacing of wells recognizes that there is a certain amount of area in the oil and gas reservoir that can be efficiently drained by one well. The spacing of wells is typically determined by a State commission based on the potential of each well to produce oil or gas to maximize development of a field, commonly 40 acres or 80 acres, but potentially much smaller in tighter sand areas or mature fields where "Infill" drilling is permitted, and likewise much greater, 640 acres (a square mile), in exploratory regions or in costlier deeper zones.
3. *Production Zones:* Often multiple strata of rock underlying an oil field can or will produce hydrocarbons. Sediments laid down over the millennia created multiple zones separated vertically by hundreds, if not thousands, of feet. The rights to those other zones are not typically part of the leasing rights on developmental projects. Many developmental fields are also "checker boarded" meaning drilling rights extend only to the red squares while proving up the value of the black square controlled by others or the production company.
4. *Engineering*: ***"Petroleum Reserve Engineers"*** assess the economic outcomes of drilling projects for a given geology utilizing volumetric analysis (the estimated amount of hydrocarbons within the drilling area based upon thickness of producing zones and geology across an area), production and decline curves, operational and production and lifting costs, taxes, reworking, fracking, pricing, oil characteristics, disposal

wells costs and completion rates to identify a few areas. As indicated above, only a fraction of the oil in place is ever recoverable depending on several factors. Petroleum reserve engineers assess those factors to determine the economic life of a well or an entire prospect. Proven reserves describe the producing capability of wells based on known characteristics of the oil field at assumed prices. Unproven reserves are a best guess estimate of what may be produced in the future, but which are by no means certain.

5. *Price* - is a key component of calculating reserves because higher prices for crude permit wells to operate in the black for longer periods before their economic limit is reached. For example, at $100/bbl., a well's reserves might be a million barrels over 15-18 years, but at $50/bbl., proven reserves could drop to perhaps 40% of that figure with an economic life of 7-10 years. The impact of price is also felt most significantly with heavily promoted developmental wells drilled into shallower or tighter sand formations and infill wells on tighter spacing.
6. *Developmental Wells* - tend to have high flush production and steep decline curves, meaning economic returns are dependent on early payout even if production is sustainable for several years at low production rates. In a rising market, the wells may be sustainable for years assuming lifting costs are low. Fracking, secondary or tertiary recovery treatments are costly but do result in increased production for relatively brief periods of time. Royalty or carried interest owners who do not participate in the costs of enhanced recovery methods will see increased returns in comparison to the promoted working interest partners who shoulder all the costs. This is a critical element of consideration, namely that the financial interests of the working interests are based on different economics.
7. *Economics of Oil Production*: Oil and gas production produces a stream of revenues that ends when the costs of production exceed the revenues of production. Wells occasionally are shut-in awaiting higher prices, but such delays tend to reduce returns significantly. In terms of financial analysis, oil and gas investments, like mortgages and leasing programs, are annuities that are expected to self-liquidate over time. Residual value typically amounts to salvage value at best. Characteristically, an annuity returns both principal and interest in its cash flows; oil and gas is no different. Principal is recovered through "***percentage depletion***," a tax exemption based upon production revenues available to small producers. While undrilled oil and gas leases can achieve substantial appreciation, once a well is producing it is no longer an appreciating asset like commercial real estate, but a commodity based stream of revenues

discounted to present value and haircut again for risk. This is a very significant factor in making an investment decision.

8. *Payout*: One significant point in the life of an oil or natural gas well is when the revenues from the well equal and begin to exceed the expenditures and costs of the well. This critical moment is known in the industry's "Oil Patch" as "***Payout***" and it signals potential substantive changes in the ownership and revenue distributions among the drilling partners. Some of the drilling partners will experience reductions in their working interest percentages. Production payments may kick in and overriding royalty interests and working interests can shift to actually increase the promotion on working interest owners and drilling partners. Importantly, a well's payout affects the drilling partners differently depending on their level of promotion. Interests often shift when wells achieve payout, yet often significantly before the promoted interest partners achieve their breakeven. For example, while a well must payout about 140+% of its drilling cost to achieve breakeven to the working interest, it must payout nearly 500% of costs for the retail investor to break even in many developmental drilling programs. Each layer of promotion increases the burden on revenues.
9. *Syndication*: Retail investors over the years have been offered participations in wells through syndication. This adds additional promotions, including underwriting expenses, commissions, management fees and revenue and cost sharing formulas that reduce returns and increase risk beyond normal drilling joint ventures. A syndication is offered to the public by a Sponsor or Issuer. Commonly the Sponsor/Issuer is a "non-operating" oil company, meaning the Sponsor does not actually drill wells but instead joint ventures with drilling partners by taking a fractional working interest on a one-third for a one-quarter participation. Non-operating oil companies vary in sophistication; some have extensive geological and engineering staffs while others do not.

Operating oil companies actually originate, engineer and drill the wells with a professional staff that locates and leases prospects. Commonly, operating oil companies joint venture with other oil companies sharing and trading risks and rewards to develop entire prospects and to explore for new areas of production. Rarely do they go the syndication route to deal with dozens if not hundreds of individual investors directly. However, in addition to operating and non-operating companies, there are production companies which drill for their own account and syndicate a portion of their prospects through the securities channel, typically in, a "checkerboard" as described above. This allows the production company to prove-up reserves in adjacent drill sites without taking drilling risk, something they could not do with industry partners as a general rule.

Syndications typically reserve between 15% and 20% of subscriptions for a variety of upfront costs, including legal, sales commissions, first year management fees and general and administrative costs leaving on average about 80% - 85% of all subscriptions for operations including drilling and completion costs and reserves. Furthermore, it is becoming common for a sponsor or affiliate to retain an overriding royalty off the top before operating expenses and to share that override with the selling group either from the outset or as a back-in after the investors receive a full return of their investments. It is a powerful inducement. Based on projections, the shared overrides often promise a back-end revenue stream that exceeds the commissions, a significant inducement to qualifying selling group members achieving sales thresholds.

Sponsors also may retain a percentage of net partnership distributions after expenses, ranging from 1% - 10% before investor payout and increasing thereafter. In recent years, some sponsors have been opting for overrides instead of a proportionate share of revenues because investor payout rarely if ever is achieved in large drilling program without borrowing heavily. An override of 1% - 10% before operating costs can be substantial in drilling projects with high production costs in tight sands, shales or chalk formations, or which utilize secondary or tertiary recovery methods to increase production.

Private placements are offered via an offering memorandum or, in the case of a public program, a prospectus. One of the disclosures in these sales documents is a summary of past performance of prior programs. This breaks down into drilling success rates and cash flows to investors. Drilling success is a nearly meaningless statistic that at most tells you more about the type of production than returns. More important is the question of payout to prior investors. All wells experience predictable production declines based on known geology and technology. Often, developmental wells drilled in known producing areas will decline by 50% - 60% within the first year and perhaps half again in year two. Unless investors attain payout within 36 - 48 months, we believe the probability is they will never recoup their investment within a reasonable number of years. Furthermore, reworking, re-fracking or re-treating wells becomes a necessity, increasing costs. A second frack typically requires nearly double the fluids of the first frack and so on each time driving costs higher to the working interests and reducing the net. Over time, a properly spaced drilling project with secondary or tertiary treatment will become uneconomic for the partners actually paying the costs and who then could be forced to abandon their interests entirely.

Once fully invested, most programs also lack the funds to develop their prospects without an assessment or debt. But rather than assess partners, increase debt or reduce distribution for subsequent development, most syndications "farm-out" their interests to subsequent promoted syndications in exchange for a small overriding royalty, burdening the new investors while depriving existing partners of the full development potential their investments have proven up. This is a common practice for sponsors of large drilling programs who can now re-promote wells that would otherwise be developed without promotion.

Consider collateralized mortgage obligations of a few years ago, where a pool of mortgages was stratified into tranches, each with a priority in distributions. At the bottom of the CMO was the equity tranche, whereby investors got to reap the rewards of higher returns if the CMO performed as pitched. But as we know, it was the equity tranches in CMOs that predictably experienced severe if not total loss, highlighting the inequality of risk from tranche to tranche. The risk and return of oil and gas programs is quite similar. Royalty holders are at the top and pay no costs, one-quarter Carried Interest Owners have a separate set of economics from the promoted Working Interest owners paying one-third of the costs for one quarter of the working interest revenues. Lastly are the equity syndications which adds non-industry level of promotion on top of the already promoted working interest, effectively paying the costs but receiving another haircut distribution.

There is almost no commonality of interest between a retail investor in a syndication and the operating company. Even when venturing with the biggest and best drillers in US, the disparity in economic returns and risk are substantial, particularly given that the working interest owners can rework wells using investors' money without sharing the cost or risk in many instances. Moreover, reworking wells, including fracking, increases production for only a limited period of time before the well reverts to much lower production.

Oil and gas are depleting assets and even when price increases occur, it is the early flush production which usually determines whether or not the investment will payout and be profitable to retail investors. Oil reserves too are subject to wide fluctuations due to price movements. As the recent decline in prices has shown, the economic life of producing wells has been shortened substantially when prices collapsed despite the fact that the oil reserve actually remains undisturbed in the ground.

Oil revenues include both principal recovery and return on investment. Investors need to be cautioned that a sinking fund needs to be established if the investor wishes to recoup original investment. Otherwise, investors run the risk that the asset they thought could sustain them for decades barely if ever returns their original investment. There are substantial tax benefits given to investors who drill wells, however, the investor must also understand the tax preference aspects of the investment, including the alternative minimum tax.

Conclusion

The question a due diligence analyst needs answered for every oil and gas drilling program is this: "How long until the investor gets his money back?" Answering that question before recommending drilling programs requires a depth of understanding due specifically to the vast disparity in financial interest between the retail investor in a syndication and the royalty owner and the production company who operates the program, each of whom is looking for his payout. Recommending a drilling program requires far more than an evaluation of the structure of the private placement because the multiple levels of promotion on top of the investors can and often do make even a seemingly low-risk investment a foreseeable disaster.

A rule of thumb is, we believe, if the track record of distributions on similar sized drilling programs is significantly less than full payout to the investor within 48+/- months, the new offering should probably be rejected. For the most part, oil and gas investments do not stack up well against income investments and carry far greater risk than most. In drilling programs, some of the risk may be defrayed through tax write-offs of the intangible drilling costs, but it is erroneous to suggest to any investor that a developmental oil and gas drilling program can provide a reliable stream of income throughout retirement.

Oil and gas placements must be treated as self-liquidating investments with little residual value in all but the most exceptional situations. An analysis of the impact of all levels of promotion, as well as the geology, decline curves, price assumptions and program costs on the partnership is essential. A petroleum engineer's report to investors projecting returns to the limited partners based on their costs, promotions, and net revenue interests should be a minimum requirement when conducting reasonable basis due diligence for every drilling program.

What follows below is my screening analysis for a drilling program that highlights the issues discussed. Most of the chart is self-explanatory. All the information was taken out of an actual PPM and broker due diligence report in about an hour or two of my review. The analysis projects a 20.7% return to investors at the point of payout to the well, meaning that each successful well needs to payout 4.83 times for investors to break even under the program structure assuming no dry holes. Considering a projected 50% first year decline in production, 27.6% first year return (adjusted for 9-month payout per well), while impressive on the surface, suggests a high probability that investors will not recover their full investment - if ever - within a reasonable period and that investors will begin to experience severe declines in cash flow once the program is fully drilled. In other words, what appears favorable on the surface may very well be problematic under the Earth's surface.

Payout Analysis for Completed Well
Drilling Program
Waterflood Proj
Proj Success rate 90%

Investor Subscriptions		74,250,000			
Partnership promotions, costs, commns	-15.00%	(11,137,500)			
Net in the Ground for Operations(well cost)		63,112,500			
			% Payout	Divisor	
Gross Production Revenue	100.00%	63,112,500	100%	$ 63,112,500	dollars in ground
Production and severance taxes	-7.25%	(4,575,656)			
		58,536,844			
Land Owner Royalty	-13.50%	(7,902,474)			
Overriding Royalties	-20.82%	(12,187,371)			
Net Revenue interest	65.68%	38,446,999			
3/4 Working interest net of carried interest	75.00%	28,835,249	45.69%	$ 63,112,500	dollars in ground
Farm-in overrides	0.00%	-			
Net to Investor Interests at Payout		28,835,249	38.80%	$ 74,250,000	gross investment
Well Op exp & Prod Costs	-33.00%	(9,515,632)			
Partnership G & A Exp & Direct Exp	-2.75%	(792,969)			
GP Net Rev Int (Shared with selling group)	-10.00%	(2,883,525)			
Available for Distribution		15,643,123			
Sponsor interest	-1.00%	(156,431)			
Net Distr to Investors	99.00%	15,486,691	20.9%	of orig. Investment	9.00 months
			4.79	Well Payouts per Investor Payout/well	
			28%	First Year Payout-Constant production	
			43.15	Months to Invtr Payout Const.Prodt'n	
			75%	Production Decline, First Year Avg	

A 360 DEGREE VIEW OF ROLES AND RESPONSIBILITIES CONCERNING DIMINISHED CAPACITY: FINANCIAL ADVISERS' OBLIGATIONS TO CLIENTS, LAWYERS REPRESENTING CLIENTS, AND LAWYERS PREPARING THEIR PRACTICES

Elissa Germaine, Nicole G. Iannarone, and Teresa Verges[1]

Aging is inevitable and impacts everyone. The risk of a person developing cognitive impairment or some other incapacity affecting daily life increases with each passing year. While some will live long lives without suffering from cognitive decline, others will not be so fortunate. One thing is clear: seniors have the greatest risk of developing some form of impairment that will impact their ability to make their own decisions and that will put them at risk of fraud by predators or of harm by well-intentioned but ill-informed persons seeking to help them. As lawyers representing clients in FINRA proceedings, PIABA members see this problem daily and are uniquely positioned to see it from nearly every angle.

Cognitive decline and aging are significant concerns in this country. Persons aged 65 and older represent the fastest growing segment of the U.S. population.[2] Approximately 10,000 people will turn age 65 every day for the next 15 years.[3] By 2030, 1 in 5 Americans (approximately 72 million people)

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The authors would like to thank Benjamin P. Edwards, Jill I. Gross, and Lance C. McCardle for their suggestions and comments.

2. CARRIE A. WERNER, THE OLDER POPULATION: 2010 (Nov. 2011), *available at* https://www.census.gov/prod/cen2010/briefs/c2010br-09.pdf. Between 2000 and 2010, the population of persons aged 65 grew 15%, compared to the 9.7% growth of the overall U.S. population. *Id.*

3. SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS AND FINRA REPORT ON NATIONAL SENIOR INVESTOR INITIATIVE, at 3 (Apr. 15, 2015) (hereinafter, "SEC/FINRA National Senior Investor Report") (citing ADMINISTRATION ON AGING ADMINISTRATION FOR COMMUNITY LIVING, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, A PROFILE OF OLDER AMERICANS:

will be over 65.[4] Those over 65 hold 70% of the nation's wealth.[5]

The magnitude of the aging population in the United States, coupled with its collective wealth, makes fraud concerning senior investors a significant issue. In addition to being a prime target for fraud, this exploding demographic is particularly vulnerable to investment fraud because seniors are at a time in their lives when they cannot meaningfully add to their retirement savings, yet have significant needs.[6] Unfortunately, seniors are most at risk of abuse or fraud at home, with over 40% of abusers identified as family, spouses, or caregivers.[7] Sadly, "trusted professionals," specifically including attorneys, financial professionals, and "fiduciary agents" are among the largest categories of perpetrators.[8] The risk of fraud or abuse at the hands of family members or trusted professionals is even more acute given the reality of how seniors interact with the financial system post-retirement.

As retirees begin to tap into their retirement savings, many will lack the ability to manage their investments, or even their financial affairs generally.

2012, at 1 (2012), *available at:* http://www.aoa.gov/Aging_Statistics/Profile/2012/docs/2012profile.pdf).

4. WAN HE ET AL., 65+ IN THE UNITED STATES: 2005 (Dec. 2005), *available at* https://www.census.gov/prod/2006pubs/p23-209.pdf.

5. Note, *The Not-So-Golden Years: Power of Attorney, Elder Abuse, and Why Our Laws Are Failing a Vulnerable Population*, 82 ST. JOHN'S L. REV. 289, 290 (2008) (citing Jane Gross, *New Techniques Used to Fight Elder Abuse*, PITTSBURGH POST-GAZETTE, Oct. 1, 2006, at A7).

6. In a 2009 study, it was estimated that the financial loss by victims of elder financial abuse was $2.6 billion per year. METLIFE MATURE MARKET INSTITUTE, BROKEN TRUST: ELDERS, FAMILY & FINANCES (Mar. 2009), *available at* https://www.metlife. com/assets/cao/mmi/publications/studies/mmi-study-broken-trust-elders-family-finances.pdf (joint study with National Committee for the Prevention of Elder Abuse and the Center for Gerontology at Virginia Polytechnic Institute and State University (hereinafter, "2009 MetLife Study")). In 2010, the MetLife Mature Market Institute ("Metlife") conducted a follow-up joint survey that found a 12% increase in the amount of financial losses reported, to $2.9 billion per year. METLIFE MATURE MARKET INSTITUTE, THE METLIFE STUDY OF ELDER FINANCIAL ABUSE: CRIMES OF OCCASION, DESPERATION AND PREDATION AGAINST AMERICA'S ELDERS 2 (June 2011), *available at* https://www.metlife.com/assets/cao/mmi/publications/studies/ 2011/mmi-elder-financial-abuse.pdf.

7. 2009 MetLife Study, *supra* note 6, at 12.

8. *Id*.

As an initial matter, many individuals (regardless of age) lack the training or specialized knowledge to make sound decisions about investments and appropriate withdrawal rates, among other issues.[9] As a result, many seek out professional advice, choosing to work with some form of financial adviser. As the SEC and FINRA recently observed in a joint report, however, seniors with such limited knowledge, when combined with historically low yields on savings accounts and more conservative investments, are particularly vulnerable because "some broker-dealers may be recommending riskier and possibly unsuitable securities to senior investors looking for higher returns and may be failing to adequately disclose the terms and risks of the securities they recommend."[10]

Even seniors with sufficient knowledge to manage their investments during retirement will likely face other challenges that may limit their ability to direct and protect their retirements. Specifically, there is no question that increasing mental and physical ailments associated with aging can impede many seniors' ability to handle their financial affairs.[11] The Alzheimer's Association reports that 13% of persons over 65, and 45% of persons over 85, suffer from dementia.[12] It further estimates that by 2050, the number of individuals with the disease is expected to nearly triple to a projected 13.8 million people.[13]

Declining cognitive abilities may not affect all seniors, but other realities of aging may make seniors more likely to be victims of financial abuse or fraud. For instance, many seniors will face significant declines in their physical well-being, such as their mobility or vision. These changes may not impact their ability to make a decision, but may make it difficult for them to participate in,

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9. Lawrence A. Frolik, *Protecting Our Aging Retirees: Converting 401(k) Accounts into Federally Guaranteed Lifetime Annuities*, 47 SAN DIEGO L. REV. 277, 278 (Spring 2010). Moreover, the shift from "defined benefit plans" to "defined contributions plans" places retirees at risk of outliving their savings because, among other things, significant mental and physical decline exposes seniors to financial exploitation and abuse. *Id.* at 296-97.

10. SEC/FINRA National Senior Investor Report, *supra* note 3, at 3.

11. Frolik, *supra* note 9, at 292-94.

12. ALZHEIMER'S ASSOCIATION, 2012 ALZHEIMER'S DISEASE FACTS AND FIGURES, at 14 (2012), *available at*: https://www.alz.org/downloads/facts_figures_2012.pdf.

13. *2016 Alzheimer's Disease Facts and Figures*, ALZ.ORG, http://www.alz.org/facts (last visited Sep. 12, 2016).

let alone direct, their financial well-being.[14] Additionally, social isolation and excessive dependence on one person or adviser also increases the likelihood of financial exploitation.[15]

Aging-related challenges, whether cognitive or physical, will affect millions, creating enormous challenges for the individual seniors, their families, financial advisers, and lawyers. These challenges raise significant questions concerning how to best interact with impaired individuals and ensure that they are not exploited or otherwise abused. Yet when considering the challenges that aging presents, lawyers often neglect to consider their own challenges and limitations. The average age of lawyers in America appears to be steadily increasing. From 1980 to 2005, the median age of lawyers increased from 39 to 49.[16] In 2005, over fifty percent of lawyers were 45 or older.[17] In several jurisdictions, significant portions of the attorney population are over the age of 55.[18] In Vermont, for example, lawyers over the age of 80 outnumber lawyers in their twenties.[19] A recent study and report from a coalition of the National Organization of Bar Counsel, the Association of Professional Responsibility Lawyers, and the American Bar Association Commission on Lawyer Assistance Programs who studied lawyers and aging described the advancing age of attorneys as a "senior tsunami."[20] Given the

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14. Frolik, *supra* note 9, at 292-94.

15. *See* Julia A. Lemke & Seymour Moskowitz, *Protecting the Gold in the Golden Years: Practical Guidance for Professionals on Financial Exploitation*, 7 MARQ. ELDER'S ADVISOR 1, 9 (Fall 2005).

16. *See* AMERICAN BAR ASSOCIATION, LAWYER DEMOGRAPHICS YEAR 2016, *available at*: http://www.americanbar.org/content/dam/aba/administrative/market_research/lawyer-demographics-tables-2016.authcheckdam.pdf (hereinafter "ABA Lawyer Demographics").

17. *Id*.

18. *See, e.g.*, CHIEF JUSTICE'S COMMISSION ON PROFESSIONALISM, CONVOCATION ON PROFESSIONALISM, AGING IN THE LAW: IT'S MORE THAN A SENIOR MOMENT PROGRAM MATERIALS, Generational Chart, Active Members of the State Bar of Georgia (on file with author) (23% of active Georgia lawyers over 60). *See also* Kristi Vetri & H. Amos Goodall, Jr., NAELA, *Twilight Lawyers*, NAELA NEWS 12 (Oct./Nov. 2014) (percentage of lawyers over 55 in Florida – 33%, Washington – 71%, California – 42%, Pennsylvania – 38%).

19. Vetri, *supra* note 18.

20. NOBC-APRL-COLAP SECOND JOINT COMMITTEE ON AGING LAWYERS, FINAL REPORT 1 (Apr. 2014).

realities presented with the passage of time, it is imperative that we understand the obligations, responsibilities, and roles of all individuals working with senior investors.

To adequately represent clients in FINRA proceedings, members must understand financial service providers' obligations to investors who suffer from cognitive impairment, decline, or another disability impacting their decision-making abilities. Lawyers who work with clients suffering from impairment, either in FINRA proceedings or in other practice areas, must be aware of the challenges and responsibilities such representation brings to adequately represent and best protect their clients. In addition, because lawyers also face the risk of cognitive decline or other impairment as they age, they must understand their own ethical obligations to prepare for any impairment that may influence their ability to competently represent their clients and to protect the integrity of the profession.

The three articles that follow address cognitive impairment from each of these angles: (1) financial advisers' obligations when working with clients suffering from impairment; (2) lawyers' responsibilities to impaired clients; and, (3) lawyers' responsibilities to prepare for the possibility of their own potential impairment. As all three frame the substantial concerns associated with aging and cognitive decline, the authors intentionally wrote them at the same time, and they are presented here in a staged series, published in one volume. The authors intend that the articles initially be read together and then consulted separately for discrete issues as they may arise in practice.

The first article, *The Broker-Dealers' Role in the Detection and Prevention of Elderly Financial Exploitation*, begins the progression and provides an overview of the problem from the financial services sector's point of view, outlining the recent regulatory efforts to address cognitively impaired investors, the current state of rules, and best practices that financial services professionals should employ when working with investors. The second article, *Lawyers' Obligations When Representing Clients with Diminished Capacity*, focuses on lawyers' ethical and professional responsibilities to clients who may suffer some form of diminished capacity. The final article, *Keeping our Houses in Order: Lawyers' Obligations Concerning our own or our Colleagues' Inability to Competently Represent Clients,* brings the discussion full circle and addresses lawyers' ethical obligations in light of their own potential diminished capacity or other impairment. The article reviews the ethical and professional rules concerning lawyers with diminished capacity, including individual obligations as well as the obligation to act if a lawyer becomes aware of another lawyer's diminished capacity impacting his or her ability to competently advise and represent clients.

Cognitive decline or impairment is a problem that will undoubtedly arise in some aspect of a securities arbitration lawyer's practice. It may become an issue when reviewing how a financial adviser interacted with a client, when personally dealing with a client who has a potential claim, or in a lawyer's own practice. Understanding the obligations of all parties involved in this area better prepares lawyers to deal with the various issues associated with aging that will affect them and their clients.

THE BROKER-DEALER'S ROLE IN THE DETECTION AND PREVENTION OF ELDERLY FINANCIAL EXPLOITATION

Teresa Verges[1]

Increasingly referred to as the "Crime of the 21st Century,"[2] elder financial exploitation is ubiquitous and devastating: an estimated one million elders lose over $2.9 billion each year due to financial abuse.[3] This problem is significantly larger than reported,[4] and it is growing by virtue of the fact that the U.S. population is aging. Persons aged 65 and older represent the fastest growing segment of the U.S. population.[5] By 2030, 1 in 5 Americans

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1. Teresa Verges is the Director of the University of Miami School of Law Investor Rights Clinic and a Lecturer in Law. The author would like to thank Benjamin P. Edwards, Elissa Germaine, Nicole G. Iannarone, Jill I. Gross, and Lance C. McCardle.

2. J.F. Wasik, *The Fleecing of America's Elderly*, CONSUMER DIGEST, at 78-79 (Mar./Apr. 2000).

3. In a 2009 study, it was estimated that the financial loss by victims of elder financial abuse was $2.6 billion per year. METLIFE MATURE MARKET INSTITUTE, BROKEN TRUST: ELDERS, FAMILY & FINANCES (Mar. 2009), *available at*: https://www.metlife.com/assets/cao/mmi/publications/studies/mmi-study-broken-trust-elders-family-finances.pdf (joint study with National Committee for the Prevention of Elder Abuse and the Center for Gerontology at Virginia Polytechnic Institute and State University (hereinafter, "2009 MetLife Study")). In 2010, the MetLife Mature Market Institute ("Metlife") conducted a follow-up joint survey that found a 12% increase in the amount of financial losses reported, to $2.9 billion per year. METLIFE MATURE MARKET INSTITUTE, THE METLIFE STUDY OF ELDER FINANCIAL ABUSE: CRIMES OF OCCASION, DESPERATION AND PREDATION AGAINST AMERICA'S ELDERS 2 (June 2011), *available at* https://www.metlife.com/assets/cao/mmi/publications/studies/2011/mmi-elder-financial-abuse.pdf.

4. The 2009 MetLife Study found that elder financial abuse, like elder abuse generally, is significantly underreported for a variety of reasons, including, embarrassment, fear of interference from family or government in their personal lives, lack of realization that they have been victimized, fear of additional harm from the perpetrator, and a belief that financial abuse is a consequence of "doing business" or taking risks, among other things. 2009 MetLife Study, *supra*, note 3, at 21. *See also* Julia A. Lemke & Seymour Moskowitz, *Protecting the Gold in the Golden Years: Practical Guidance for Professionals on Financial Exploitation*, 7 MARQ. ELDER'S ADVISOR 1, 2 (Fall 2005).

5. CARRIE A. WERNER, THE OLDER POPULATION: 2010 (Nov. 2011), *available at*

(approximately 72 million people) will be over 65.[6] These individuals hold 70% of the nation's wealth.[7] As they have begun to retire, seniors are drawing on their retirement savings and seeking investments that generate income, leaving them especially vulnerable to unscrupulous investment advice and exploitation.[8]

Federal and state regulators have long recognized the important role broker-dealers and financial advisers can play in identifying, preventing, and reporting elder financial exploitation. The SEC's Office of the Investor Advocate recently observed that "[m]any broker-dealers and investment advisers have known their clients for years and may be among the first to recognize signs of diminished capacity or financial exploitation."[9] Financial advisers frequently become aware of suspicious activity even before the investor's family or friends.[10]

Despite this recognition, the current landscape of financial advisers' role and obligations in the detection and prevention of senior financial exploitation is in constant evolution. There is currently no one set of concrete obligations or responsibilities from any single source, but rather a sometimes clashing patchwork quilt of interpretations of existing mandatory federal and state law, pending rule proposals to address discrete issues, recommended (but not required) steps from regulators, and best practices implemented by individual firms. Despite the lack of a cohesive regulatory structure, federal and state

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https://www.census.gov/prod/cen2010/briefs/c2010br-09.pdf. Between 2000 and 2010, the population of persons aged 65 and over grew at over 15%, faster than the 9.7% growth of the overall U.S. population. *Id.*

6. WAN HE ET AL., 65+ IN THE UNITED STATES: 2005 (Dec. 2005), *available at:* https://www.census.gov/prod/2006pubs/p23-209.pdf.

7. Note, *The Not-So-Golden Years: Power of Attorney, Elder Abuse, and Why Our Laws Are Failing a Vulnerable Population*, 82 ST. JOHN'S L. REV. 289, 290 (2008) (citing Jane Gross, *New Techniques Used to Fight Elder Abuse*, PITTSBURGH POST-GAZETTE, Oct. 1, 2006, at A7).

8. SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS AND FINRA REPORT ON NATIONAL SENIOR INVESTOR INITIATIVE 2 (Apr. 15, 2015) (hereinafter, "SEC/FINRA National Senior Investor Report").

9. SEC OFFICE OF THE INVESTOR ADVOCATE, REPORT ON ACTIVITIES FOR FISCAL YEAR 2015 10 (2015); *see also* FINRA, NOTICE TO MEMBERS 15-37 (2015) at 5.

10. Naomi Karp & Ryan Wilson, *Protecting Older Investors: The Challenge of Diminished Capacity*, AARP PUBLIC POLICY INSTITUTE 17 (Nov. 2011), *available at*: http://www.aarp.org/content/dam/aarp/research/public_policy_institute/cons_prot/2011/rr2011-04.pdf.

regulators and brokerage firms seem to agree that existing and proposed regulatory requirements should be examined to ensure that the financial community is situated to respond to the challenges presented before we are engulfed by the so-called "senior tsunami."

I. REGULATORS' FOCUS ON NEED FOR ACTION AND GUIDANCE TO FIRMS

Regulators have been carefully and thoughtfully considering how to best address the challenges associated with aging or cognitively impaired investors, working across jurisdictional lines to study the problem and potential solutions. A decade ago, the SEC's Office of Compliance Inspections and Examinations, FINRA, and the North American Securities Administrators Association (NASAA) engaged in a coordinated initiative "designed to protect seniors from investment fraud and sales of unsuitable securities."[11] The resulting 2007 Report announced the results of 110 targeted examinations conducted by the SEC, the National Association of Securities Dealers (NASD), and the New York Stock Exchange Member Regulation (which combined with the NASD in 2007 to form FINRA), and NASAA between April 2006 and June 2007 that focused on areas of the country having large senior populations and that targeted firms offering "free lunch" seminars to senior investors.[12]

The 2007 report found "troubling sales practices" aimed at seniors nearing or in retirement, including "inaccurate or exaggerated claims regarding the safety, liquidity or expected returns of the investment . . . scare tactics; misrepresentations or material omissions about the product or strategy; conflicts of interest; or misleading credentials used by persons sponsoring the seminar."[13] As a result, the SEC, FINRA, and NASAA all launched major initiatives to protect seniors from financial exploitation. Such initiatives included: the SEC's series of "Senior Summits" highlighting scams and high-pressure sales tactics; FINRA's placement of senior issues among its highest

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11. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SECURITIES AND EXCHANGE COMMISSION ET AL., PROTECTING SENIOR INVESTORS: REPORT OF EXAMINATIONS OF SECURITIES FIRMS PROVIDING "FREE LUNCH" SEMINARS 2 (Sep. 2007), *available at*: https://www.sec.gov/spotlight/seniors/freelunchreport.pdf (hereinafter "FREE LUNCH REPORT").

12. *Id*.

13. FINRA, NOTICE TO MEMBERS 07-43 (2007) at 6; *see also* FREE LUNCH REPORT, *supra* note 11, at 2.

priorities in its examination and enforcement programs; and NASAA's focus on investment schemes involving "high-pressure sales tactics," "free lunch" seminars, and the use of senior designations.[14]

A year later, the SEC, FINRA, and NASAA issued a report that summarized information voluntarily shared by firms about their senior-focused supervision and compliance reviews.[15] The 2008 Report, and its 2010 Addendum, identified practices that those firms had put in place to serve customers suffering from diminished capacity and potential issues of financial exploitation.[16]

Most recently, the National Senior Investor Initiative report, published by the SEC and FINRA in 2015, lists nearly a decade of regulatory initiatives that have concentrated on senior investors and financial industry practices related to senior investors. The report – the product of 44 examinations of broker-dealers that focused on the types of securities senior investors were purchasing and the firms' sales practices – serves as a reminder of the industry's critical role in curbing financial abuse.[17] In addition to joint studies, securities regulators' "collaborative initiatives" include investor education and outreach, targeted examinations of broker-dealers to detect abusive sales practices, surveys of firms to identify firm policies and procedures for handling senior issues, training, and aggressive enforcement of securities regulation and

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14. Donald S. Davidson, *A Perfect Storm: Aging Baby Boomers, Annuities, Skeptical Regulators and Elder Abuse Laws*, 18 SEC. NEWS 16 (Fall 2007).

15. SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS ET AL., PROTECTING SENIOR INVESTORS: COMPLIANCE, SUPERVISORY AND OTHER PRACTICES USED BY FINANCIAL SERVICES FIRMS IN SERVING SENIOR INVESTORS (Sep. 22, 2008) (hereinafter "2008 Report").

16. The 2008 Report and 2010 Addendum are *available at:* http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf and https://www.sec.gov/spotlight/seniors/seniorspracticesreport081210.pdf, respectively.

17. SEC/FINRA National Senior Investor Report, *supra* note 8, at 3-5, 32.

FINRA conduct rules.[18] Nearly a decade later, these issues remain top enforcement and examination priorities.[19]

II. REGULATORY FRAMEWORK ADDRESSING AGING OR INCAPACITATED CLIENTS

Regulators' increased focus on issues concerning an aging investor population underscore the existing regulatory framework applicable to financial advisers' dealings with senior investors. Both federal and state law provide some protection and guidance, and regulators are consistently working to craft proposals to fill in any perceived gaps.

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18. *Id.* at 3-4. *See also 2016 FINRA/SIFMA Senior Investor Protection Conference*, FINRA, https://www.finra.org/industry/2016-finrasifma-senior-investor-protection-conference?utm_source=MM&utm_medium=email&utm_campaign=Conf_061416_FINAL (last visited Sep. 15, 2016) (overview of October 2016 conference "bringing together financial advisers, regulators, compliance officers, attorneys and academic experts for a joint conference dedicated to advancing efforts to protect our senior investors."); *NASAA Recognizes and Supports World Elder Abuse Awareness Day by Announcing Senior$afe Training week*, NASAA, http://www.nasaa.org/39700/nasaa-recognizes-supports-world-elder-abuse-awareness-day/?utm_source=NASAA.org+Updates+%28RSS%29&utm_campaign=007d648200-RSS_EMAIL_CAMPAIGN&utm_medium=email&utm_term=0_0835d82b94-007d648200-132157533 (last visited Sep. 15, 2016) (North American Securities Administrators Association (NASAA) training "for broker-dealers and investment advisers to help identify and report suspected cases of elder financial exploitation.").

19. SEC/FINRA National Senior Investor Report, *supra* note 8, at 3-4. *See also* RICK KETCHUM, 2016 FINRA REGULATORY AND EXAMINATION PRIORITIES LETTER (Jan. 5, 2016), *available at:* http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter. FINRA observed that seniors have been victimized by persons both within and outside the securities industry who have gained a position of trust to obtain control over the victims' assets: "In some instances, registered representatives have borrowed large sums of money from elderly clients, and in other situations have taken control of assets through Powers of Attorney and other mechanisms. We have seen products recommended that are not suitable for an elderly investor but provide high commissions and payouts to the salesperson." *Id.* at 7.

A. Federal Regulatory Framework Applicable to Vulnerable Investors

FINRA's regulatory framework contains a number of rules governing the responsibilities owed to vulnerable investors, including the Suitability and Know Your Customer Rules. Though these rules may not contain such phrases as "senior," "aging," or "incapacitated" anywhere within them, they describe the core responsibilities owed to all investors and have been interpreted as requiring specific responsibilities owed to seniors. Moreover, FINRA and the SEC have specifically included issues concerning senior investors as part of their enforcement focus, and their enforcement actions provide meaningful interpretation of these existing responsibilities.

1. The Suitability Rule

Like recommendations to any other investor, brokers have an obligation to ensure that recommendations made to seniors are suitable. In its first regulatory notice addressing senior investors, Regulatory Notice 07-43, FINRA focused on brokers' responsibilities under the suitability rule, explaining that although there are no "special rules for seniors," and firms owe all customers the same obligations and duties, in executing those duties firms must consider the "important factors" of a customer's age and life stage.[20] A broker cannot adequately assess the suitability of a product or transaction without "making reasonable efforts to obtain information about the customer's age, life stage and liquidity needs."[21] Moreover, prior to making any recommendation, firms must ensure that their customers fully understand the recommended product, provide "fair and balanced" disclosure of the risks, costs, and benefits of a particular product, and "fully consider the risk of the product with the age and retirement status of the customer in mind."[22]

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20. FINRA, NOTICE TO MEMBERS 07-43 (2007) at 2.

21. *Id.* at 3. At the time, former NASD RULE 2310 (1996), *Recommendations to Customers (Suitability)*, did not make any reference to an investor's age. Rather, the rule provided that "a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

22. FINRA, NOTICE TO MEMBERS 07-43 (2007). Other questions that the broker should consider include employment (and how much longer the customer plans to work), the customer's expenses, sources of income, customer's savings, the customer's financial and investment goals. *Id.* The 2008 Report issued by the SEC,

FINRA's new suitability rule, Rule 2111, expressly includes a customer's age as one of the factors brokers should consider in making a recommendation.[23] Other factors included in the rule, such as investment time horizon and liquidity needs, also directly impact the question of suitability of a particular product for an elderly customer.[24]

Additionally, although FINRA did not identify any particular product as *per se* unsuitable for older investors, it warned firms that its examination staff would focus on recommendations to seniors involving certain products and investment strategies that have been used to victimize seniors.[25] These include products with high surrender charges or that otherwise lack liquidity, variable life settlements, complex structured products, and strategies such as the use of mortgage equity and early withdrawals from retirement savings and Individual Retirement Accounts (IRAs) to invest in high risk investments.[26]

FINRA and NASAA, further warned firms that "[a]n investor's age and life stage are critical components of an investor's profile and firms cannot meet their regulatory obligations without considering these factors." 2008 Report, *supra* note 15, at 3.

23. FINRA, RULE 2111(a) (2012). The new rule retained the basic features of Rule 2310, but broadened list of customer-specific factors that firms and associated persons must consider in making a recommendation (previously other investments, financial situation and needs, tax status and investment objectives) to include: age, investment experience, time horizon, liquidity needs and risk tolerance. *See generally*, FINRA, NOTICE TO MEMBERS 11-01 (2011).

24. Moreover, in certain circumstances a broker owes a fiduciary duty to the customer. Courts may impose a fiduciary duty when facts establish that the customer is dependent on the broker, or if the customer has "impaired faculties" and may not be able to protect his or her own interests. Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will A Uniform Fiduciary Duty Make a Material Difference?*, 14 J. BUS. & SEC. L. 105, 116 (2014).

25. FINRA, NOTICE TO MEMBERS 07-43 (2007) at 3-4.

26. *Id.* at 4. The coordinated examinations of broker-dealers conducted by the SEC and FINRA in 2013 revealed that the top revenue-generating securities at the examined firms based on sales to seniors included: (1) open-end mutual funds; (2) variable annuities; (3) equities; (4) fixed income; (5) unit investment trusts (UITs) and exchange-traded funds (ETFs); (6) non-traded real estate investment trusts (REITs); (7) alternative investments such as options and inverse-leveraged ETFs; and (8) structured products. SEC/FINRA National Senior Investor Report, *supra* note 8, at 6.

2. The Know Your Customer Rule

In addition to the obligation to make only suitable recommendations, brokers must to take affirmative action to obtain certain information from their customers to assist them in making recommendations. Thus, FINRA Rule 2090, *Know Your Customer*, requires firms to use "reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[27] This obligation is not transaction specific; rather, it exists throughout the firm-customer relationship and requires members to continually assess the needs of senior investors and to act accordingly.[28]

The Know Your Customer rule has also been used by FINRA as a potential tool in protecting against elder abuse. For example, in Regulatory Notice 11-25 (May 2011), *Know Your Customer and Suitability*, *New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations*, FINRA reminded firms that the Know Your Customer obligation under Rule 2090 requires firms to know the names of the persons authorized to act on behalf of the customer and the limits of their authority.[29] Having such information on file with the firm can help firms identify and possibly prevent financial exploitation of persons with diminished capacity.

3. Communications to the Public

Firms are also required to ensure that their registered representatives are properly supervised, particularly in areas of concern like their communications

27. FINRA, RULE 2090 (2011); FINRA developed a voluntary, model "New Account Application Template," that brokerage firms could use as a resource when considering their own account documentation processes. *See New Account Application Template*, FINRA, http://www.finra.org/Industry/Tools/P117268 (last visited Sep. 15, 2016).

28. The supplementary materials to the rule provide: "For purposes of this Rule, facts 'essential' to 'knowing the customer' are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules." FINRA, RULE 2090.01 (2011).

29. FINRA, NOTICE TO MEMBERS 11-25 (2011) at 2 (Question/Answer 1).

with senior investors. Securities regulators have raised significant concerns about registered representatives' use of senior designations that suggest an expertise in financial services for seniors (e.g., "senior specialist").[30] A FINRA Foundation survey found that 25% of seniors had been told by their investment professional that he or she was "specially accredited" to advise seniors on financial issues, and that 50% of those seniors were more likely than not to listen to the professional's advice because of the designation.[31] Yet given the varying standards required by organizations providing such designations (from a "rigorous curriculum" and testing on one end of the spectrum, to a simple membership fee payment on the other end of the spectrum), such designations could be misleading and violate FINRA communication and advertising rules, as well as possibly the antifraud provisions of the federal securities laws.[32]

FINRA's concerns regarding senior designations prompted it to issue Regulatory Notice 11-52, in which it "remind[ed] firms of their supervisory obligations regarding the use of certifications and designations that imply expertise, certification, training or specialty in advising senior investors."[33] The notice also published FINRA's findings of the widespread use of senior designations in the industry.[34] FINRA reminded firms that they must have written supervisory procedures in place to prevent the use of misleading senior designations, which could include banning the use of any designation, providing a pre-approved list of designations, submitting proposed designations to a committee comprised of principals, using compliance and/or legal personnel, training (including training on working with senior investors),

30. *See* FINRA, NOTICE TO MEMBERS 07-43 (2007) at 5; SEC/FINRA National Senior Investor Report, *supra* note 8, at 10-15.

31. FINRA, NOTICE TO MEMBERS 07-43 (2007) at 5.

32. *Id.*

33. FINRA, NOTICE TO MEMBERS 11-52 (2011) at 1.

34. *Id.* at 2. FINRA surveyed firms of all sizes and, of the 157 firms that responded, 68% allowed registered representatives to use senior designations; of the firms allowing such designations, 89% of the individual brokers used them. *Id.* The survey further revealed that among the firms that allowed the use of senior designations, 23% required approval but did not verify credentials, and 11% did not require approval and did not verify credentials. *Id*. In its 2013 coordinated examinations, the SEC and FINRA found that the use of such designations was at 64% of the firms examined; the firms collectively permitted the use of 25 different senior designations, and 44% of the allowed designations were not recognized by any independent accrediting organization. SEC/FINRA National Senior Investor Report, *supra* note 8, at 10-11.

and requiring annual attestations.[35] The concern over misleading senior designations also prompted NASAA to adopt a Model Rule regarding the use of Senior-Specific Certifications and Professional Designations in response to the risk posed by misleading designations.[36]

B. State Laws Protecting Senior and Vulnerable Investors

State law provides another layer of protection for senior or otherwise vulnerable investors. According to the 2013 Nationwide Survey of Mandatory Reporting Requirements for Elderly and/or Vulnerable Persons ("2013 Survey"),[37] all states have passed statutes requiring or permitting certain professionals, including, but not limited to, attorneys, accountants, doctors, nurses and other health care workers, nursing homes and care providers to report suspected abuse to the state's Adult Protective Services or law enforcement officials. The 2013 Survey shows that to date, only 21 states and

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35. SEC/FINRA National Senior Investor Report, *supra* note 8, at 3-6; *see also* FINRA, NOTICE TO MEMBERS 07-43 (2007) at 5.

36. NASAA MODEL RULE ON THE USE OF SENIOR-SPECIFIC CERTIFICATIONS AND PROFESSIONAL DESIGNATIONS (adopted Mar. 20, 2008), *available at*: http://www.nasaa.org/wp-content/uploads/2011/07/3-Senior_Model_Rule_Adopted.pdf. The Model Rule provides that "use of a senior specific certification or designation by any person in connection with the offer, sale, or purchase of securities, or the provision of advice as to the value of or the advisability of investing in, purchasing, or selling securities . . . that indicates or implies that the user has special certification or training in advising or servicing senior citizens or retirees, in such a way as to mislead any person shall be a dishonest and unethical practice in the securities, commodities, investment, franchise, banking, finance, or insurance business within the meaning of [the state's securities statute provision]." *Id.* §1.

At least 30 states have adopted the NASAA model and two other states had previously adopted rules similar to the Model. *See* NASAA, Comment Letter to the Consumer Financial Protection Bureau, Docket No. CFPB-2012-0018, Request for Information Regarding Senior Financial Exploitation (Aug. 12, 2012), *available at*: http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-CFPB-Comment-Letter_FINAL_082012.pdf.

37. NEW YORK DISTRICT ATTORNEY'S OFFICE & NAPSA ELDER FINANCIAL EXPLOITATION ADVISORY BOARD, 2013 NATIONWIDE SURVEY OF MANDATORY REPORTING REQUIREMENTS FOR ELDERLY AND/OR VULNERABLE PERSONS (Aug. 2013), *available at*: http://www.napsa-now.org/wp-content/uploads/2014/11/Mandatory-Reporting-Chart-Updated-FINAL.pdf.

the District of Columbia require financial institutions to adhere to reporting requirements.[38] While anyone "may" report financial abuse, only three states, Iowa, Virginia and Washington, have statutes that specifically include "financial institutions" among the group of professionals who may report instances of financial abuse (but, of course, reporting is voluntary and not mandatory).[39] Moreover, among the states that include employees of financial institutions within the category of persons either required or permitted to report suspected abuse to authorities, the definition of a "financial institution" does not necessarily include a broker-dealer or investment adviser.

For example, in California, since January 1, 2007, officers and employees of financial institutions are required to report suspected financial abuse of an elder or dependent adult, with "elder" defined simply as a California resident age 65 or older.[40] However, the California law is limited because, among other things, "financial institutions" are specifically defined to include national banks, savings and loans, state banks, and trust companies whose deposits are not limited solely to funds held in a fiduciary capacity, and federal or state credit unions.[41]

C. Pending Rule Proposals to Fill Regulatory Gaps

FINRA's focus on and review of obligations that its members owe to senior investors also identified some areas that must be addressed. For example, although the suitability rule requires brokers to obtain customer-

38. Fifteen states require "any person" or "any individual" to report suspected financial exploitation to the relevant authorities, including: Delaware, Florida, Indiana, Kentucky, Louisiana, Mississippi, New Hampshire, New Mexico, North Carolina, Oklahoma, Rhode Island, South Carolina, Tennessee, Texas, Utah and Wyoming. The remaining six states, Arizona, Arkansas, California, Georgia, Kansas and Maryland, and the District of Columbia, have specific references to "financial institutions" or persons having custody or control of the vulnerable adult's property. *Id.*

39. *Id.* Effective since June, 2010, Washington State has a mandatory reporting requirement, but only in special circumstances. Specifically, *if* the institution places a hold on a disbursement of funds due to suspected financial exploitation, only then it *must* report the suspected abuse to authorities. WASH. REV. CODE ANN. § 74.34.215 (2010).

40. CAL. WELF. & INST. CODE §§ 15610.27, 15630.1 (2007).

41. *Id*. at § 15630.1(b).

specific information when making investment recommendation,[42] in cases involving customers with diminished capacity, the information elicited may be wholly unreliable.[43] Additionally, in cases of suspected financial abuse or exploitation, questions persist as to whether a firm can contact a third party to report such concerns or take affirmative steps to prevent dissipation of the customer's assets. These issues, along with other unanswered questions concerning how to interact with potentially incapacitated investors, have prompted regulators to promulgate proposed rules to fill the existing gaps.

1. Trusted Contact Person

Establishing a "trusted contact person" for customers' accounts is among the new rule proposals that FINRA published for comments late last year in Regulatory Notice 15-37, *Financial Exploitation of Seniors and Other Vulnerable Adults*.[44] In it, FINRA proposes amending Rule 4512 (*Customer Account Information*), to *require* firms opening a new customer account to make a reasonable effort to obtain the name and contact information of a "trusted contact person" who may be contacted by the firm about the customer's account.[45] In addition, the proposed amendment would require firms to disclose to customers in writing that the firm "is authorized to contact the trusted contact person and disclose information about the customer's account to confirm the specifics of the customer's current contact information, health status, and the identity of any legal guardian, executor, trustee or holder of a power of attorney, and as otherwise permitted . . . ."[46]

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42. FINRA, RULE 2111(a) (2012); *see also* discussion *supra* Section II(A)(1).

43. FINRA, NOTICE TO MEMBERS 12-25 (2012) at 11 (Question/Answer No. 16) (Although brokers should be able to rely upon their customers' responses, the notice identified situations where the broker may not be able to do so, including, among other things, the customer exhibits clear signs of diminished capacity or other "red flags" indicating that the customer's information may be inaccurate.).

44. FINRA, NOTICE TO MEMBERS 15-37 (2015).

45. FINRA, PROPOSED RULE 4512(a)(1)(F) (2015). The "trusted contact person" would have to be age 18 years or older and not authorized to transact business on the account. *Id.*

46. FINRA, PROPOSED RULE 4512.06 (Supplementary Materials) (2015). Should the customer refuse to provide a "trusted contact person," the firm is allowed to open the account for that customer, provided that the firm made a reasonable effort to obtain the name and contact information of a "trusted contact person" in the first place. *Id.*

Establishing a contact person on accounts – either voluntarily or as required by Rule 4512(a)(1)(F) if adopted – would provide firms with a mechanism to respond to concerns about customers suffering from diminished capacity. To the extent a customer's condition raises concerns about the reliability of the information elicited for suitability purposes, for example, the firm can contact the trusted person and ask about the customer's health and mental capacity. In situations involving suspected financial abuse, the firm would be able to contact that person (assuming he or she is not the individual suspected of perpetrating the abuse), thereby providing an opportunity to address the suspected abuse.[47]

Until the proposed amendment to Rule 4512 becomes final, however, firms must look to state law to determine whether reporting suspected abuse is permitted or required.[48] Firms may report suspected senior financial abuse on Suspicious Activity Reports ("SARs") filed with the Financial Crimes Enforcement Network ("FinCEN"), a Bureau of the U.S. Department of the Treasury.[49] However, since SARs primarily serve to alert regulators of conduct

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47. FINRA, NOTICE TO MEMBERS 15-37 (2015) at 3-4. "FINRA intends the trusted contact person to be a resource for the firm in administering the customer's account and responding to potential financial exploitation." *Id.* at 3.

48. *See* discussion *supra* Section II(B). NASAA recently promulgated a model act, titled "An Act to Protect Vulnerable Adults from Financial Exploitation," which, if adopted by a state would require a broker-dealer or investment adviser to report to the state securities regulator and state adult protective services when it has "a reasonable belief that financial exploitation of an eligible adult has been attempted or has occurred." NASAA, NASAA MEMBERS ADOPT MODEL ACT TO PROTECT SENIORS AND VULNERABLE ADULTS (Feb. 1, 2016), *available at*: http://www.nasaa.org/38777/nasaa-members-adopt-model-act-to-protect-seniors-and-vulnerable-adults; NASAA, NASAA MODEL LEGISLATION OR REGULATION TO PROTECT VULNERABLE ADULTS FROM FINANCIAL EXPLOITATION (hereinafter "NASAA Model Act") (adopted Jan. 22, 2016), *available at*: http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Model-Seniors-Act-adopted-Jan-22-2016.pdf.

49. Financial institutions file SARs with FinCEN to report suspicious activity involving money laundering and terrorist activity, as well as activities related to securities fraud, consumer fraud and elder abuse. 31 C.F.R. § 1020.30; *see also* FINCEN, ADVISORY TO FINANCIAL INSTITUTIONS ON FILING SUSPICIOUS ACTIVITY REPORTS REGARDING ELDER FINANCIAL EXPLOITATION, FIN-2011-A003 (Feb. 22, 2011), *available at*: https://www.fincen.gov/sites/default/files/advisory/fin-2011-a003.pdf. FinCEN asked firms to file SARs with the characterization of "elder financial exploitation" in the narrative portion of the report "in order to assist law enforcement in its effort to target instances of financial exploitation of the elderly." *Id.* at 3.

for potential examinations or enforcement actions, such reports may not provide immediate assistance in any individual situation.

2. Temporary "Pause" on Suspicious Disbursements

FINRA also proposed new Rule 2165, *Financial Exploitation of Specified Adults*, which would permit, but not require, firms to implement a process to temporarily place a hold on any disbursements.[50] Also known as the "pause rule," Rule 2165 would permit "qualified persons"[51] of firms to place temporary holds on disbursements of funds or securities from the accounts of "Specified Adults"[52] where there is a reasonable belief "that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted."[53]

Within two days after placing the hold, the firm must notify the person(s) authorized to transact business on the account and the "Trusted Contact Person" or, if the firm believes that person is involved in the financial

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In 2013, eight federal agencies, including the SEC, issued guidance to financial institutions regarding their obligations under privacy laws and their reporting suspected financial abuse. The agencies explained that financial exploitation was an exception to the prohibition of disclosure of nonpublic information to law enforcement or other appropriate state authorities. *See* SEC, INTERAGENCY GUIDANCE ON PRIVACY LAWS AND REPORTING FINANCIAL ABUSE OF OLDER ADULTS (2013), *available at*: http://www.sec.gov/news/press/2013/elder-abuse-guidance.pdf. The guidance further provided a list of possible signs of financial abuse of older adults. *Id.*

50. FINRA, NOTICE TO MEMBERS 15-37 (2015) at 4. The NASAA Model Act similarly provides for "delaying disbursements" if a qualified individual reasonably believes that the disbursement may result in financial exploitation. NASAA Model Act, *supra* note 48, § 7.

51. A "qualified person" is defined as "an associated person of a member who serves in a supervisory, compliance or legal capacity" that is reasonably related to the account of the specified adult. FINRA, RULE 2165(a)(3) (2015). Subsection (a)(1) of the rule defines "specified adult" as a natural person who is age 65 or older, or a natural person age 18 and older "who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests." *Id.*

52. A "Specified Adult" is defined as a "natural person age 65 and older." FINRA, RULE 2165(a)(1)(A) (2015).

53. FINRA, RULE 2165(b)(1)(A) (2015).

exploitation, an immediate family member, and must also conduct an internal review.[54] The temporary hold expires after 15 days, unless extended under certain defined circumstances.[55] Proposed Rule 2165 does not create an obligation to place a hold on funds or securities where financial exploitation may be occurring, but it provides a safe harbor to firms who exercise discretion to place the temporary hold in such circumstances.[56]

In the context of a permissive rule, the procedures that firms must implement and follow create a strong disincentive for firms to provide this important protection to their clients. Specifically, if a firm chooses to exercise its discretion to place a temporary hold on funds, the firm is required to: (1) establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the rule;[57] (2) develop and document specific training policies or programs reasonably designed to ensure that registered persons comply with the requirements of this Rule;[58] and (3) establish and maintain records related to the compliance with the rule.[59] The easier and less expensive choice for firms would be simply to do nothing. As such, investor advocacy groups have urged FINRA to revise the proposed rule to require the implementation of such procedures or, at minimum, mandatory reporting to state authorities or adult protective services.[60] A mandatory reporting requirement would also establish a much needed, uniform standard for investors wherever they reside.[61]

Until the adoption of a uniform standard, firms must look to existing state law to determine whether reporting suspected abuse is required or allowed, or

54. FINRA, RULE 2165(b)(2)(b) (2015).

55. FINRA, RULE 2165 (b)(1)(C) (2015).

56. FINRA, RULE 2165.01 (2015).

57. FINRA, RULE 2165.02 (Supplementary Materials) (2015).

58. FINRA, RULE 2165.03(Supplementary Materials) (2015).

59. FINRA, RULE 2165 (b)(2)(C) (2015).

60. *See, e.g.,* Comment Letters on FINRA, REGULATORY NOTICE 15-37 (2015) submitted by PIABA, AARP and The Alzheimer's Association, among others, *available at*: http://www.finra.org/industry/notices/15-37.

61. "There is little consistency between the protections available to a senior investor who happens to reside in Washington and one that resides in New York. It is important that no matter where the investor lives, they have the same protections." Lisa A. Catalano & Christine Lazaro, *Financial Abuse of the Elderly: Protecting the Vulnerable*, 15 PIABA B.J. 1, 15 (2008).

if the firm can otherwise place a temporary hold on suspicious disbursements. Additionally, firms have implemented training and other best practices to handle incidents of suspected abuse, balancing firms' obligations to maintain the confidentiality of their customers' information with the interests of protecting their customers from suspected abuse, and potential reporting obligations under state law.

3. DOL Fiduciary Rule

Surprisingly, the rule that may have the most immediate impact on curbing financial abuse was issued by the Department of Labor ("DOL"), not the SEC or FINRA. On April 8, 2016, the DOL issued a final rule to address conflicts of interest surrounding the management of retirement accounts, imposing a fiduciary duty on investment professionals who sell investments or make a recommendation to a plan, plan fiduciary, plan participant and beneficiary or IRA owner for compensation.[62] Broker-dealers who make an investment recommendation in connection with a retirement account are exempted from the rule's prohibition against transaction-based compensation under the "best interest" contract exemption.[63] This exemption allows broker-dealers to continue to receive transaction-based compensation as long as the firm and its representatives "provide investment advice that is in the best interests of their customers."[64]

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62. US DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMIN., DEPARTMENT OF LABOR FINALIZES RULE TO ADDRESS CONFLICTS OF INTEREST IN RETIREMENT ADVICE, SAVING MIDDLE CLASS FAMILIES BILLIONS OF DOLLARS EVERY YEAR, Fact Sheet (April 8, 2016) (hereinafter "DOL Rule Fact Sheet"), *available at*: https://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html. The DOL expanded the definition of "fiduciary" to include any person who, for a fee or other compensation, makes a recommendation "regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA." *Id.* at 3. This definition would naturally include broker-dealers (currently subject to a suitability standard under FINRA, RULE 2111 (2012)) recommendations who, absent an exemption, would be prohibited from receiving transaction-based compensation. *Id*. at 2. The effective date of the final rule was June 7, 2016, but the "applicability date" of certain provisions were staggered to allow firms to implement new policies and procedures. The revised definition of fiduciary will not be applicable until April 10, 2017, and compliance with the new standards and obligations under the best interest contract exemption are not applicable until January 1, 2018. *Id*. at 7.

63. DOL Rule Fact Sheet, *supra* note 62, at 5-6.

64. *Id.* at 6. To rely on the best interest contract exemption, a firm must: 1)

Should it survive challenges by Congress and industry groups,[65] the DOL Fiduciary Rule would elevate the standard for rendering investment advice in connection with over $7.2 trillion held in IRA accounts in the U.S.[66] The higher standard may very well help curb "the annual loss of billions of dollars to ordinary retirement investors as a result of conflicted advice."[67] Although the rule does not apply to retail brokerage accounts, the SEC has indicated it is working on a uniform fiduciary standard rule, which it is authorized to promulgate under Section 913 of Dodd-Frank Wall Street Reform Act.[68] The

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acknowledge fiduciary status with respect to the investment advice to the investor; 2) adhere to impartial conduct standards requiring it to give advice that is in the investor's best interest, charge no more than reasonable compensation, and make no misleading statements about the transaction, compensation and conflicts of interest; 3) implement policies and procedures reasonably designed to prevent violations of the impartial conduct standards; 4) refrain from giving or using incentives for advisors to act contrary to the customer's best interests; and, 5) fairly disclose the fees, compensation and material conflicts of interests with is recommendation. Best Interest Contract Exemption, 81 Fed. Reg. 21,002, 21,007 (Apr. 8, 2016).

65. On June 8, 2016, President Obama vetoed a congressional resolution (H.J. Res. 88) to block the new DOL Fiduciary Rule. M. Schoeff, *Obama Vetoes Resolution Against DOL Fiduciary Rule,* INVESTMENT NEWS (June 8, 2016), *available at*: http://www.investmentnews.com/article/20160608/FREE/160609915/obama-vetoes-resolution-against-dol-fiduciary-rule-court-sets-date. Subsequently, the U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association ("SIFMA") and other industry groups filed legal challenges in federal district courts to the rule. A. Ackerman & L. Scism, *Obama Retirement-Savings Rule Faces Industry-Led Court Battle*, WALL ST. J. (May 31, 2016), http://www.wsj.com/articles/industry-groups-prepare-lawsuit-over-obama-retirement-rule-1464704230.

66. METLIFE FOURTH QUARTER 2014 NEWSLETTER, TOTAL U.S. RETIREMENT ASSETS REACHED $24 TRILLION (2015), *available at*: https://www.metlife.com/retirement-plan-edge/issues/2014-Q4/Total-US-retirement-assets-24-trillion.html. The balance is held in annuity reserves ($2.0 trillion), government defined benefit plans ($5.1 trillion), private sector defined benefit plans ($3.2 trillion) and defined contribution plans ($6.6 trillion). *Id.*

67. DOL Rule Fact Sheet, *supra* note 62, at 2.

68. SEC Chairman White testified in June 2016 before the Senate Banking Committee on the status of a fiduciary rule, explaining that it was unlikely that she was committed to implementing a rule, but that the SEC was not likely to do so before the expiration of President Obama's term, and that the agency would "watch the unfolding of the [DOL] fiduciary rule to see if a 'conflict develops.'" M. Waddell, *No SEC Fiduciary Rule Till After Obama Departs: SEC Chief White*, THINKADVISOR.COM (June 14, 2016), http://www.thinkadvisor.com/2016/06/14/no-

DOL Fiduciary Rule and SEC's move towards a uniform "fiduciary standard" may have a significant impact on curbing unsuitable recommendations to all customers generally and may be a significant tool to curb exploitation of seniors at the hands of unscrupulous brokers.

III. FIRMS SHOULD IMPLEMENT "BEST PRACTICES" UNTIL THE REGULATORY STANDARDS EVOLVE INTO A COMPLETE FRAMEWORK

Regulators' pending and proposed rules will undoubtedly have an effect on the detection and prevention of financial exploitation on those suffering from diminished capacity. Until there is a cohesive and concrete regulatory framework applicable to all financial advisers working with seniors or those suffering from diminished capacity, however, perhaps the best protection one can hope for is the voluntary action of firms to implement "best standards" to protect senior and other vulnerable investors.

First and foremost, firms should initiate training to ensure that brokers are able to recognize signs of diminished capacity or financial abuse.[69] FINRA Rule 1250(b) requires firms to maintain continuing education programs for its associated persons and to evaluate their training plans annually.[70] Required training plans should be tailored to fit the particular firms' business model and, at minimum, must cover certain "suitability and sales practice considerations" in connection with the securities products or services offered by the firm.[71] Brokers trained to recognize signs of diminished capacity are better able to fulfill their suitability obligations.[72] FINRA recently observed that many firms

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sec-fiduciary-rule-till-after-obama-departs-sec.

69. 2008 Report, *supra* note 15, at 6-9.

70. FINRA, RULE 1250(b)(2)(A) (2015).

71. FINRA, RULE 1250(b)(2)(B) (2015).

72. There are a number of resources available to firms for developing educational training on working with senior investors and learning how to recognize signs of diminished capacity. AARP and the Financial Planning Association issued a guide that explains the challenges of physical and mental impairments experienced by seniors and provides steps that financial professionals can take when meeting with their clients. AARP & FINANCIAL PLANNING ASS'N, A FINANCIAL PROFESSIONAL'S GUIDE TO WORKING WITH OLDER CLIENTS, *available at*: http://assets.aarp.org/www.aarp.org_/articles/money/financial_planning/financial_professional.pdf. The SEC has also placed a link on its website to a training module prepared by Morgan Stanley that provides a discussion of working with seniors investors and identifies

have already developed and implemented training, policies, and procedures to address the challenges raised by the aging of their customer base, such as the decline in cognitive function that many of their senior customers will experience.[73]

In addition to training, firms should also establish clear internal processes for escalating issues and taking next steps.[74] For example, if a broker suspects that his or her client is suffering from diminished capacity, the firm's procedures could require the broker to escalate the issue to a person or committee designated by the firm to handle such issues; prohibit the broker from making any recommendations on the account until such concerns are resolved; and communicate with the investor's emergency contact (if one was provided) or person having a power of attorney (if applicable).[75] In fact, in connection with the opening of new accounts, some firms have counseled customers about designating a person that the firm has permission to contact in the event the firm is unable to contact the customer or has concerns about the account.[76] Of course, unless the customer's financial adviser has been trained to recognize the signs of diminished capacity or abuse, he or she may not identify an issue or problem to escalate in the first place.

In its first regulatory notice addressing senior investors in 2007, FINRA identified policies and procedures that some firms had voluntarily implemented to better protect their senior customers, encouraging (but not requiring) other firms to consider whether any or all of them were appropriate

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signs of diminished capacity. MORGAN STANLEY, WORKING WITH SENIOR INVESTORS, *available at*: https://www.sec.gov/investor/seniors/workingwseniors.pdf. *See also* NAOMI KARP & RYAN WILSON, PROTECTING OLDER INVESTORS: THE CHALLENGE OF DIMINISHED CAPACITY, AARP POLICY INSTITUTE (Apr. 2011) (describing firm protocols and responses for financial advisors dealing with clients suffering from diminished capacity), *available at*: http://www.aarp.org/content/dam/aarp/research/public_policy_institute/cons_prot/2011/rr2011-04.pdf.

73. FINRA recently completed an examination initiative on senior issues and noted that "many firms are increasingly proactive in dealing with senior investors by developing specific internal guidelines to strengthen suitability decisions and providing training on the needs of these investors, including, in some cases handling individuals experiencing diminished capacity or elder abuse." RICK KETCHUM, 2016 FINRA REGULATORY AND EXAMINATION PRIORITIES LETTER (Jan. 6, 2015), at 10.

74. 2008 Report, *supra* note 15, at 9.

75. *Id.* at 9-10.

76. *Id.* at 10; FINRA, NOTICE TO MEMBERS 07-43 (2007), at 7-8.

for their own businesses.[77] The 2008 Report issued by the SEC, FINRA, and NASAA identified additional best practices that firms implemented (or were considering) to better serve their senior customers and comply with firms' own ethical obligations and securities regulations.[78] Many of those same firms adopted policies and procedures, or "notable practices," to address regulators' concerns about recommendations of unsuitable products, misleading communications, and senior designations.[79] Regulators' review of these "best practices" policies and procedures led them to recommend that firms consider, on a voluntary basis, implementing the following policies if they have not already done so:

- **Ensuring the accuracy of the customer's information:** Expand the questions at the account opening stage by asking lifestyle questions such as timing of retirement, anticipated income and expenses, and whether the customer has any children or grandchildren who are dependent upon him or her financially; determine whether the customer has a will or financial power of attorney, or is otherwise willing to provide the name of someone the firm may contact in the event the firm cannot reach the customer or there is an issue or problem; ask the customer to voluntarily provide the name of a trusted contact person; require an in-person meeting to complete the account opening documents and review the accuracy of the information; require more frequent updates of account information; confirm with investors directly whether transactions were solicited or unsolicited; document conversations with investors and send follow-up letters to investors reflecting what was discussed at meetings; and suggest that the senior customer bring a relative or trusted friend to meetings.[80]

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77. FINRA, NOTICE TO MEMBERS 07-43 (2007), at 7-8. Prior to issuing the notice, FINRA had surveyed broker-dealer firms on, among other things, practices they had implemented to deal with the "special issues that are common to many senior investors." *Id.* at 1. Although the notice was primarily concerned with recommendations and communications impacting senior investors, it also addressed issues of diminished capacity and suspected financial abuse. *Id.* at 7-8.

78. 2008 Report, *supra* note 15. Regulators had solicited securities professionals, broker-dealers and investment advisers (of varied sizes and organizational models) and industry groups to voluntarily share information about their interactions with senior investors, and the practices and procedures the firms had put in place – or were considering to implement – to deal with their senior customer base. *Id.* at 2.

79. *Id*. at 4; SEC/FINRA National Senior Investor Report, *supra* note 8, at 9, 11, 15, 17, 20, 23, 26.

80. 2008 Report, *supra* note 15, at 5-6, 12, 14; 2010 Addendum, *supra* note 16, at 5.

- **Products:** Assign investment objectives to each product the firm sells to aid brokers in assessing appropriateness of a product for the senior customer, and facilitate comparisons by compliance personnel of stated investment objective on the account and the product purchased; review products for appropriateness for senior investors; establish age-based restrictions on certain products or product features; and limit or prohibit sales of certain investment products (such as structured products and variable annuities) based upon the customer's investment profile or age, or require additional targeted or "suitability" documentation before approval of the transaction.[81] Some firms have also enhanced their new products committee process by analyzing and identifying potential risks to senior investors when creating new products.[82]
- **Communications, Advertising, and Marketing to Seniors:** Review marketing materials to ensure they avoid "financial jargon;" use plain language and larger font sizes, i.e., implement specific approval processes for all seminars, outside speaking events, continuing education seminars, "investor appreciation" events and review marketing materials that target particular age groups, or use the words "senior seminar" or "senior meeting;" and implement supervisory protocols to include a minimum number of unannounced compliance visits to seminars a year, or a "mystery shopper" program where a compliance professional attends seminars to verify that representatives are complying with firm policies and procedures.[83]
- **Senior Designations:** Review the training materials of the entities or organizations that confer a designation "to ensure that predatory sales techniques are not included as part of the training;" review the use of

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81. 2008 Report, *supra* note 15, at 4, 15. The 2008 Report also listed a number of practices firms had implemented to address concerns about the sales of variable annuities to senior investors, observing that a number of firms had implemented heightened review of all variable annuity purchases in order to assess the appropriateness of the purchase given the investor's age, liquidity needs and time horizon. *Id.* at 15. Heightened review practices include, among other things, creating a centralized and independent review process for all annuity transactions, training a dedicated team of "annuity application reviewers," a heightened review process for investors with a low net worth or tax bracket, requiring the financial adviser to complete an attestation about the investor's profile and reason for purchase, and that they made certain representations and disclosures to the investor about the time horizon, liquidity. *Id.*

82. 2010 Addendum, *supra* note 16, at 5.

83. 2008 Report, *supra* note 15, at 5-6, 11-12.

proposed senior designations; maintain a list of approved and prohibited designations (including prohibiting the use of the word "senior" to minimize confusion); and verify the appropriate use of designations through periodic inspections of business cards used by professionals at field offices.[84]

- **Enhanced Supervisory Practices:** Maintain trade blotters that contain key account information (age, net worth, and investment objectives) alongside the transaction information for ease of review; use exception reports to flag certain high risk or speculative transactions for certain age groups; and identify accounts of investors that (a) generated a commission-to-asset ratio above a certain percentage over a preceding period, (b) have a "conservative" or "income" profile but have engaged in margin balance or engaged in options trading, (c) are accounts of persons over a certain age where trading activity has occurred and a power of attorney has been recently added, and (d) include the sale of annuities or other specified products to investors over a certain age.[85]

These practices are neither required nor exhaustive. They do not create or modify any existing obligations.[86] But regulators published them to provide the industry with guidance and urge firms to consider them (based on their business model, size of the firm, and other factors) in an effort to respond to the issues specific to senior investors.[87] Fortunately, many firms have begun

84. *Id.* at 12-13.

85. *Id.* at 17-18. Additional supervisory measures identified in the 2010 Addendum include creating policies that require an annual discussion between supervisors and sales professionals about sales to seniors, conducting risk-based statistical sampling based upon variables such as age, product type and whether a product replacement is involved, requiring corrective action when account documentation is incomplete, and heightened review or reviewing the entire book of business and compliance records of professionals whose book of business includes a large percentage of sales to seniors. 2010 Addendum, *supra* note 16, at 5-6.

86. *See* FINRA, NOTICE TO MEMBERS 07-43 (2007), at 7-8; 2008 Report, *supra* note 15, at 2; 2010 Addendum, *supra* note 16, at 2.

87. The SEC and FINRA "highlight[ed] recent industry trends that have impacted the investment landscape and discuss[ed] key observations and practices identified during the [coordinated 2013 examinations] with regard to securities sold to senior investors, training, use of senior designations, marketing and communications, account documentation, suitability, disclosures, customer complaints and supervision" in order to "support [broker-dealers'] thoughtful analysis of their policies and procedures as they serve the needs of senior investors." SEC/FINRA National Senior Investor Report, *supra* note 8, at 32.

to implement practices and procedures to deal with the complicated issues of diminished capacity and potential financial abuse. But until regulators implement mandatory rules and regulations, senior investors and those looking to protect them must rely on the core responsibilities of brokers to recommend only suitable investments and to know their customers – fundamental responsibilities that apply to every investor.

IV. CONCLUSION

Despite increased senior initiatives by federal and state regulators, financial exploitation of the elderly and those suffering from diminished capacity is rising, in large part because the number of elderly investors is rapidly increasing. Preventing elder abuse requires a multifaceted approach that includes the key participants in the senior investor's life – including his or her financial professional. Proposed rules allowing for the reporting of suspected abuse and freezing suspected payments are a step in the right direction but, at minimum, when there is an objectively reasonable basis to suspect financial abuse, reporting should be mandatory. Moreover, given the vast amount of retirement wealth at financial firms, additional training on senior-specific issues and avoiding conflicted advice would go a long way to curb abuses at the hands of unscrupulous and careless brokers.

Notes & Observations

LAWYERS' OBLIGATIONS WHEN REPRESENTING CLIENTS WITH DIMINISHED CAPACITY

Elissa Germaine[1]

Lawyers have a significant role to play in protecting clients with diminished capacity from financial exploitation. PIABA members, in particular, see the issue from a unique vantage point – usually after a person with diminished capacity (or a family member or concerned third party) notices a drop in value in his or her brokerage account and approaches the lawyer to help figure out what happened in the account and, if appropriate, to pursue a claim to recover damages. As such, members must understand their own obligations as lawyers to clients with diminished capacity, obligations that apply in the context of client representation during FINRA proceedings as well as in other areas of legal practice.

Clients with diminished capacity present significant challenges. As is the case for advisers in the financial arena, the existing rules for lawyers might not provide every answer. Of course, the relevant jurisdiction's ethical rules should always serve as a starting point, most likely at the jurisdiction's equivalent of ABA Model Rule 1.14, Clients with Diminished Capacity. Though laudable in its goal to balance the competing interests and concerns, Rule 1.14 leaves much unanswered. Moreover, it is not the only source of ethical considerations concerning clients with diminished capacity. Thus, attorneys should refer to the "Four C's" of legal ethics: (1) client identification, (2) conflicts of interest, (3) confidentiality, and (4) competence.[2] In addition, the National Academy of Elder Law Attorneys

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2. ABA COMMITTEE ON LAW & AGING, WHY AM I LEFT IN THE WAITING ROOM? UNDERSTANDING THE FOUR C'S OF ELDER LAW ETHICS (2015), *available at:* http://www.americanbar.org/content/dam/aba/administrative/law_aging/EthicsBrochure.authcheckdam.pdf (hereinafter "UNDERSTANDING THE FOUR C'S OF ELDER LAW ETHICS"); *see also* ABA COMMITTEE ON LAW & AGING & AMERICAN PSYCHOLOGICAL ASS'N., ASSESSMENT OF OLDER ADULTS WITH DIMINISHED CAPACITY: A HANDBOOK FOR LAWYERS (2005) (hereinafter "ABA-APA HANDBOOK").

(NAELA)[3] created a set of guidelines in 2005 – the "Aspirational Standards for the Practice of Elder Law" – to assist attorneys practicing in the area of Elder Law.[4] The Aspirational Standards aim to fill in the gaps and answer questions that might not be fully answered by the ABA Model Rules of Professional Conduct and each state's professional responsibility rules.[5]

Lawyers should conduct an "integrated analysis" that addresses the issues of client identity, multiple representation and conflicts of interest, confidentiality, and the interests of third parties to determine how to best represent the interests of the identified client.[6] This analysis should involve "a searching inquiry into the underlying attitudes, feelings, and circumstances of the individual clients to understand their respective interests."[7] This article provides an overview of the issues that attorneys must consider to meet their ethical duties to clients who may suffer from diminished capacity. Section I provides an overview of the Four C's of client representation, unpacking the ethical obligations and choices the attorney must make. Section II outlines the guidelines for representing a client with diminished capacity, focusing on

3. NAELA is a professional association of attorneys dedicated to improving the quality of legal services provided to people as they age and people with special needs. ABOUT NAELA, https://www.naela.org/Public/About/Public/About_NAELA/About.aspx?hkey=3ae07a3c-c172-4565-a52b-091d49e31841 (last visited Sep. 13, 2016).

4. Professionalism & Ethics Committee of the National Academy of Elder Law Attorneys, *Aspirational Standards for the Practice of Elder Law with Commentaries*, 2 NAELA J. 5, 6-7 (2006), *available at:* https://www.naela.org/App_Themes/Public/PDF/Media/AspirationalStandards.pdf (hereinafter "NAELA *Aspirational Standards*"). NAELA is currently working to update these standards. *See* Roberta K. Flowers, *Practical Ethics: Confronting Ethical Questions that Practitioners Ask*, NAELA NEWS (Dec. 2014/Jan. 2015), *available at:* https://www.naela.org/Public/Library/Publications/Publications_Main/NAELA_News_Archive/NAELA_News_2014/Dec2014Jan2015/Practical_Ethics_Aspirational_Standards__News_.aspx.

5. NAELA *Aspirational Standards*, *supra* note 4, at 6-7; Gregory S. French, CELA, CAP, *Aspirational Standards for the Practice of Elder Law Distinguish NAELA Members from Other Attorneys*, NAELA NEWS (Feb./Mar. 2013), *available at*: https://www.naela.org/Public/Library/Resource_Database/Topics/1_Ethical_Issues/1a_ASPIRATIONAL_STAND/Aspirational_Standards.aspx.

6. Joseph A. Rosenberg, *Adapting Unitary Principles of Professional Responsibility to Unique Practice Contexts: A Reflexive Model for Resolving Ethical Dilemmas in Elder Law*, 31 LOY. U. CHI. L. J. 403, 454 (2000).

7. *Id.* at 454-55.

keeping the relationship as normal as reasonably possible and, when protective action is needed, taking the least restrictive action possible.

I. SATISFYING THE FOUR C'S OF CLIENT REPRESENTATION

Lawyers owe all clients certain ethical duties, including client-centered representation, conflict-free representation, confidentiality, and competence. These so-called Four C's provide a baseline from which to evaluate many of the issues that arise in representing senior clients or those with some incapacity.

A. Ensuring Client-Centered Representation by Identifying the Client

As basic as it seems, identifying the client is a necessary yet often challenging step in situations involving the elderly or those with diminished capacity, as the client is not always easily identifiable because of the common presence of other people, such as family members.[8] Family members may be very involved in the legal concerns of the person with diminished capacity, and they may have a stake in the outcome.[9] Identifying the client at the outset of the relationship will help attorneys understand and identify whose interests are being addressed; understand and clarify the person to whom the lawyer has professional duties of competence, diligence, loyalty, and confidentiality; clarify what steps can and cannot be taken after an initial consultation if the client is not present; and arrange at the earliest possible time for private, direct, and personal (preferably face to face) communication with the client.[10] In addition, clear early client identification will ensure that other involved parties are aware of the person in whose interest the lawyer is acting.[11]

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8. Roberta K. Flowers & H. Amos Goodall, Jr., *In Fear of Suits: The Attorney's Role in Financial Exploitation*, 2014 EMERGING ISSUES 7263, at 9 (Oct. 21, 2014). *See also* Rosenberg, *supra* note 6, at 405 ("The traditional concept of a solitary client making decisions about a legal problem isolated from the interests of others does not apply.").

9. UNDERSTANDING THE FOUR C'S OF ELDER LAW ETHICS, *supra* note 2; NAELA Aspirational Standards, *supra* note 4, at A-1 Comment.

10. NAELA *Aspirational Standards*, *supra* note 4, at 7.

11. For example, if the attorney is involved in drafting estate planning documents, family members may assume that the attorney represents their interests as well as the elderly client's interests. *See* Julia A. Lemke & Seymour Moskowitz, *Protecting the*

Client identification can be accomplished by gathering information, preferably via an intake form, as early as possible.[12] The responses on the intake form will indicate the responder's perception of who the client is.[13] Nevertheless, there is not always a clear answer and attorneys should investigate beyond the form, thinking about how the representation may later evolve and the differing interests that might later appear, if they are not already present.[14] This type of situation could occur at the beginning of a possible client engagement regarding losses in an investment account, when a prospective client brings an adult child or spouse who is not a joint account holder to an initial intake meeting. One possible response for a lawyer faced with such uncertainties is to always identify the client as the "vulnerable" or elderly person.[15] However, while this may eliminate conflicts of interest issues, it may not yield a satisfactory result, as an adult child may still expect (and the parent may want) her child to be part of the initial interview meeting, as well as subsequent meetings and communications.[16] In this situation, the lawyer may consider whether to identify the client as the vulnerable adult, as the adult child, as the adult child as a fiduciary for the vulnerable adult, or as

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Gold in the Golden Years: Practical Guidance for Professionals on Financial Exploitation, 7 MARQ. ELDER'S ADVISOR 1, 5 (Fall 2005).

12. NAELA *Aspirational Standards*, *supra* note 4, at 7-8.

13. *Id*.

14. For example, if an adult child contacts a lawyer regarding legal advice on behalf of an elderly parent, and the adult child states she is seeking to schedule an appointment for her mother, the lawyer can easily determine that the client is the mother. Rosenberg, *supra* note 6, at 447. However, this determination may become more complex and troublesome if the adult child is seeking legal advice on behalf of her mother who has Alzheimer's disease (even before the attorney knows the mother's level of competence). *Id.* Additionally, situations that begin as a simple request for legal advice or services can often evolve into a more complicated set of facts. *Id*. at 448. Identifying the client may also depend upon the type of legal advice or services sought as well as the level of involvement of the adult child and other adult children or involved third parties. *Id.* For example, what if the adult child tells the lawyer that her mother wants to make a will that gives the mother's entire estate to this child and not her siblings? *Id*. Or, what if the adult child asks how she can become her mother's guardian, apply for Medicaid, and preserve the family home for herself? *Id.*

15. Rosenberg, *supra* note 6, at 448.

16. *Id.*

both parties through some form of joint or multiple representation.[17] An intake form is only a first step, especially if the intended client did not fill out the form or did so with the assistance of another. In such a situation, the attorney should meet with the identified prospective or actual client in private to assess the client's capacity and voice directly.[18] If the attorney determines that it is not in the best interest of the client to meet privately with the attorney, she should take other steps to ensure that the client's wishes are identified and respected.[19]

After identifying the client, the attorney should prepare a written engagement agreement that identifies the client and the scope and objectives of the representation. The agreement should also disclose any relevant foreseeable conflicts among the clients; explain the lawyer's obligation of confidentiality and confirm that the lawyer will share information and confidences among joint clients, if applicable; set out the fee arrangement; and explain when and how the attorney-client relationship may end.[20]

Finally, ensuring client-centered representation includes taking steps to protect the client's objectives, including communicating the identity of the client to all involved parties.[21] Identifying the client as a person with

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17. *Id.* at 449-51.

18. NAELA *Aspirational Standards*, *supra* note 4, at 8. For example, if other family members accompany the client to an attorney meeting, the attorney should carefully explain why a confidential meeting with the client is important. In a private meeting with the client, the lawyer should try to ascertain whether the client is under any direct or indirect pressure to make particular decisions. This is especially important when family members may gain some advantage over others or when asset transfers are being considered. *Id*.

19. *Id.* at 8-9. These steps include making sure that the client understands the benefits of a confidential meeting but still rejects it, noting any indication of discomfort by the client or influence by another family member, noting the dominating tenor of another family member, and considering any inconsistencies with prior wishes. *Id*.

20. *Id.* at 9.

21. *Id.* at 7. *See also* Flowers & Goodall, *supra* note 8, at 9 ("[a]fter identifying the client and the other people 'present' in the representation, the attorney must then determine and adhere to the client's objectives of the representation."); MODEL RULES OF PROF'L CONDUCT r. 1.2 (AM. BAR. ASS'N 2016) ("a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued.").

diminished capacity does not prevent the attorney from representing this person. Even when a client has diminished capacity, the attorney "must look to the client, and not family members, to make decisions on the client's behalf," except when protective action is necessary, as discussed more fully below.[22]

B. Avoiding Conflicts of Interest and Determining the Best Type of Representation

Lawyers have an ethical obligation to avoid conflicts of interest, and owe their clients a duty of undivided loyalty.[23] Thus, lawyers must, at the outset of a potential engagement, identify any source of conflict and determine the type of representation that they will undertake, which could be the representation of one client, joint representation of multiple clients, sole representation of multiple clients, or representation of a client through a fiduciary.

1. The Vulnerable Individual as the Lawyer's Sole Client

Perhaps the safest way to avoid conflicts of interest is to represent only the individual with diminished capacity. This is because bringing others into the representation risks "that the elder's trust and confidence in the lawyer may erode, that a vulnerable client may be silenced by other clients, and that the client's civil rights will be undermined."[24]

The sole representation scenario is not, however, without risk or other obligation. Family members are often intimately involved with the client's affairs in a supportive and facilitating capacity. Attorneys should take care not to unintentionally treat third parties as clients, either by virtue of their physical presence, because they are potential beneficiaries of the client's decisions, or because of their role in the client's decision-making.[25] But as long as family members' involvement is consistent with the client's wishes and values, the attorney should continue to involve them while treating them as unrepresented

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22. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 3 (AM. BAR. ASS'N 2016).

23. MODEL RULES OF PROF'L CONDUCT r. 1.7 cmt. 3 (AM. BAR. ASS'N 2016).

24. Rosenberg, *supra* note 6, at 455.

25. Flowers & Goodall, *supra* note 8, at 9.

persons.[26] If a family member or another third party offers to pay the vulnerable client's legal fees, the attorney should accept such payment only if the client gives informed consent, the third party will not influence the attorney's independent professional judgment, and information related to client representation is kept confidential as required by ABA Model Rule 1.6.[27]

2. Joint Representation of Vulnerable Client and Others

At times, joint representation may be preferred if there is no apparent conflict of interest, as it can "further shared goals, common interests, family harmony, economic efficiency, consistency of action, and enhanced likelihood of serving the best interest of the clients."[28] For example, where spouses are joint account holders of an investment account at issue in a FINRA proceeding, lawyers may consider joint representation of a client with diminished capacity and his or her spouse.[29]

Despite its positive aspects, however, joint representation can also produce misunderstandings among family members. Therefore, attorneys should inform both clients and family members about the type of representation being considered, especially with respect to the attorney's obligation to keep or share confidences.[30] In addition, the attorney should inform all clients of the

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26. NAELA *Aspirational Standards*, *supra* note 4, at 11-12.

27. MODEL RULES OF PROF'L CONDUCT R. 1.8(f) (AM. BAR. ASS'N 2016). *See also* MODEL RULES OF PROF'L CONDUCT r. 1.7 cmt. 13 (AM. BAR. ASS'N 2016); NAELA *Aspirational Standards*, *supra* note 4, at 12. The attorney should communicate these standards to the client and to the non-client payor, and be sure that the third party understands that paying the attorney fees does not turn the third party into the client or allow access to otherwise confidential information.

28. NAELA *Aspirational Standards*, *supra* note 4, at 10.

29. Another example of a situation where lawyers often decide to enter a joint representation arrangement is when spouses struggling with dementia seek to create wills and other documents to address disability planning; long-term care financing (including the opportunity for Medicaid coverage); and the potential benefits of alternative plans that may involve trusts, transfers of property during life, and decisions about long-term care and living arrangements. Rosenberg, *supra* note 6, at 447. In this type of situation, joint representation provides cost savings with regard to attorney fees and honors "the primacy of relationships over individual interests." *Id.*

30. NAELA *Aspirational Standards*, *supra* note 4, at 10.

advantages and disadvantages, including the foreseeable conflicts of interest and risks, in a manner that will be understood by each potential client.[31] Separate, private, and direct communications with each potential client may be called for to ensure that each potential client is candid and able to freely ask questions.[32] Only after receiving educated consent and a waiver of conflicts by all parties should the attorney undertake joint representation. Further, if the attorney agrees to joint representation, she should establish a clear understanding and agreement that she will not keep client secrets from any other client in the joint representation.[33]

3. Separate Representation of Multiple Clients

Sometimes attorneys will consider representing multiple clients in an individual (vs. joint) capacity if they can provide "competent and diligent representation to each affected client" and meet the other requirements of ABA Model Rule 1.7(b).[34] Where an attorney represents multiple clients, including one who suffers from diminished capacity, conflicts tend to arise not because the clients are directly adverse to each other, but because the representation of one client materially affects the representation of another.[35] This means that there is "a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests."[36] Before undertaking this type of representation, lawyers should consider "the likelihood that a difference in interests will eventuate and, if it does, whether

31. *Id.* at 11.

32. *Id.*

33. *Id.* at 15.

34. MODEL RULES OF PROF'L CONDUCT r. 1.7(b) (AM. BAR. ASS'N 2016) (providing that notwithstanding the existence of a concurrent conflict, a lawyer may represent a client if: "(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.").

35. Flowers & Goodall, *supra* note 8, at 12.

36. MODEL RULES OF PROF'L CONDUCT r. 1.7 cmt. 8 (AM. BAR. ASS'N 2016).

it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client."[37]

4. Representation Through a Fiduciary

Attorneys may sometimes represent a fiduciary (under a power of attorney, trust, or conservatorship/guardianship) of an individual with diminished capacity. In this situation, the attorney must ensure that the client understands that the duties of both the fiduciary and the attorney ultimately are governed by the known wishes and best interests of the principal (i.e., the person with diminished capacity).[38] The NAELA Aspirational Standards instruct that when representing a fiduciary for a person with diminished capacity, lawyers must "be guided by the known wishes and best interests of the person with diminished capacity, and may disclose otherwise confidential information, in the event a conflict arises between the fiduciary and the person with diminished capacity, if necessary to avoid substantial harm to the interest of the person with diminished capacity."[39] In this situation, both the lawyer and the fiduciary owe a duty to the principal, and both are bound by the principal's wishes, values, and best interests.[40] The NAELA Aspirational Standards also advise, however, that while there is well-reasoned authority for imposing a duty to the principal by the attorney who represents the fiduciary, state professional responsibility rules and opinions vary significantly in prescribing the extent of that duty, if any, to the principal.[41]

When a lawyer represents a client with diminished capacity, the conflicts of interest analysis requires that lawyers understand the individual circumstances of each potential client and the likely involvement of third parties – often well-meaning but sometimes not – in undertaking an integrated and considered analysis.

37. *Id.*

38. NAELA *Aspirational Standards*, *supra* note 4, at 14.

39. *Id.* at 27. When a fiduciary appears to be acting contrary to the client's previously expressed wishes when competent, the lawyer should determine whether the fiduciary is self-dealing to the detriment of the client. *See id.* at 27-28. (providing an example and explaining when protective action may be warranted).

40. *Id.* at 27.

41. *Id*. at 14.

C. Maintaining Confidentiality of Client Information

Lawyers have an obligation to keep information concerning the representation of a client confidential.[42] Upholding this duty requires special care if a client has diminished capacity, due to the common involvement of family members, caregivers, or other third parties. Attorneys should carefully explain confidentiality to the client and ask whether the client wants to provide the lawyer with authority – limited or otherwise – to disclose confidential information to any third party, and for what objective.[43] When clients request disclosure, attorneys should help them understand the possible risks and consequences of disclosure (e.g., possible waiver of attorney-client privilege), and put this in writing. In cases of diminished capacity, however, if consultation with family members or other third parties is "necessary to assist in the representation," such disclosure generally does not affect the applicability of the attorney-client privilege.[44]

Some clients may consent to full disclosure of their discussions with the attorney to their family members, others may desire complete confidentiality, and others may prefer partial disclosure.[45] The lawyer should strive "to honor the client's relationship with the third party while protecting the integrity of the attorney-client privilege."[46]

In addition to educating the client, attorneys should also explain the confidentiality obligations to other involved parties to avoid any misunderstanding.[47] This is especially important where a third-party family member pays the attorney fees. Communicating with family members or other interested parties about issues of client identification and confidentiality increases the likelihood that family members will understand if or when the attorney does not share confidential information with them or meets privately with the client.[48]

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42. MODEL RULES OF PROF'L CONDUCT r. 1.6 (AM. BAR. ASS'N 2016).

43. NAELA *Aspirational Standards*, *supra* note 4, at 15.

44. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 3 (AM. BAR. ASS'N 2016); NAELA *Aspirational Standards*, *supra* note 4, at 16-17.

45. Lemke & Moskowitz, *supra* note 11, at 7.

46. Rosenberg, *supra* note 6, at 449.

47. NAELA *Aspirational Standards*, *supra* note 4, at 15.

48. Lemke & Moskowitz, *supra* note 11, at 7.

D. Assessing Client Competence

The final "C" of elder law ethics – competence – addresses two issues: (1) assessing the client's competence, and (2) the traditional legal ethics requirement of ensuring that the lawyer is competent.

1. Lawyer as Assessor of Competence

While most lawyers are not trained as medical professionals, a lawyer does not meet her duty of competence if she fails to assess a client's competence. Thus, attorneys should develop and use skills for preliminary client competency assessments.[49] A lawyer's assessment scale should weigh several balancing factors in evaluating her client's competence: the client's ability to articulate reasoning leading to a decision, the client's variability of state of mind and ability to appreciate consequences of a decision, the substantive fairness of a decision, and the consistency of a decision with the known long-term commitments and values of the client.[50] Attorneys can assess these factors during a client interview and/or counseling conversation.[51]

The lawyer's own assessment is only the first of three levels of potential capacity screening: (1) an initial assessment component and, if necessary, (2) use of a clinical consultation or formal evaluation by a clinician, and (3) a final legal judgment about capacity by the lawyer.[52] At the initial assessment, the lawyer will often be able to conclude that: (1) there is no or very minimal evidence of diminished capacity and representation can proceed, (2) there are some mild but not substantial capacity concerns and representation can proceed, (3) capacity concerns are more than mild and merit professional consultation or formal assessment, or (4) capacity to proceed with the requested representation is lacking.[53]

While lawyers may be concerned with making these assessments because they are not mental health professionals, there are resources available. For

49. NAELA *Aspirational Standards*, *supra* note 4, at 20. *See also* MODEL RULES OF PROF'L CONDUCT R. 1.14 ("acknowledg[ing] the lawyers' assessment functions, and indeed, suggest[ing] a duty to make informal capacity judgment in certain cases.").

50. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 6 (AM. BAR. ASS'N 2016).

51. ABA-APA HANDBOOK, *supra* note 2, at 2.

52. *Id.* at 3.

53. *Id.*

example, the ABA-APA Handbook guides the lawyer in working with a clinician on a consultation or referral for formal assessment as well as assisting the lawyer in understanding and using a capacity assessment report.[54] Moreover, the ABA Model Rules of Professional Conduct anticipate that a lawyer might need to obtain outside assistance when assessing the extent of the client's diminished capacity and expressly permits lawyers to seek guidance from an "appropriate diagnostician."[55]

In making their assessment, lawyers should distinguish between incapacity and the inability to remember. That a client does not remember a decision does not mean that the client did not have the capacity to make the decision at the time it was made.[56] Thus, lawyers should be alert to changes in their clients' capacity over the course of the client-attorney relationship and within the bounds of a specific engagement.

2. Ensuring our Competence as Lawyers

Historically, most attorneys did not attempt to assess capacity and the standard of practice in this area was minimal.[57] Therefore, legal malpractice for failure to address capacity questions was uncommon.[58] Today, with the increased prevalence of diminished capacity and incapacity, attorneys should consider capacity issues not only to best serve their clients, but also to address possible legal malpractice issues as well. The ABA-APA Handbook notes that the failure to assess a client's capacity has been alleged as grounds for legal malpractice by would-be beneficiaries.[59] For example, a disinherited child could allege in a will contest that a lawyer did not exercise proper care or that the lawyer failed to determine the testator's capacity to execute a will.[60] In the securities arbitration context, a spouse or adult child could question the decision by a client with diminished capacity to settle for a perceived insufficient amount rather than proceed to arbitration. Thus, while lawyers

54. *Id*. at 31-41.

55. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 6 (AM. BAR. ASS'N 2016).

56. NAELA *Aspirational Standards*, *supra* note 4, at 22.

57. ABA-APA HANDBOOK, *supra* note 2, at 2.

58. *Id.*

59. *Id.*

60. *Id.*

should not refer every client for clinical evaluation, they should conduct and document a capacity assessment if there are any signs of diminished capacity.[61]

II. Representing the Client with Diminished Capacity: Keep the Relationship as Normal as Reasonably Possible

If a lawyer determines that a client suffers from diminished capacity, the leading authorities agree on the lawyer's obligations to the client – keep the attorney's relationship with the client with as normal as reasonably possible.[62] While maintaining the ordinary lawyer-client relationship may not be possible in all respects,[63] the goal of keeping the relationship as normal as possible stems from the underlying concept that the attorney must respect the client's autonomy and right to confidentiality even with the onset of diminished capacity.[64] Thus, a lawyer should take care in communicating with the client and keeping her informed of the relevant facts of the representation.[65] Moreover, if a lawyer must take some steps to protect the client, she should ensure that those steps are the least restrictive necessary. Finally, a lawyer should be aware that there are limits to the disclosure of information even if some action is needed to protect the client.

A. Approaches to Communicating with a Client Suffering from Some Diminished Capacity

Because "a client with diminished capacity often has the ability to understand, deliberate upon, and reach conclusions about matters affecting the

61. *Id*.

62. MODEL RULES OF PROF'L CONDUCT r. 1.14(a) (AM. BAR. ASS'N 2016); NAELA *Aspirational Standards*, *supra* note 4, at 19; ABA-APA HANDBOOK, *supra* note 2, at 2.

63. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 1 (AM. BAR. ASS'N 2016).

64. NAELA *Aspirational Standards*, *supra* note 4, at 19.

65. Comment 2 to ABA Model Rule 1.14 counsels that "[t]he fact that the client suffers a disability does not diminish the lawyer's obligation to treat the client with attention and respect. Even if the person has a legal representative, the lawyer should as far as possible accord the represented person the status of client, particularly in maintaining communication." MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 2 (AM. BAR. ASS'N 2016).

client's own well-being,"[66] diminished capacity does not extinguish the attorney's ethical obligation to keep the client informed and to sufficiently explain the matter so that the client can make an informed decision.[67] Thus, where a client signs an authorization permitting the lawyer to communicate with her child about the client's legal matter, the lawyer should still keep the client directly informed and provide the client with copies of any documents.[68]

While ordinarily the attorney should provide to clients the level of information appropriate for a client who is a comprehending and responsible adult, it may be impracticable to meet this standard when the client suffers from diminished capacity.[69] In these circumstances, the amount and type of information the attorney should provide to the client will be governed by several factors, including the complexity of the matter, the client's ability to understand the information, and the impact of the information on the client.[70]

The following approaches for client communication, building trust, and enhancing the client's decision-making ability can help keep the attorney-client relationship as normal as possible:

- Be sensitive to age-related changes without losing sight of the individuality of each older person.[71]
- Do everything possible to make your office and counseling approach "elder friendly" and accessible to individuals with a range of disabilities.
- Adapt the interview environment, timing of meetings, communications, and decision-making processes to maximize the client's capacities.[72] This might mean taking more time or holding multiple sessions as needed to establish trust and put the client at ease.[73] Encourage maximum client participation to increase the client's sense of investment in the process.[74]

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66. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 1 (AM. BAR. ASS'N 2016).

67. MODEL RULES OF PROF'L CONDUCT r. 1.4(a)(3), 1.4(b) (AM. BAR. ASS'N 2016); NAELA ASPIRATIONAL STANDARDS, *supra* note 4, at F3 cmt.

68. NAELA *Aspirational Standards*, *supra* note 4, at 30.

69. MODEL RULES OF PROF'L CONDUCT r. 1.4 cmt. 6 (AM. BAR. ASS'N 2016).

70. NAELA *Aspirational Standards*, *supra* note 4, at 30-31.

71. ABA-APA HANDBOOK, *supra* note 2, at 27.

72. NAELA *Aspirational Standards supra* note 4, at 22.

73. ABA-APA HANDBOOK, *supra* note 2, at 27.

74. *Id.*

- Maintain direct communication with the client, even when the client chooses to involve others in the process, and especially when significant decisions are involved.[75]
- Strive to address clients, whether in person, on the telephone, or through correspondence, in ways they can readily understand. Use plain English rather than legalese or terms of art and use examples that the client can apply to real life situations.[76]
- Interview the client alone to ensure confidentiality and build trust, and consider the important role of support persons. If the client is more at ease with a friend or family member in the room, consider including the support person for a portion of interview or at least during the introductory phase. Talk to the client rather than past the client to others.[77]
- Stress the confidentiality of the relationship, as some older adults may fear losing control of their affairs if they divulge information. Assure the client that information will not be shared with others without prior consent.[78]

Additionally, to strengthen client engagement in the decision-making process, the ABA-APA Handbook suggests the use of Linda F. Smith's "gradual counseling" technique to compensate when a client has diminished capacity, or to compensate for age-related differences in memory and problem-solving ability.[79] To help a client with diminished capacity reach an informed decision, the gradual counseling technique provides a method for inquiring into and understanding the client's decision-making process and assists clients in thinking through their underlying concerns, goals, and values.[80] Ideally, clients are then able to choose a course of action consistent with those concerns, goals, and values.[81] Specifically, the process of gradual counseling:

> involve[s] clarification, reflection, feedback, and further investigation.... Gradual counseling requires the attorney to repeatedly refer to the client's goals and values in assessing each alternative and in discussing the pros and cons of an alternative. This

75. NAELA *Aspirational Standards*, *supra* note 4, at 29.

76. *Id.* at 31.

77. ABA-APA HANDBOOK, *supra* note 2, at 27.

78. *Id.*

79. *Id.* at 29 (citing Linda F. Smith, *Representing the Elderly Client and Addressing the Question of Competence*, 14 J. CONTEMPORARY L. 61 (1988)).

80. *Id.*

81. *Id.*

> will involve a great deal of clarifying and reflecting of the clients' thoughts and feelings….The attorney should proceed to explain each relevant option and elicit the client's reactions.[82]

Using this method, attorneys can help clients identify their goals or problems to be solved, ascertain their values, evaluate the available options and compare to their goals, assess the clients' reaction to each option, and give clients feedback to help make a decision.[83] The gradual counseling approach respects the client's autonomy[84] and is consistent with the goal of keeping the relationship as normal as reasonably possible.

B. Taking the Least Restrictive Action Possible when Acting to Protect a Client

When it is not possible to maintain a normal client-attorney relationship, attorneys have the discretion to take protective action to protect a client with diminished capacity from financial (or other) harm. As ABA Model Rule 1.14(b) provides:

> When the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client…[85]

Lawyers have great latitude in taking appropriate protective measures but must use the least restrictive tool required to act in the client's best interest. Protective measures could include:

> consulting with family members, using a reconsideration period to permit clarification or improvement of circumstances, using voluntary surrogate decision making tools such as durable powers of attorney or consulting with support groups, professional services, adult protective

82. ABA-APA HANDBOOK. (citing Smith, *supra* note 79, at 90, 92).

83. *Id.* at 30. The ABA-APA Handbook cautions that if a client's capacity for the decision is questionable despite these techniques and accommodations, the lawyer may need assistance from a clinician. *Id.*

84. *Id.*

85. MODEL RULES OF PROF'L CONDUCT r. 1.14(b) (AM. BAR. ASS'N 2016); *see also* NAELA ASPIRATIONAL STANDARDS, *supra* note 4, at E-4.

agencies or other individuals or entities that have the ability to protect the client.[86]

ABA Model Rule 1.14 is supplemented by the NAELA Aspirational Standards, which explain that capacity may be "task-specific" and the attorney should determine whether the client has the capacity to perform the task in question before taking any protective action.[87] An attorney may face a situation where, for example, the client visits the attorney to draft a new will and health care directive but seems unfocused and unable to stay on topic.[88] The attorney may believe that the client knows where she wants her money to go after death but may be confused about the meaning of a health care directive.[89] In this example, the NAELA Aspirational Standards instruct the attorney to consider asking the client additional questions to form an opinion about the client's abilities, administering a mental capacity test, or creating the documents and meeting with the client again to see if the client is less confused after seeing the documents.[90] Similarly, an attorney may represent a client with some level of diminished capacity in a FINRA proceeding, but believe that the client is capable of making decisions related to the proceeding, such as whether to engage in mediation or accept a settlement offer. The NAELA Aspirational Standards would apply in this context as well.

While the ABA Model Rules permit lawyers to take protective measures, lawyers should defer to the client's wishes and values to the extent known, keeping in mind the best interest of the client.[91] Lawyers should avoid intruding into the client's decision-making autonomy only to the least extent feasible, and should maximize client capacities while respecting the client's family and social connections.[92] Attorneys should look to two main factors when determining what is in the client's best interest: (1) the client's rights,

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86. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 5 (AM. BAR. ASS'N 2016).

87. NAELA *Aspirational Standards*, *supra* note 4, at 23.

88. *Id.*

89. *Id.*

90. *Id.*

91. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 5 (AM. BAR. ASS'N 2016); *accord* NAELA *Aspirational Standards*, *supra* note 4, at 24.

92. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 5 (AM. BAR. ASS'N 2016); *accord* NAELA *Aspirational Standards*, *supra* note 4, at 24.

remedies, and economic interests, and (2) the extent to which the attorney knows what the client would decide if the client were capable of deciding.[93]

Further, with the goal of taking the least restrictive protective action possible, the lawyer should consider a range of actions other than court proceedings and adult protective services.[94] Attorneys should be mindful of the potential conflict between the attorney's "zealous advocacy" and the client's wishes.[95] This conflict may arise where the attorney has concerns about the client's capacity for decision-making, and thus requires the attorney to choose between the client's wishes or the client's best interests, including client autonomy, safety, independence, financial well-being, healthcare, and personal liberty.[96] To balance these concerns, the attorney should consider several factors, including the type of representation sought by the client, the forum in which the attorney's services are to be provided, and the involvement of other parties in the matter.[97]

In deciding what, if any, type of protective action is appropriate, the attorney should consider family and social connections, which may provide an alternative to protective action or serve as a source of information about the appropriate protective action.[98] Geographically close family and social connections may provide a level of protection for the client and result in less intervention.[99] Attorneys should keep in mind that there are many types of protective actions that may be more effective, less restrictive, and less intrusive than court proceedings or adult protective services, including a cooling-off period, family involvement, and the creation and use of planning documents.[100] The attorney should choose the least restrictive action available that provides the needed level of protection by tailoring the protective action to the degree of the client's incapacity.[101]

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93. NAELA *Aspirational Standards*, *supra* note 4, at 24.

94. *Id.* at 25.

95. *Id.* at 24.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

Finally, lawyers should view guardianship and conservatorship as actions of last resort and only recommend such actions when all other possible alternatives are insufficient.[102] In line with this principle, even when guardianship is the last resort, lawyers should seek a guardianship that is limited and tailored to the client's needs.[103]

C. Disclosing Client Confidences to Protect a Client

Lawyers must be aware of the risks of disclosing the client's confidences and condition and take affirmative steps to limit disclosure in the event that it is necessary. The client-attorney relationship is bounded by the duties of loyalty and confidentiality. Generally, information relating to client representation is protected by ABA Model Rule 1.6, and it may not be disclosed unless authorized.[104] When taking protective action, however, the lawyer is impliedly authorized to make necessary disclosures, even when contrary to the client's instructions.[105]

When a client suffers from diminished capacity and needs some protection, the lawyer may need to disclose some confidential information to a third party.[106] Lawyers should be aware that any disclosure, even limited, could have serious negative consequences for the client, including possible involuntary commitment.[107] Before consulting with other individuals or entities or seeking the appointment of a legal representative, lawyers should determine the likelihood that the person or entity consulted will act adversely to the client's interests.[108]

Therefore, lawyers should "disclose[] client confidences only when essential to taking protective action and to the extent necessary to accomplish the intended protective action."[109] For example, when a lawyer has concerns

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102. *Id.* at 26.

103. *Id.*; *see also* MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 5 (AM. BAR. ASS'N 2016).

104. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 8 (AM. BAR. ASS'N 2016).

105. *Id*.

106. NAELA *Aspirational Standards*, *supra* note 4, at 25.

107. *Id.* at E-6, E-6 cmt; MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 8 (AM. BAR. ASS'N 2016).

108. MODEL RULES OF PROF'L CONDUCT r. 1.14 cmt. 8 (AM. BAR. ASS'N 2016).

109. NAELA *Aspirational Standards*, *supra* note 4, at 25; *accord* MODEL RULES OF

about a client's capacity and the client has previously included his or her children in meetings with the lawyer, and the lawyer has perceived that the children are supportive and interested in the parent's best interest, the lawyer should notify the children of a potential problem before seeking the appointment of a legal representative.

Despite the goal of taking the least restrictive action possible, state law may require lawyers to report misconduct or abuse on behalf of elderly or otherwise vulnerable clients. According to the 2013 Nationwide Survey of Mandatory Reporting Requirements for Elderly and/or Vulnerable Persons, all states have passed statutes requiring or permitting reporting of suspected abuse to the state's Adult Protective Services or law enforcement officials.[110] While only a handful of states single out attorneys as individuals required to report suspected abuse, others require "any person" to report abuse.[111] Attorneys should be aware of the requirements in their jurisdiction, while at the same time being mindful of the duty of confidentiality owed to clients. Lawyers must consider when they have to take steps to protect confidentiality (e.g., through a motion for a protective order or by seeking clarification as to the limits of a mandatory reporting requirement) even in the face of a reporting requirement. This is a complicated and challenging area of law fraught with risk, and lawyers' decisions in this area are not likely to be straightforward.[112]

PROF'L CONDUCT r. 1.14(c) (AM. BAR. ASS'N 2016).

110. NEW YORK COUNTY DISTRICT ATTORNEY'S OFFICE & NATIONAL ADULT PROTECTIVE SERVICES ASSOCIATION (NAPSA) ELDER FINANCIAL EXPLOITATION ADVISORY BOARD, 2013 NATIONWIDE SURVEY OF MANDATORY REPORTING REQUIREMENTS FOR ELDERLY AND/OR VULNERABLE PERSONS, *available at:* http://www.napsa-now.org/wp-content/uploads/2014/11/Mandatory-Reporting-Chart-Updated-FINAL.pdf.

111. *Id.*

112. There are, however, resources available to lawyers in these situations. In addition to guidance from the ABA and NAELA, the SEC's Office of Investor Education and Advocacy and the Consumer Financial Protection Bureau's Office for Older Americans issued an investor bulletin to help investors understand the potential impact of diminished capacity on their ability to make financial decisions and to encourage investors to plan in advance for possible diminished financial capacity. *See* SECURITIES & EXCHANGE COMM'N, INVESTOR BULLETIN AND CONSUMER ADVISORY: PLANNING FOR DIMINISHED CAPACITY AND ILLNESS (June 1, 2015), *available at:* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_illness.html. The bulletin includes links to several resources that lawyers may find helpful if they need to report suspected elder abuse, including appropriate adult protective services agencies, as well as links to resources that may be more familiar to PIABA

CONCLUSION

When working with clients with diminished capacity, lawyers – whether representing clients in FINRA proceedings or in other areas of their practice – must be mindful of their ethical and professional obligations to these vulnerable clients. Lawyers should begin with their jurisdiction's rule on representing clients with diminished capacity, refer to the Four C's of legal ethics, and look to NAELA's Aspirational Standards for guidance, while keeping the relationship as normal as reasonably possible.

attorneys, such as the SEC, FINRA, and state securities regulators. *Id.*

Notes & Observations

KEEPING OUR HOUSES IN ORDER: LAWYERS' OBLIGATIONS CONCERNING OUR OWN OR OUR COLLEAGUES' INABILITY TO COMPETENTLY REPRESENT CLIENTS

Nicole G. Iannarone[*]

Securities arbitration lawyers are well aware of the harms that senior investors with cognitive decline face. Lawyers are not immune to incapacitating conditions that likewise harm clients. Though a lawyer's main focus is typically on the client's decision-making ability, there is no question that lawyers have responsibilities concerning their own potential cognitive decline, disability, or incapacity. Just like clients, lawyers are human and face the same risk of age-related incapacity. The realities of law practice might even make it more likely that lawyers will experience incapacity preventing their continued professional work. Whether lawyers are aware of their own incapacity or not, legal ethics rules require attorneys to take action if an incapacity limits their ability to competently represent clients. Lawyers are also responsible for policing the profession: a lawyer aware of another lawyer's incapacity preventing that attorney from competently practicing is obligated to take action.

This article addresses the ethical duties concerning lawyer incapacity. Part I provides an overview of the risks and realities of law practice that may lead to an incapacity restricting a lawyer's ability to practice. Part II focuses on the individual lawyer, outlining the ethical duties that the lawyer owes to ensure competent representation and the protection of the client's interests should a lawyer no longer be able to meet that standard. Part III shifts the focus to the profession and all lawyers' ethical responsibilities to protect the public by taking action should a fellow member of the bar be unable to competently represent clients. Finally, Part IV discusses the need for individual lawyers and firms to plan for lawyer incapacity.

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I. LAWYERS AND INCAPACITY

Lawyers face multiple risks that can lead to an inability to fully and adequately represent clients, including the passage of time or the interplay between stress and mental well-being. Current age or good health status are not reasons for lawyers to ignore cognitive decline or disability, as both have far reaching implications on the ability to competently represent clients.[1] The risk of diminished capacity increases with age, but age is not the only cause of lawyer impairment. There is a real risk of disability before retirement: "[a]t every age between 22 and 52, [lawyers] are at least twice as likely to become disabled as [they] are to die before reaching age 65."[2] Moreover, the considerable stresses that lawyers face also place them at greater risk of incapacity. There is no question that law is a stressful profession, with rates of depression, anxiety, and suicide in lawyers far exceeding those in the general population.

Studies concerning lawyers' mental and emotional well-being raise significant concerns concerning longevity in the legal profession. One commentator described lawyers as "among the most depressed people in America."[3] In 1999, lawyers' risk of depression was reported to be nearly four times higher than that of the general population, a rate that appears to have remained stable for at least 15 years.[4] Lawyers have the dubious distinction

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1. NOBC-APRL-COLAP SECOND JOINT COMMITTEE ON AGING LAWYERS, FINAL REP. 2 (Apr. 2014) (hereinafter "NOBC FINAL REP.") ("A thirty year old lawyer who has not begun planning for retirement is facing an aging-lawyer issue because some day that lawyer will likely want to retire and should be planning for it now.").

2. CHIEF JUSTICE'S COMMISSION ON PROFESSIONALISM, CONVOCATION ON PROFESSIONALISM, AGING IN THE LAW: IT'S MORE THAN A SENIOR MOMENT PROGRAM MATERIALS, Generational Chart, Active Members of the State Bar of Georgia (November 12, 2014) (on file with author).

3. Patrick J. Schiltz, *On Being a Happy, Healthy, and Ethical Member of an Unhappy, Unhealthy, and Unethical Profession*, 52 VAND. L. REV. 871, 874 (1999). *See also* Lawrence S. Krieger, *Institutional Denial about the Dark Side of Law School, and Fresh Empirical Guidance for Constructively Breaking the Silence*, 52 J. LEGAL EDUC. 112, 114-15 (2002) ("In a 1990 Johns Hopkins study, practicing lawyers ranked highest in major depressive disorder among 104 occupational groups.").

4. *Compare* Schiltz, *supra* note 3 at 874 ("major depressive disorder exists at a rate 3.6 times higher than non-lawyers who shared [lawyers'] key sociodemographic traits.") *with* Rosa Flores & Rose Marie Arce, *Why are Lawyers Killing Themselves*?, CNN (Jan. 20, 2014), http://www.cnn.com/2014/01/19/us/lawyer-suicides/ (last

of ranking fourth in highest rates of suicides by profession.[5] Substance abuse is a substantial problem among lawyers. Some estimate that over "15% of lawyers are alcoholics."[6]

Aging and mental well-being may be related to an increased likelihood of disciplinary actions or malpractice claims.[7] Indeed, there is evidence that impairment, either due to substance abuse or cognitive decline, is involved in a substantial percentage of disciplinary proceedings and malpractice claims against lawyers.[8]

Lawyers' predominant styles of practice indicate that cognitive decline or impairment will become a larger problem. Lawyers in private practice overwhelmingly practice alone or in small firms, with 49% of private practitioners working as solo practitioners[9] and another 14% practicing in firms of two to five attorneys.[10] In addition, lawyers practice longer than prior generations, for reasons as varied as feeling well longer to the need for additional income in retirement.[11] And, unfortunately, most jurisdictions do

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visited May 11, 2016) (same). *See also* Susan Daicoff, *Lawyer, Know Thyself: A Review of Empirical Research on Attorney Attributes Bearing on Professionalism*, 46 AM. U. L. REV. 1337, 1347 (1997) (reporting lawyer rate of depression at 19%).

5. Flores, *supra* note 4. *But see* Krieger, *supra* note 3, at 114-15 (lawyer suicide risk fifth highest among professions).

6. Schiltz, *supra* note 3, at 876. *See also* Daicoff, *supra* note 4, at 1347 (lawyer substance abuse of 15-18% compared to 10-13% in general population).

7. Daicoff, *supra* note 4, at 1423 (lawyer coping mechanisms "are likely to produce … lawyer malpractice resulting from depression or substance abuse.").

8. George Edward Baily, *Impairment, the Profession and your Law Partner*, 15 ME. B.J. 96, 98 (2000); John Freeman, *Turning in Impaired Lawyers for Misconduct*, 15-JAN S.C. LAW. 9 (Jan. 2004) ("a majority of lawyer misconduct cases stem from some form of impairment on the respondent's part, typically alcoholism or drug abuse.").

9. AM. BAR ASS'N, LAWYER DEMOGRAPHICS: YEAR 2015, *available at:* http://www.americanbar.org/content/dam/aba/administrative/market_research/lawyer-demographics-tables-2015.authcheckdam.pdf (last visited May 26, 2016).

10. *Id*.

11. David D. Dodge, *Ethics and the Aging Lawyer*, 50-NOV ARIZ. ATT'Y 12 (Nov. 2013); Martin Cole, *Growing Old Together*, 65-APR BENCH & B. MINN. 16 (Apr. 2008). *See also* Kendra L. Basner, *Aging Population of Lawyers Means Colleagues Need to Keep Watchful Eye*, 30 LAW. MAN. PROF. CONDUCT 637 (Sep. 24, 2014) ("the number of men continuing to work after the age of 65 has increased by 70 percent, the number of women in the workforce over 65 has increased by 110

not affirmatively require individual lawyers or law firms to plan for the possibility of incapacity, disability, or retirement,[12] making it more likely that lawyers in small or solo practices and their clients will suffer disproportionate damage by an incapacitated attorney.

While legal ethics rules do not require lawyers to plan for events that may restrict their ability to practice, they do address lawyers' responsibilities when cognitive impairment prevents competent client representation. Even lawyers who do not suffer from such an impairment have ethical responsibilities when they learn of another lawyer who does. Lawyers, at a minimum, owe their clients the duty to understand the ethical rules that are implicated if either they or their colleagues suffer from some form of a practice-limiting incapacity.

II. LAWYERS' ETHICAL DUTIES TO CLIENTS CONCERNING THEIR OWN INCAPACITY

Lawyers facing diminished capacity or some other incapacity still owe their clients all duties under the relevant legal ethics rules.[13] A lawyer's duties

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percent, and the number of individuals working after the age of 75 has increased by 110 percent.").

12. Over 20 years ago, the American Bar Association issued a formal ethics opinion holding that despite the lack of any specific ethical rule requiring such, solo practitioners should identify and appoint another attorney to take possession of their files and act to protect those clients should the solo practitioner die. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 92-369 (1992). Florida requires attorneys licensed to practice law in Florida to appoint an "inventory attorney" to take action on behalf of an attorney and/or her clients in the event the attorney "is suspended, disbarred, becomes a delinquent member, abandons a practice, disappears, dies, or suffers an involuntary leave of absence due to military service, catastrophic illness, or injury." *See* FLA. BAR RULE r. 1-3.8. Arkansas and Wyoming have bar rules that require sole practitioners to designate another attorney to stand in their shoes in the event of their incapacity, and many jurisdictions continue to investigate implementing similar provisions in light of the impending "senior tsunami." NOBC FINAL REP., *supra* note 1, at 15 n.11. Of particular interest to PIABA members may be the SEC's recent rule proposal that would require investment advisers to adopt business continuity and transition plans. *See* Adviser Business Continuity and Transition Plans, Investment Advisers Act Release No. IA-4439 (June 28, 2016).

13. Each licensing jurisdiction has its own set of ethical rules governing a lawyer's responsibilities. For the remainder of this article, we will focus on the American Bar Association Model Rules of Professional Conduct (hereinafter "ABA Model Rules") which, according to the American Bar Association "serve as models for the ethics

to a client do not cease if he or she becomes incapacitated or impaired. Indeed, as the American Bar Association opined, "[i]mpaired lawyers have the same obligations under the Model Rules as other lawyers."[14]

A. Lawyers Must Provide Competent Representation to Clients

Lawyers owe all clients the fundamental duty of competent representation.[15] Competence is a foundational principle in the client-attorney relationship and "requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."[16] Cognitive impairment or incapacity become potential ethics issues when they impinge on the lawyer's ability to competently represent clients.

Whether temporary or permanent, if a lawyer suffers from impairment preventing competent representation, action is required. The lawyer must cease the representation and not take on additional clients unless and until the condition causing incompetence concludes.[17] This obligation is not found within the competence rule, but instead within the rule concerning the circumstances under which a lawyer is either required or permitted to withdraw from representing a client, ABA Model Rule 1.16.[18] This rule has been described by one expert as a complement to the fundamental duties that lawyers owe clients, like competence, and "a reminder to lawyer and client alike that they must continually communicate with each other and monitor their relationship."[19]

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rules of most states." MODEL RULES OF PROF'L CONDUCT, AM. BAR ASS'N, http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct.html (last visited May 24, 2016). Lawyers are cautioned, however, to ensure that they follow the rules enacted in their licensing jurisdiction(s).

14. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003).

15. MODEL RULES OF PROF'L CONDUCT r. 1.1 (AM. BAR ASS'N 2016).

16. *Id*.

17. MODEL RULES OF PROF'L CONDUCT r. 1.16(a) (AM. BAR ASS'N 2016).

18. *See* MODEL RULES OF PROF'L CONDUCT r. 1.16 (AM. BAR ASS'N 2016).

19. GEOFFREY C. HAZARD ET AL., THE LAW OF LAWYERING (4th Ed. 2016) §21.02 at 21-4.

B. The Lawyer's Responsibility to Withdraw if Impairment Precludes the Provision of Competent Legal Services

ABA Model Rule 1.16 contains two provisions that may prohibit a lawyer suffering from some form of cognitive incapacity or other impairment from continuing to represent the client. First, ABA Model Rule 1.16(a)(2) provides a specific provision requiring that a lawyer withdraw from a representation and accept no further clients if "the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client."[20] This result is required because "[s]uch a lawyer by definition could not provide the competent or diligent representation required by [Model] Rules 1.1 and 1.3."[21]

At first blush, the mandate of ABA Model Rule 1.16(a)(2) seems to be extremely prohibitive when applied to lawyers' ability to practice. A close reading of the provision makes clear, however, that withdrawal is only required if the condition "materially" impacts the lawyer's provision of legal advice.[22] Thus, the provision attempts to strike a balance, permitting representation so long as a client's interests are not at significant risk.[23] The provision in that sense also implicates the legal profession's obligations to the public at large, ensuring that lawyers only practice if they have the requisite capacity to do so.

Even if the specific language of ABA Model Rule 1.16(a)(2) does not require a lawyer's withdrawal, a second, more general provision of the rule might. ABA Model Rule 1.16(a)(1) contains a substantially broader provision than its counterpart in 1.16(a)(2), serving as a catchall to prevent lawyers from assisting clients who ask their lawyer to behave illegally or unethically or to prevent any other potential violations of the ethics rules.[24] Under ABA Model Rule 1.16(a)(1), lawyers are not permitted to undertake a new client engagement or continue representing a client if "the representation

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20. MODEL RULES OF PROF'L CONDUCT r. 1.16(a)(2) (AM. BAR ASS'N 2016).

21. Hazard et al., *supra* note 19, §21.04 at 21-7; *see also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §31(2)(d) (2000) (lawyer loses authority to act on behalf of client if, among other things, lawyer "becomes physically or mentally incapable of providing representation.").

22. MODEL RULES OF PROF'L CONDUCT r. 1.16(a)(2) (AM. BAR ASS'N 2016).

23. Freeman, *supra* note 8, at 10 (noting South Carolina equivalent of Model Rule 1.16(a)(2) "is targeted at protecting clients, as well as the legal system's integrity.").

24. Hazard et al., *supra* note 19, §21.04 at 21.8-21.9.

will result in a violation of the rules of professional conduct or other law."[25]

While ABA Model Rule 1.16(a)(2) is sufficiently clear to prohibit cognitively incapacitated attorneys from continuing to represent clients when a client's interests are at risk, the broader provision could come into play in some of the gray areas where there is no diagnosed illness, incapacity, or disability but clients are nevertheless at risk and the representation is materially affected. For instance, the provision has been invoked when lawyers simply cannot handle their caseloads even when there is no suggestion of any illness or disability that prevents them from doing so.[26]

C. Protecting the Client's Interests Post-Withdrawal

Though a lawyer has an obligation to withdraw and loses actual authority to represent a client when lacking the capacity to competently complete the representation, withdrawal requires more than simply walking away from a case. Withdrawal does not extinguish duties that the lawyer owes to the client as a fiduciary.[27] Thus, even if required to withdraw under ABA Model Rule 1.16, the lawyer must still "take steps to the extent reasonably practicable to protect a client's interests."[28]

Protecting the client's interests includes ensuring that the client receives "reasonable notice" of the withdrawal, allowing time for the client to secure other counsel, obtain the necessary papers, and receive back any unearned fee paid in advance to the attorney.[29] The lawyer must also take steps to ensure

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25. MODEL RULES OF PROF'L CONDUCT r. 1.16(a)(1) (AM. BAR ASS'N 2016).

26. *See, e.g.,* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 06-411 (2006) ("If a lawyer's workload is such that the lawyer is unable to provide competent and diligent representation to existing or potential clients, the lawyer should not accept new clients. If the problem of an excessive workload cannot be resolved through the non-acceptance of new clients or by other available measures, the lawyer should move to withdraw as counsel in existing cases to the extent necessary to bring the workload down to a manageable level, while at all times attempting to limit the prejudice to any client from whose case the lawyer has withdrawn.").

27. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 92-369 (1992) ("the lawyer's fiduciary obligations of loyalty and confidentiality continue beyond the termination of the agency relationship.").

28. MODEL RULES OF PROF'L CONDUCT r. 1.16(d) (AM. BAR ASS'N 2016).

29. *Id*.

that others, including the client, opposing counsel, and the tribunal, are aware that the lawyer has withdrawn from the representation and does not act on behalf of the client.[30] In the event the lawyer represents a client in a proceeding before a tribunal, which by definition includes a FINRA arbitration proceeding,[31] the lawyer is required to provide notice and seek permission before withdrawing if the tribunal has such a requirement.[32]

III. RESPONSIBILITIES OF THE BAR TO ACT WHEN AWARE OF ANOTHER LAWYER'S INABILITY TO COMPETENTLY REPRESENT CLIENTS

Sometimes lawyers are unaware of their own incapacity and do not take the requisite steps to terminate the representation. Other lawyers fail to take any action even when aware of their own incapacity, for reasons as varied as fear, the competitive nature of law practice, or embarrassment.[33] Knowledge of an incapacity affecting competence is not an essential element of a disciplinary claim. Bar disciplinary authorities may discipline lawyers who are unaware of a practice limiting impairment. In addition, lawyers may be required to act if they know a fellow lawyer's incapacity prevents the lawyer from competently serving clients.

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30. MODEL RULES OF PROF'L CONDUCT r.1.16(c),(d) (AM. BAR ASS'N 2016). *See also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §31 (2000), Comment i ("When a lawyer's actual authority ends, the lawyer must no longer purport to exercise authority and must notify persons who the lawyer reasonably should know are relying on continuing existence of the authority"); MODEL RULES OF PROF'L CONDUCT r. 1.4(a)(3) (AM. BAR ASS'N 2016) ("A lawyer shall …keep the client reasonably informed about the status of the matter").

31. MODEL RULES OF PROF'L CONDUCT r. 1.0(m) (AM. BAR ASS'N 2016) (defining "tribunal" as including "an arbitrator in a binding arbitration proceeding").

32. MODEL RULES OF PROF'L CONDUCT r. 1.16(c) (AM. BAR ASS'N 2016).

33. Judith Rush & Pat Burns, *Our Ethical Responsibility to Help Ourselves and our Colleagues*, BENCH & B. OF MINN. (Mar. 2016). *See also* Laura Rothstein, *Law Students and Lawyers with Mental Health and Substance Abuse Problems: Protecting the Public and the Individual*, 69 U. PITT. L. REV. 531, 533 (2008) ("[b]ecause of the high stakes involved in the legal profession and the stigma attached to mental illness and substance abuse problems, individuals with these problems are often reluctant to seek help.").

A. Impaired Lawyers Are Subject to Discipline to Protect the Public

There is an old adage that ignorance of the law is no excuse. Lawyers lacking the capacity to determine that they are not competent to represent clients remain subject to discipline whether or not they are aware of their incapacity.[34] "Simply stated, mental impairment does not lessen a lawyer's obligation to provide clients with competent representation."[35] Since one of the aims of the lawyer disciplinary system is the protection of clients,[36] this intuitively makes sense: as a self-regulating profession, the legal profession should act when a lawyer may be harming clients.[37]

The ABA Model Rules do not require that the lawyer be aware of an incapacity and resultant lack of competence before requiring the lawyer to withdraw from a representation.[38] If a lawyer continues to represent clients when an incapacity renders competent representation impossible, the lawyer is subject to discipline up to disbarment.[39]

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34. *See, e.g.,* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003) ("Unfortunately, the lawyer who suffers from an impairment may be unaware of, or in denial of, the fact that the impairment has affected his ability to represent clients.").

35. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003).

36. ABA STANDARDS FOR IMPOSING LAWYER SANCTIONS 1.1 ("The purpose of lawyer discipline proceedings is to protect the public and the administration of justice from lawyers who have not discharged, will not discharge, or are unlikely to properly discharge their professional duties to clients, the public, the legal system and the legal profession.").

37. MODEL RULES OF PROF'L CONDUCT, Preamble at [12] (AM. BAR ASS'N 2016) ("The legal profession's relative autonomy carries with it special responsibilities of self-government. The profession has a responsibility to assure that its regulations are conceived in the public interest …").

38. *See* MODEL RULES OF PROF'L CONDUCT r. 1.16 (AM. BAR ASS'N 2016) (containing no knowledge requirement).

39. *See, e.g.,* ABA STANDARDS FOR IMPOSING LAWYER SANCTIONS 4.51 ("Disbarment is generally appropriate when a lawyer's course of conduct demonstrates that the lawyer does not understand the most fundamental legal doctrines or procedures, and the lawyer's conduct causes injury or potential injury to a client.").

B. *Obligations of Lawyers Aware of a Colleague's Impairment Materially Impacting His or Her Ability to Competently Represent Clients*

Attorney discipline is a drastic step and unlikely to be the first course of action related to an attorney who is practicing despite a condition making competent representation impossible. The signs of an individual lawyer's cognitive impairment are likely to be witnessed by another lawyer, either within or outside the same firm, before such symptoms become known to a client (if a client is ever aware of them) or bar disciplinary authorities.[40] Lawyers may not turn a blind eye if they become aware of another lawyer who is no longer able to competently practice. The American Bar Association has twice addressed how lawyers who become aware of another lawyer's impairment must act.[41] The obligations differ slightly depending on whether the lawyer with knowledge practices in a firm with the potentially impaired lawyer.

1. Lawyers Practicing Within the Same Firm

Lawyers practicing in the same firm have a number of ethical obligations mandating action if they become aware that a lawyer in their practice may be experiencing cognitive decline or impairment.[42] As an initial matter, partners and supervisory lawyers have a responsibility under ABA Model Rule 5.1 to ensure that they have instituted procedures for ensuring that ethical rules are followed. Thus, under ABA Model Rule 5.1, partners and lawyers with similar supervisory authority must "make 'reasonable efforts' to establish internal policies and procedures designed to provide 'reasonable assurance' that all

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40. Eileen Libby, *Sharing the Consequences: A Lawyer's Mental Impairment Raises Ethics Issues for Other Members of the Firm*, ABA J. (July 2003) ("When mental impairment overtakes a lawyer, firm partners or supervisors often recognize the problem even before their suffering colleague is able or willing to acknowledge it.").

41. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-431 (Aug. 8, 2003); ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003).

42. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003). *See also* Douglas R. Richmond, *Law Firm Partner as Their Brothers' Keepers*, 96 KY. L.J. 231 (2008) (describing full scope of law partners' responsibilities concerning overseeing their colleagues' ethical behaviors within a law firm, whether related to impairment or other violations of ethics rules).

lawyers in the firm, not just lawyers known to be impaired, fulfill the requirements of the ABA Model Rules."[43] This requirement exists to ensure that a firm has a system in place for protecting its clients.[44]

ABA Model Rule 5.1 does not proscribe any particular policies or procedures that a firm must implement, instead giving firms flexibility based upon the particularities of their firm to implement something that provides the requisite assurances of compliance with ethical rules.[45] Defining this obligation in the context of lawyers with potentially diminished capacity to practice law, the ABA simply notes that "[t]he firm's paramount obligation is to take steps to protect the interests of its clients."[46] Such steps could include consulting with a medical professional to obtain additional information to assess the lawyer's ability to practice law, confronting the attorney, urging the attorney to accept help, and, where practicable, making appropriate accommodations or implementing safeguards so the impaired attorney can continue to practice.[47]

The firm must, however, prevent impaired attorneys from representing clients if the attorney cannot satisfy all ethical duties to a client.[48] Should firm partners or supervisory lawyers fail to implement reasonable practices or take action when they are aware of their colleague's impairment making it impossible for that lawyer to competently represent clients, the supervisory lawyers could themselves be liable for an ethical violation.[49]

Partners and other managerial lawyers in a firm are not the only lawyers required to act when they have knowledge that another lawyer's incapacity has resulted in harm to clients. Any lawyer within the firm who becomes aware

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43. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003) (citing MODEL RULES OF PROF'L CONDUCT r. 5.1 (AM. BAR ASS'N, 2016)).

44. *Id*.

45. *Id*.

46. *Id*.

47. *Id*.

48. *Id*.

49. MODEL RULES OF PROF'L CONDUCT r. 5.1(c) (AM. BAR ASS'N, 2016) ("A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if (1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or (2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.").

of another lawyer's ethical violations as a result of diminished capacity or some other impairment might be required to report their colleague under ABA Model Rule 8.3.[50] Under that rule,

> a lawyer who ***knows*** that another lawyer ***has committed*** a violation of the Rules of Professional Conduct ***that raises a substantial question*** as to that lawyer's honesty, trustworthiness or ***fitness as a lawyer*** in other respects, ***shall inform*** the appropriate professional authority.[51]

ABA Model Rule 8.3 has many component parts, each of which must be satisfied before reporting is required. Actual knowledge of an ethics violation is required, as is a continuing threat to the lawyer's ability to continue to practice.[52]

Even if a lawyer determines that conduct is reportable under ABA Model Rule 8.3, it is worth noting that the ABA Model Rules are not binding authority. The ABA Model Rules are persuasive and promulgated for states to consider when enacting their own regulatory schemes. Some, but not all, states have enacted ABA Model Rule 8.3 exactly as the ABA drafted it. Others have opted to make the reporting duty permissive rather than mandatory.[53] Accordingly, lawyers must be sure to consult the applicable rules in their jurisdiction before taking any action.

Finally, obligations concerning an impaired lawyer do not end simply because the impaired lawyer leaves the firm. Firm lawyers may also be

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50. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003).

51. MODEL RULES OF PROF'L CONDUCT r. 8.3(a) (AM. BAR ASS'N, 2016) (emphasis added).

52. *Id*. *See also* Kansas Bar Ass'n Legal Ethics, Op. No. 14-01 (2014) ("A lawyer is not required to report another lawyer to the Disciplinary Administrator unless the lawyer has knowledge of an action, inaction or conduct of the other lawyer which constitutes misconduct under the Kansas Rules of Professional Conduct. Rather, in the event there are memory lapses, cognitive deteriorations, or other potentially disabling conditions, the subject lawyer should be referred to the Kansas Lawyers Assistance Program or other suitable service."); S.C. Bar Ethics Advisory Comm., Op. 02-13 (2002); Utah Ethics Advisory Comm., Op. 98-12 (1998) ("A lawyer is required to report…any unlawful possession or use of controlled substances by another lawyer if two conditions are satisfied: (1) the lawyer has actual knowledge of the illegal use or possession, and (2) the lawyer has a reasonable, good-faith belief that the illegal use or possession raises a substantial question as to the offending lawyer's honesty, trustworthiness or fitness as a lawyer in other respects.").

53. *See, e.g.*, GEORGIA RULES OF PROF'L CONDUCT r. 8.3(a) (2016) (lawyers should, but not must, report misconduct).

required to provide information to clients pursuant to ABA Model Rule 1.4 (Communication) and explain any changes to the lawyers handling the clients' matters.[54] This is particularly so if the impaired attorney is leaving the firm, firm clients are determining whether to go with that attorney or to remain with the firm, and the firm is aware of a continuing concern with the departing lawyer's ability to competently represent clients.[55] Such an obligation does not exist, however, if the clients have already decided to move to the departing lawyer's new firm.[56] In that case, the firm "should avoid any communication with former clients who have transferred their representation to the departed lawyer that can be interpreted as an endorsement of the ability of the departed lawyer to handle the matter."[57]

2. Lawyers not Practicing Together

Lawyers working together in firms are not the only lawyers required to take some action when faced with knowledge that another lawyer's impairment prevents that lawyer from competently representing clients. Lawyers who do not practice in the same firm also have ethical obligations under ABA Model Rule 8.3 if they become aware that another lawyer suffers from an impairment that resulted in an ethical violation materially affecting his or her ability to adequately represent clients. In a formal ethics opinion issued just two months after commenting on lawyers' obligations concerning impaired lawyers within the same firm, the ABA opined that "[a] lawyer who believes that another lawyer's mental condition materially impairs her ability to represent clients, and who knows that the lawyer continues to do so, must report that lawyer's consequent violation of Rule 1.16(a)(2), which requires that she withdraw from the representation of clients."[58]

Lawyers are not required to take on the role of medical professionals. But they cannot "shut [their] eyes to conduct reflecting generally recognized symptoms of impairment (e.g., patterns of memory lapse or inexplicable

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54. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-429 (June 11, 2003).

55. *Id*.

56. *Id*.

57. *Id*.

58. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 03-431 (Aug. 8, 2003).

behavior not typical of the subject lawyer, such as repeated missed deadlines.)."[59] Lawyers witnessing another lawyer's potential impairment should consider several courses of action, including seeking the advice of a health care professional, speaking with the lawyer in question, or seeking assistance from a lawyer assistance program.[60] Alternatively, the lawyer can attempt to speak with another lawyer in the affected lawyer's firm and ask the firm to take responsibility for addressing the issue in a responsible fashion.[61]

A lawyer could conclude, after taking these steps, that there is no conduct to report under Model Rule 8.3 and that the situation is resolved.[62] The ABA cautions, however, that a concerned lawyer should not rely simply on the potentially impaired lawyer's denials and claims that the issue has been resolved.[63] The lawyer must instead determine whether the lawyer's conduct reaches a reportable level under Model Rule 8.3 and if it was an isolated incident or otherwise will not result in harm to clients.[64]

IV. Lawyers and Firms Should Plan for Potential Incapacity

Attorney cognitive decline or impairment is a sobering topic and the reactive approach of addressing the problem only after an attorney is no longer able to represent clients (or has actually harmed a client) is anything but satisfactory. Lawyers owe it to their clients and their colleagues to put in place a plan to mitigate the burdens and responsibilities of lawyer incapacity now. In fact, experts recommend that law firms develop a response plan for attorney incapacity.[65] Each firm's plan should be specific to its own culture and needs. Though difficult, the conversation with friends and family about how lawyers plan to address their potential inability to continue representing clients is

59. *Id*.

60. *Id.*

61. *Id*.

62. *Id.*

63. *Id*.

64. *Id*.

65. Kendra L. Basner, *Aging Population of Lawyers Means Colleagues Need to Keep Watchful Eye*, 30 LAW. MAN. PROF. CONDUCT 637 (Sep. 24, 2014) (outlining steps lawyers should take when faced with another lawyer's cognitive decline).

preferable to the even more difficult situation colleagues and families will face if no provisions are made.

In addition, as part of a self-regulating profession aware of the potential harms, lawyers should work within their licensing jurisdictions to advocate for more education and specific ethics rules tailored to better address attorney cognitive impairment. As one example of such education, the Supreme Court of Georgia Chief Justice's Commission on Professionalism made education about attorney cognitive decline the focus of its 2014 Convocation on Professionalism, bringing together leading doctors and researchers to present the medical data, inviting a prominent attorney to share his own experiences with a diagnosis of mild cognitive impairment, and asking experts to discuss the relevant ethical issues.

For a regulatory example, one can look to the 2015 trio of changes that South Carolina adopted to address impaired attorneys. First, South Carolina's ethics rules were amended to add a specific provision requiring partners and managers within a law firm to act if they "reasonably believe that a lawyer in the law firm may be suffering from a significant impairment of that lawyer's cognitive function."[66] In conjunction with this rule change, the state also added a provision by which lawyers can seek assistance in addressing an impaired attorney, including allowing the state bar president authority to appoint "Attorneys to Intervene."[67] Such appointed intervenors "shall attempt to meet with the lawyer alleged to be impaired and, if in the best interest of both the lawyer and the public, propose a course of conduct to be followed."[68] Finally, South Carolina amended its Canons of Judicial Conduct to require that judges who become aware of another lawyer's impairment, whether due to substance abuse or illness, take action.[69] This tripartite approach, while requiring lawyers and judges to act, also balances the needs of the attorney and the public and seeks to ensure that potential issues concerning an attorney's ability to competently represent clients are addressed and resolved in an expedient manner.

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66. S.C. RULES OF PROF'L CONDUCT, r. 5.1(d) (2016).

67. S.C. APP. CT. R. 428(a) (2015).

68. *Id.*

69. S.C. CANONS OF JUDICIAL CONDUCT Canon 3(G) (2016).

CONCLUSION

Recognizing that everyone is at risk of incapacity, lawyers must be prepared for their own potential inability to practice and institute appropriate plans. These plans should include understanding the ethical responsibilities owed to clients and the profession. Lawyers should also be prepared to respond should one of their colleagues, either within or outside the firm, suffer from an incapacity impacting his or her ability to practice. And, finally, as members of a self-regulated profession, lawyers must take steps to provide their colleagues with guidance and assistance through appropriate rule making, education, and support.

USING INVESTOR ALERTS TO STRENGTHEN SECURITES ARBITRATION CLAIMS INVOLVING FIXED INCOME SECURITIES

Michael B. Engdahl, JD, MS, CFP®[1]

In my 2015 PIABA Bar Journal article, titled "Using Investor Alerts to Strengthen Securities Arbitration Claims,"[2] I explained how and why reference to relevant investor alerts issued by the U.S. Securities & Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), and North American Securities Administrators Association (NASAA) can strengthen an investor's legal claim in securities arbitration. My 2015 article also summarized twelve important investor alerts that were issued over the past dozen years.

This article will describe the investor alerts issued by the aforementioned three organizations and provide an update on how to locate investor alerts. Also, this article will summarize six important investor alerts regarding fixed income securities that have been issued over the past several years. Furthermore, this article will discuss the relevance of each summarized investor alert and its potential for strengthening an investor's legal claim.

I. INTRODUCTION INVESTOR ALERTS

The SEC, FINRA, and NASAA each publish investor alerts. The following provides a brief overview of each organization's investor alerts as well as updated instructions regarding locating investor alerts.

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2. Michael B. Engdahl, *Using Investor Alerts to Strengthen Securities Arbitration Claims*, 22 PIABA B.J. 97-120 (2015).

A. *SEC Investor Alerts and Bulletins*

The SEC issues Investor Alerts and Bulletins through its Office of Investor Education and Advocacy. The SEC describes the focus and legal effect of its Investor Alerts and Bulletins as follows:

The SEC's Office of Investor Education of Advocacy provides a variety of services and tools to address problems you may face as an investor. Investor Alerts, focused on recent investment frauds and scams, and Investor Bulletins, focused on topical issues including recent Commission actions, are provided as a service to investors. They are neither legal interpretations nor statements of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult an attorney who specializes in securities law.[3]

Also, the SEC Office of Investor Education and Advocacy's homepage contains the following language:

> The SEC Office of Investor Education and Advocacy provides a variety of services and tools to address the problems and questions you may face as an investor. We cannot tell you what investments to make, but we can help you to invest wisely and avoid fraud.[4]

Therefore, it is reasonable to conclude that, even though SEC Investor Alerts and Bulletins are neither legal interpretations nor statements of SEC policy, they are issued in order to assist investors with investing wisely and avoiding fraud.

Individuals can find SEC Investor Alerts and Bulletins by taking the following steps:

1. go to www.sec.gov
2. left click on "Investors"
3. left click on "Investor Alerts and Bulletins"

The SEC began issuing Investor Alerts and Bulletins in 1998, and there are well over 100 Investor Alerts and Bulletins posted on the SEC's website. The issuance date of the Investor Alert or Bulletin is included within each Investor Alert or Bulletin, and the Investor Alerts and Bulletins are listed in chronological order of issuance. Individuals can also search for a particular Investor Alert or Bulletin by entering a keyword or phrase.

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3. The SEC's Investor Alerts and Bulletins homepage can be viewed at SEC, http://www.sec.gov/investor/alerts#.VAxclid1HLs (last visited Aug. 7, 2016).

4. The SEC's Office of Investor Education and Advocacy homepage can be viewed at SEC, http://www.sec.gov/oiea#.VAxel1d1HLs (last visited Aug. 7, 2016).

B. *FINRA Investor Alerts*

FINRA is a non-governmental self-regulatory organization that regulates its member brokerage firms. Its website contains over 100 Investor Alerts dating back to 2001. FINRA has posted the date on which the Investor Alert was last updated at the bottom of most Investor Alerts. The Investor Alerts can be found under the name of one or more of the 12 FINRA Investor Alert categories. The categories are as follows:

- 529 Plans
- Annuities and Insurance
- Bonds
- Frauds and Scams
- Margin and Borrowing
- Money Management
- Mutual Funds and ETFs
- Private Offerings
- Promissory Notes
- Real Estate Investment Trusts (REITs)
- Retirement Accounts
- Trading Securities

Individuals can find FINRA Investor Alerts by taking the following steps:

1. go to www.finra.org
2. left click on "SEE ALL INVESTOR ALERTS"

C. *NASAA Investor Alerts and Tips*

NASAA is the oldest international organization devoted to investor protection. It is a voluntary association whose membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.[5] NASAA's website contains approximately 40 Investor Alerts and Tips. Most Investor Alerts and Tips contain the month and year when the Investor Alert or Tip was issued or updated.

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5. Information regarding NASAA's role and history can be found on its website: http://www.nasaa.org (last visited Aug. 7, 2016).

Individuals can find NASAA Investor Alerts and Tips by taking the following steps:

1. go to www.nasaa.org
2. left click on "Investor Education"
3. left click on "Investor Alerts & Tips"

II. IMPORTANT INVESTOR ALERTS AND THEIR POTENTIAL FOR STRENGTHENING SECURITIES ARBITRATION CLAIMS INVOLVING FIXED INCOME SECURITIES

Below is a summary of several investor alerts that claimant attorneys may find useful in securities arbitration cases involving fixed income securities:

A. *Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio (FINRA – Last Updated February 14, 2013)*

Given the fact that we are currently near historic interest rate lows, a future increase in interest rates and corresponding decline in bond and bond mutual fund prices is a real possibility. Recently, FINRA issued an Investor Alert, titled "Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio."[6]

Bonds are subject to interest rate risk. Interest rate risk is the risk that the price of bonds will fluctuate when interest rates go up and down. An inverse relationship exists between the price of bonds and interest rates. In other words, when interest rates decline, the price of bonds usually increases. Also, when interest rates increase, the price of bonds usually declines. Nearly all bonds are subject to this risk. However, bonds with high durations are more subject to interest rate risk than bonds with low durations.

Duration provides a time-weighted measure of a bond's cash flows in terms of payback. It is defined as the average time it takes a bondholder to receive the interest and principal from a bond in present value dollars.[7] Knowing a bond's duration can greatly aid an investor with measuring a

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6. *Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio*, FINRA (Feb. 14, 2013), http://www.finra.org/investors/alerts/duration-what-interest-rate-hike-could-do-your-bond-portfolio (last visited Sep. 15, 2016).

7. DALTON, MICHAEL A. ET AL., PERSONAL FINANCIAL PLANNING THEORY AND PRACTICE 545 (Kaplan Schweser ed., 8th ed. 2014).

bond's potential price volatility. The following formula provides an estimate, based on the duration and change in market interest rates, of the percentage change in the price of a bond:

> **Estimated % Change in the Price of a Bond** = [- Duration / 1 + Yield to Maturity] x Change in Yield to Maturity as a Decimal[8]

For example, suppose an investor wants to estimate how much the price of a bond with a current value of $1,050 and a duration of 5.5 years would decrease if interest rates (as measured by the bond's yield to maturity) increased from 4% to 5%. The answer is as follows:

> **Estimated % Change in the Price of the Bond** = [-5.5/1.04] x .01 = -.0529 = - 5.29%. Therefore, the bond's price should decrease by approximately 5.29%, resulting in a new price of $994.46 ($1,050 x .9471).

In its Investor Alert, FINRA states the following:

> Currently, interest rates are hovering near historic lows. Many economists believe interest rates are not likely to get much lower and will eventually rise. If that is true, then outstanding bonds, particularly those with a low interest rate and high duration may experience significant price drops as interest rates rise along the way. If you have money in a bond fund that holds primarily long-term bonds, expect the value of that fund to decline, perhaps significantly when interest rates rise.[9]

It is important to note that FINRA also states that "just because a bond or bond fund's duration is low, it does not mean your investment is risk-free. In addition to duration risk, bonds and bond funds are subject to inflation risk, call risk, default risk, and other risk factors."[10]

Reference to this Investor Alert may strengthen an investor's claim when an investor has suffered losses from a bond or bond fund due to an increase in interest rates and his or her financial advisor's recommendation to place money in the bond or bond fund was unsuitable or imprudent. This may be the case when the investor's expected investment time horizon is shorter than

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8. *Id.* at 548.

9. *Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio*, FINRA (Feb. 14, 2013), http://www.finra.org/investors/alerts/duration-what-interest-rate-hike-could-do-your-bond-portfolio (last visited Sep. 15, 2016).

10. *Id.*

the bond or bond fund's duration. Moreover, reference to this Investor Alert may aid the investor in refuting a financial advisor's potential defense that he or she should not be held liable for the investor's losses since the drop in the price of the bond or bond fund from an increase in interest rates was unforeseen. FINRA's Investor Alert communicates a clear expectation that an increase in interest rates will cause the price of bonds and bond funds to decline.

B. *NASAA Cautions Investors Not to Stumble When Interest Rates Fall Flat (NASAA – Issuance Date: February 1, 2012)*

Shortly after the Federal Reserve's announcement in early 2012 that interest rates are expected to remain low until at least late 2014, NASAA issued an Investor Alert, titled "NASAA Cautions Investors Not to Stumble When Interest Rates Fall Flat."[11] In the Investor Alert, NASAA cautions investors to be aware of risky or fraudulent investments promising higher yields or returns. According to Jack Herstein, NASAA President and Assistant Director of the Nebraska Department of Banking & Finance Bureau of Securities, "investors are running away from low yields on fixed investment products and stumbling into the arms of unscrupulous salespeople promising low risk and high returns."[12]

The Investor Alert also emphasizes that securities regulators are concerned that seniors, who depend on the income from fixed income investments, may be tempted to invest in risky alternative investments promising higher returns as opposed to safe, slower growing investments. Additionally, in the Investor Alert, NASAA states that risk and return are positively correlated. According to Herstein, "when evaluating any investment, it pays to remember that risk and reward go together. Anyone promising high yield or high returns with little or no risk should be approached with a high degree of skepticism."[13]

Furthermore, NASAA recommends that, before purchasing any investment, investors ask the following questions:

Are the claims made for the investment realistic? NASAA recommends that investors use common sense and seek the advice of a

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11. *NASAA Cautions Investors Not to Stumble When Interest Rates Fall Flat*, NASAA (Feb. 1, 2012), http://nasaa.org/10146/nasaa-cautions-investors-not-to-stumble-when-interest-rates-fall-flat (last visited Sep. 15, 2016).

12. *Id.*

13. *Id.*

professional third-party when presented with investment opportunities that appear to offer unusually high returns.

Has the seller provided written information that fully explains the investment? NASAA recommends that investors request a prospectus or offering circular that clearly and accurately describes the particulars of the investment.

Is the seller licensed and the investment registered in the investor's state? If the seller is not properly licensed and the investment is not properly registered, then the seller may be operating illegally.[14]

Reference to this Investor Alert may strengthen an investor's claim anytime an investor was sold an unsuitable high-risk investment, particularly if salesperson did not adequately disclose the risks of the investment to the investor. In the Investor Alert, NASAA clearly acknowledges that there is a problem with some unscrupulous salespeople recommending purportedly high-returning investments without adequately disclosing the risks inherent in those products.

C. *High Yield Investment Programs —HYIPs Are Hazardous to Your Investment Portfolio (FINRA – Last Updated: July 15, 2010)*

In 2010, FINRA issued an Investor Alert titled "HYIPs—High Yield Investment Programs Are Hazardous to Your Investment Portfolio."[15] FINRA issued the Investor Alert to warn investors to stay away from HYIPs.

According to FINRA, HYIPs are unregistered investments created and touted by unlicensed individuals. HYIPs are typically misrepresented as "safe" investments even though they promise unsustainable rates of return (e.g., 20, 30, 100 or more percent *per day*) through mysterious trading strategies. Many HYIPs operate as Ponzi schemes. Therefore, they use cash inflows from today's recruits to make "interest payments" to yesterday's investors or pay "referral fees" to those who recruit new investors.[16]

In the Investor Alert, FINRA also states that HYIPs use Web sites and social media, including YouTube, Twitter, and Facebook, to lure new

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14. *Id.*

15. *HYIPs—High Yield Investment Programs Are Hazardous to Your Investment Portfolio*, FINRA (July 15, 2010), http://www.finra.org/investors/alerts/hyips—high-yield-investment-programs-are-hazardous-your-investment-portfolio (last visited Sep. 15, 2016).

16. *Id.*

investors. In addition to promising unsustainable rates of return, fraudsters often try to create the illusion of social consensus to suggest that everyone is in investing in HYIPs. Therefore, they must be safe and legitimate investments.[17]

According to FINRA, the following may be signs of an HYIP scam:

Promises of High and Unsustainable Yields. According to FINRA, when the Investor Alert was issued in 2010, the current yield on many investment-grade bonds was less than three percent, and historical long-term average annual rate of return on large-company stocks was less than 10 percent.

Unclear Methodology for Achieving Returns. Most HYIP sites do not clearly state how the promised returns will be generated.

Lack of Concrete Information Regarding The HYIP Operator. Most HYIP sites give no clues as to who will be managing the money.

Off-Shore Operations. Many HYIP sites are located outside the U.S.

Reliance on E-Currency Sites. Virtually all HYIP sites require the investor to open an e-currency account.

Incentives to Recruit New Investors. Many HYIP schemes pay a referral fee to individuals who bring new investors into the program.

Typos and Poor Grammar. Many HYIP sites are riddled with typos and poor grammar.[18]

Reference to this Investor Alert may strengthen an investor's claim when an investor suffered financial damages resulting from an HYIP. The Investor Alert does an adequate job explaining an HYIP. Therefore, the attorney for the investor may want to consider quoting some of the language in the Investor Alert when describing an HYIP in the statement of claim.

D. *Municipal Bonds—Important Considerations for Individual Investors (FINRA – Last Updated: April 24, 2013)*

Municipal bonds are bonds issued by state and local governments. Interest income received from municipal bonds is exempt from federal income taxation. Interest income received from municipal bonds is also exempt from income taxation in the issuing state. For example, a New York resident who purchases a New York municipal bond will not owe federal or state taxes on income received from the bond. However, if a New York resident purchases

17. *Id.*

18. *Id.*

a Pennsylvania municipal bond, the income received from the bond may be subject to New York taxes.

Because of their favorable income tax treatment, municipal bonds generally have lower yields than comparable credit-worthy corporate bonds. In order to determine whether a municipal bond or comparable credit-worthy corporate bond is preferable, investors should compute the taxable equivalent yield. The taxable equivalent yield formula is as follows:

Taxable equivalent yield = Tax-exempt yield / 1 – marginal tax rate[19]

All other things being equal, if the taxable bond yield (credit-worthy corporate bond yield) exceeds the taxable equivalent yield, the investor should purchase the taxable bond. However, if, all other things being equal, the taxable bond yield is less than the taxable equivalent yield, the investor should purchase the tax-free bond (municipal bond).

For example, assume that a New York investor is in the 35% income tax bracket (combined federal and state) and is considering purchasing a New York municipal bond that is yielding 2.2% while a comparable credit-worthy corporate bond is yielding 4.0%. The taxable equivalent yield is computed as follows:

Taxable equivalent yield = .022 / .065 = .0338 = 3.38%

Since the yield on the corporate bond exceeds the taxable equivalent yield, the investor should purchase the corporate bond assuming all other things are equal. However, the "other things" are never exactly equal. The investor also needs to consider other important characteristics of each bond, including each bond's length of time to maturity and default risk, before making his or her investment decision. In addition, it generally is not advisable for an investor to place a large portion of his or her investment portfolio in any one bond. The bond should be only one part of a well-diversified investment portfolio.

In 2013, FINRA re-issued an Investor Alert, titled "Municipal Bonds—Important Considerations for Individual Investors."[20] FINRA re-issued the Investor Alert to remind investors that, while municipal bonds have been considered relatively conservative investments, they do carry risk. In

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19. DALTON, ET AL., *supra* note 7, at 527.

20. *Municipal Bonds—Important Considerations for Individual Investors*, FINRA (Apr. 24, 2013), http://www.finra.org/investors/alerts/municipal-bonds_important-considerations-individual-investors (last visited Sep. 15, 2016).

particular, FINRA states that "defaults, while rare, do occur; information about financial problems that affect the bond's issuer has not always been readily available to investors; the current market value of a municipal bond may be hard to determine because many municipal bonds trade infrequently; a bond's market value may change for reasons having nothing to do with the financial condition of the issuer, such as a change in interest rates; and in cases where an issuer has purchased bond insurance or some other protection feature, the higher overall credit rating of a bond may be more reflective of that protection than the financial condition of the issuer."[21]

In addition, within the Investor Alert, FINRA provides investors with many tips regarding municipal bond investing, including the following:

> **Don't reach for yield.** Higher yield generally comes with greater risk.
>
> **Know a bond's duration.** Generally, the prices of bonds with higher durations are expected to decline more than the prices of bonds with lower durations when interest rates rise.
>
> **Do the tax math.** Because of their favorable tax treatment, municipal bonds generally have lower yields than comparable credit-worthy corporate bonds. In order to determine whether a municipal bond or comparable credit-worthy corporate bond is preferable, investors should compute the taxable equivalent yield.
>
> **Diversify.** When diversifying within the municipal bond asset class, consider diversification by issuer, location, and maturity date.[22]

Reference to this Investor Alert may strengthen an investor's claim when an investor suffered financial damages resulting from a financial advisor's unsuitable municipal bond or municipal bond fund recommendation. The Investor Alert does an adequate job listing and explaining the types of risks associated with municipal bonds and municipal bond funds.

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21. *Id.*

22. *Id.*

III. HIGH-YIELD CDS: RED FLAGS THAT SIGNAL A SCAM

A. *FINRA Warns High-Yield CD Offers Can Be Bait for High-Commission Investments (For Release: February 9, 2016)*

During the past several years, certificate of deposit (CD) yields have been near historic lows. For example, the top CD yields on August 7, 2016 as reported by *bankrate.com* were as follows:

Maturity	APY
1 year	1.30%
2 year	1.50%
3 year	1.66%
5 year	2.03%[23]

Unfortunately, the low interest rate environment has prompted fraudulent promotions of CDs promising interest rates that are substantially higher than current averages. For example, FINRA, in its 2014 Investor Alert titled "High-Yield CDs: Red Flags That Signal a Scam," states that "investors should be wary of unsolicited e-mails and calls that offer outsized returns from financial institutions, including banks and brokerage firms, particularly those with which you have not had a business relationship."[24]

According to FINRA, the following are "red flags" that indicate a CD offer may be fraudulent:

The interest rate quoted is significantly higher than average.

An e-mail is received from an e-mail address that is not an e-mail address of the financial institution cited in the promotion.

An e-mail is received that contains misspellings or grammatical errors.

A promotion claims to be from a U.S. financial institution that has aligned with an international bank.

A promotion claims to be for a "limited time only."

A promotion claims to be directed at "best customers" and requires an extremely high minimum investment.[25]

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23. *See* BANKRATE, http://www.bankrate.com (last visited Aug. 7, 2016).

24. *High-Yield CDs: Red Flags that Signal a Scam,* FINRA (May 28, 2014), http://www.finra.org/investors/alerts/high-yield-cds-red-flags-signal-scam (last visited Sep. 15, 2016).

25. *Id.*

Also, in its Investor Alert, FINRA recommends the following:

> **Never provide personal information or authorize any transfer of funds to any unknown person who e-mails or calls you or to any institution you have not checked out.**
>
> **If you aren't sure a communication is legitimate, contact the customer service center or compliance office of the financial institution that the e-mailer or caller claims to work for.** Use the number on the firm's website or in a publicly available directory.
>
> **Always remember that higher returns come with a cost.** For example, a "market-linked" or "structured" CD can provide potentially higher returns because its performance depends on a stock market index or some other benchmark. However, the Federal Deposit Insurance Corporation (FDIC) has stated that this type of CD is risky, complex, and differs significantly from traditional CDs.[26]

In addition, in its 2016 Investor Alert titled "FINRA Warns High-Yield CD Offers Can Be Bait for High-Commission Investments," FINRA states that "advertisements touting higher-than-average CD yields might actually be a lure to trick investors into buying costly investments."[27]

Furthermore, Gerri Walsh, FINRA's Senior Vice President of Investor Education, states in the Investor Alert that "in light of today's low interest rates, these ads attract attention. Some may be legitimate marketing, but calls into our Securities Helpline for Seniors indicate that many such ads are ploys in which the CD is used as bait to try to sell you a high-commission product, such as a fixed or equity-indexed annuity. . . The reality with these CD come-ons is that you may end up walking out with a costly financial product that is not a CD, and not risk-free."[28]

Reference to this Investor Alert may strengthen an investor's claim when an investor has suffered financial damages resulting from a financial advisor or financial services firm promising higher-than-average CD yields. As the Investor Alerts explains, the end result of the fraudulent promise or advisement may be a scam or pitch to sell the investor a high-commission unsuitable financial product.

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26. *Id.*

27. *FINRA Warns High-Yield CD Offers Can Be Bait for High-Commission Investments*, FINRA (Feb. 9, 2016), http://www.finra.org/newsroom/2016/finra-warns-high-yield-cd-offers-can-be-bait-high-commission-investments (last visited Sep. 15, 2016).

28. *Id.*

IV. CONCLUSION

Reference to relevant investor alerts can strengthen an investor's legal claim in securities arbitration when the claim involves fixed income securities. As I previously stated in my 2016 *PIABA Bar Journal* article, the potential influence of investor alerts on an arbitrator should not be underestimated particularly when the arbitration forum is run by the same organization that issued the investor alert.[29] For example, in a FINRA arbitration case involving damages resulting from an alleged unsuitable recommendation that the investor place her money in a unsuitable, high-commission, equity-indexed annuity after receiving an advertisement about an unreasonably high CD rate, the claimant's attorney should consider referencing the particular FINRA Investor Alert which states that high-yield CD offers can be bait for high-commission investments.

Claimant attorneys should consider making reference to relevant investor alerts in their client's statement of claim and including a copy of the investor alert as an exhibit. Also, if the claimant will be using an expert witness, the expert should consider referencing relevant investor alerts in his or her report and testimony. Claimant attorneys should also periodically visit the SEC's website, FINRA's website, and NASAA's website to read newly issued Investor Alerts that may help strengthen future securities arbitration claims.

29. Engdahl, *supra* note 2, at 119.

INVESTORS, CORNERED
NON-DISCLOSURE, COMMISSIONS, AND FEES, OH MY!

Jason M. Kueser[1]

Fees are always a "hot button" issue with respect to the financial services industry.[2] Every dollar that an investor spends in fees is a dollar unable to generate returns.[3] While a small fee may not seem significant, the following examples will illustrate the significant impact this can have on an investor's retirement.[4]

Let's start by looking at three hypothetical investors:

Investor A invested for his retirement for 20 years. During that 20-year period, he averaged a rate of return of 6% per year.

Investor B had the same average annual rate of return of 6%, but invested for 30 years for her retirement.

Investor C managed to earn an 8% average annual rate of return on his money over a 30-year period.

Now, let's look at the impact that additional fees can have on an investor's

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2. There appears to be an explosion of hidden fees charged to consumers throughout the economy. "Nobody beats the banks and other financial services companies when it comes to adding on the fees." Emily Thornton, *FEES! FEES! FEES! Companies can't raise prices, so they're socking consumers with hundreds of hidden charges--and that's creating stealth inflation and fueling a popular backlash*, BUS. WEEK (Sep. 29, 2003).

3. "From 1980 to 2006, the financial services sector of the United States economy grew from 4.9 percent to 8.3 percent of GDP. A substantial share of that increase was comprised of increases in the fees paid for asset management." Burton G. Malkiel, *Asset Management Fees and the Growth of Finance,*27 J. ECON. PERSPECTIVES 97 (2013).

4. The current low interest rate environment magnifies the impact of fees. "(W)e are likely to live in a single-digit investment environment for some time, such high fees will do great harm to your net investment returns." Burton G. Malkiel, A RANDOM WALK DOWN WALL STREET 405 (11th ed. 2015).

retirement. If Investor A had $1 in extra fees in the first year of his investment plan, his retirement plan would be worth $3.21 less at the end of 20 years. If Investor B had $1 in extra fees in the first year of her investment plan, her retirement plan would be worth $5.74 less at the end of 30 years. If Investor C had $1 in extra fees in the first year of his investment plan, his retirement plan would be worth $10.06 less at the end of 30 years.

You might be saying, "oh well, $5 or $10 is not that much money." If that were the extent of things, you would be right. However, an investor does not just pay fees in the first year of his or her investment plan, but rather, during each and every year of that plan.

If Investor A had $1 in extra fees in EACH year of his investment plan, his retirement plan would be worth $36.79 less at the end of 20 years. If Investor B had $1 in extra fees in EACH first year of her investment plan, her retirement plan would be worth $79.06 less at the end of 30 years. If Investor C had $1 in extra fees in EACH year of his investment plan, his retirement plan would be worth $113.28 less at the end of 30 years.

Again, you might say, "$100 is not going to make or break an investor's retirement plan" and you would be correct. Unfortunately, investors often pay fees in the $100s, $1,000s, or $10,000s of dollars per year – and they often do not know about a substantial amount of the fees they pay.

If Investor A had $100 in extra fees in EACH year of his investment plan, his retirement plan would be worth $3,679 less at the end of 20 years. If Investor B had $100 in extra fees in EACH year of her investment plan, her retirement would be worth $7,906 less at the end of 30 years. If Investor C had $100 in extra fees in EACH year of his investment plan, his retirement plan would be worth $11,328 less at the end of 30 years than it would have if he had not paid those extra fees.

If Investor C pays $500 in excess fees in each of the 30 years of his retirement plan, he would have $56,642 less in his retirement plan at the end of 30 years. If Investor C pays $1,000 in excess fees in each of those 30 years, he would suffer a "loss" of more than $113,000. If Investor C pays $5,000 in excess fees in each of those 30 years, Investor C's retirement fund would end up with *one half million dollars less* than it would have been worth had he not paid those excess fees. The chart below shows the impact additional fees would have on Investor C's portfolio.

Annual Fee Consequences to Investor C's 30-Year Performance

Additional Annual Fees	Loss to Portfolio After 30 Years
$100	$11,328
$500	$56,642
$1,000	$113,283
$5,000	$566,416

Now, you might be asking, "but who in the world has $5,000 of excess fees charged to their accounts every year?" The answer might surprise you. Alternatively, you might be saying "I would certainly notice if my financial advisor was charging me $5,000 a year in excess fees." The real answer to that statement might also come as a shock.

Fees for investment services take multiple forms. There are brokerage commissions, transaction fees, investment management/advisory fees, wrap plan fees, and the list goes on and on. Certain investments also have fees that are separate from the fees charged by an investor's financial advisor, including expenses charged by mutual funds and insurance companies. "The direct cost of professional asset management, at 1.3% of assets, is high. The present value of this fee paid over 30 years amounts to approximately one-third of the assets initially invested—a large price to pay a manager who does not outperform passive benchmarks."[5]

In recent years, the SEC has made fee related issues one of its prioritized matters. FINRA has also taken action against brokers and advisers for fee related issues.[6] The Department of Labor's fiduciary standard will also make fee disclosure a top priority for brokers, advisors, and regulators.

Although much of the recent regulatory actions related to fees pertain to hedge funds, the issue has also come up in the context of broker-dealers, investment advisors, and mutual funds.

Stockbrokers and financial advisors have historically hidden various fees, commissions, expenses, etc. from their clients. The reason is fairly obvious: many of these fees and charges result in additional compensation to the broker or advisor or his firm. As noted above, these fees unnecessarily diminished – and in some cases compromise – an investor's plan.

5. Robin Greenwood & David Scharfstein, *The Growth of Modern Finance*, 27 J. ECON. PERSPECTIVES 3, 13 (Spring 2013).

6. *See* Mark Schoeff Jr., *Regulators Bare Their Teeth on Excessive Fees*, INVESTMENTNEWS (Jan. 23, 2015) *available at* http://www.investmentnews.com/article/20150123/FREE/150129955/regulators-bare-their-teeth-on-excessive-fees.

One scholar finds that there are 14 types of hidden fees of which an investor needs to be wary.[7] It is important for investors to understand how brokers and advisers conceal fees. If they do not understand how this happens, they will be ill-equipped to protect themselves – and their financial futures. The remainder of this article will discuss a few tactics brokers and advisers have used to conceal fees from clients.

Concealed Commissions

One tactic that brokers and financial advisors use to conceal fees is to buy securities in a client's account that result in a commission to the broker/ advisor, but where the commission does not appear on the clients account statement or trade confirmations.

Interestingly enough, some of these hidden fees can occur in some firms' fee-based accounts as well as their traditional retail brokerage (commission based) accounts.[8] This can actually heighten the deception related to a client's understanding of the fees and commissions they are paying because, as the fee-based assets decline in the account, the management/advisory fee charged by the firm also declines.

Some brokerage firms' account agreements for their fee-based/advisory accounts allow the purchase of securities that result in a commission to the

7. Matthew D. Hutcheson, *Uncovering and Understanding Hidden Fees in Qualified Retirement Plans*, 15 ELDER L. J., 323, 344-47 (2007). Although the hidden fees in this article are discussed in the context of 401(k) plans, many of the fees discussed occur outside of 401(k) plans, as well. There are also other hidden fees not mentioned in this article that are not specific to 401(k) plans. *See, e.g., The Hidden Costs of Investing in Mutual Funds*, INVESTOPEDIA, http://www.investopedia.com/ articles/mutualfund/08/hidden-investment-fees.asp (last visited Sep. 19, 2016)

8. "There are two main types of hidden fees. The first type are hidden fees embedded in the fundamental expense ratio. These fees are subshareholder (participant) servicing fees—called 'sub-transfer agent fees' (Sub-TA) and account distribution (sales and account servicing 12(b)-1) fees). The second type are hidden fees separate from, and in addition to, the fundamental expense ratio. These fees include (1) transaction costs—commissions between fund managers and brokerage firms; (2) soft dollar 'excess commissions' paid to brokerages pursuant to SEC rule 28(e)—embedded and symbiotic with (1); (3) variable annuity charges—such as unitized variable annuity wrap, contract, and mortality charges; (4) 'on-the-fly' pass through fees— such as administrator or CPA fees; (5) retail versions of institutional funds—funds that could be purchased at a lower price but are not, due to fiduciary ignorance." *Id*. at 356.

broker/advisor in fee-based accounts. In these accounts, rather than rebating the commission to the client, the firm reduces the fee-based asset amount (which is used determine the management/advisory fee) by the amount of the commission based securities that are purchased and held in the account. This results in a reduction of the management fees the investor pays. While this may seem like a benefit to the investor, this is only the case if the amount of the commission on the underwritten securities is less than the amount of the reduction in the management fees. Unfortunately, this is not often the case.

If the investment is a traditional security, the commission will appear on the client's trade confirmations. However, at some firms, the commissions on certain transactions do not appear on the trade confirmations or account statements. This can happen, for example, with securities that are purchased in a customer's account that are part of a public offering in which the brokerage firm was an underwriter. These securities are sold with an underwriting concession, which is collected by the firm directly upon the sale of the shares of the security they were allotted during the underwriting.

When shares of underwritten securities are purchased in a customer's account, brokerage firms do not generally report the underwriting spread or selling concession they receive on the sale of the shares on the trade confirmation that is provided to the customer. Those amounts are also not recorded on the customer's monthly statements. Rather, they appear only in the prospectus for the security, which requires the investor to have an understanding and comprehension of what to look for in the dense and lengthy disclosures. The first thing investors should look for is the underwriting spread or underwriting discount. It is not uncommon for a typical underwriting discount to equal 5% of the total amount of shares being offered, with 50% of that amount being the selling concession (to the brokerage firm and its broker/adviser).[9]

The following example illustrates how this could impact an investor's fees - and investment plan. Let's assume investor D had $2 million of assets managed by XYZ Brokerage Firm. Investor D's account agreement with XYZ brokerage firm states that he will pay an annual management/advisory fee of 1% per year. Assuming a net rate of return of 0%, investor D would plan to pay fees to XYZ in the amount of $20,000 per year.

Now, let's assume that, instead of investing all $2 million in fee-based assets, the broker/advisor invests $1.8 million in fee-based assets and $200,000

9. *See* Erik Astheimer, EQUITY OFFERINGS 101 at 3 (Nov. 6, 2001) *available at* https://www.gabelli.com/Gab_pdf/articles/erik_eqty111901.pdf; *see also* Sami Torstila, *The Distribution of Fees Within the IPO Syndicate*, 30 FIN'L MGMT. 25 (Winter 2001).

in securities in which XYZ was part of the underwriting syndicate.

Now, if we assume that each underwritten security offers a spread of 5%, of which 50% represents a selling concession, the total selling concession earned by XYZ and its broker/advisor on these transactions would be $5,000. In addition, XYZ and its broker/advisor would earn a management fee of $18,000 on the $1.8 million of fee-based assets other than the underwritten securities in the account. This would result in total commissions/fees of $23,000, which exceeded the $20,000 of fees they would have collected if the entire $2 million had been invested in fee-based assets.

Now, let's assume that, instead of just purchasing those $200,000 of underwritten securities, the broker/advisor turned the $200,000 of assets over five times in the year by purchasing and selling five different issues in Investor D's account. The remaining $1.8 million stayed invested in fee-based assets. In this scenario, XYZ and its broker/advisor would collect $25,000 in commissions on the underwritten securities, plus the $18,000 in management/advisory fees on the other assets in the account, which results in a total fee of $43,000, or 2.15% of the $2 million amount.

Now, let's assume that, instead of just purchasing $200,000 of underwritten securities, the broker/advisor purchased $400,000 of under-writing securities and turned those assets over five times in the year by purchasing and selling five different issues in Investor D's account. The remaining $1.6 million stayed invested in fee-based assets. In this scenario, XYZ and its broker/advisor would collect $50,000 in commissions on the underwritten securities, plus the $16,000 in management/advisory fees on the other assets in the account, which results in a total fee of $66,000, or 3.3% of the $2 million amount.

Mutual Fund Fees

The SEC has been focused on mutual fund fees on and off for many years. These fees include sales commissions paid to broker/advisers (sales loads or sales charges), as well as internal administrative expenses charged by mutual funds. Recently, the SEC expressed concern about whether ordinary investors have an understanding of the fees that mutual funds charge – and, more importantly, the impact that those fees can have on the performance of their investments.[10]

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10. *See* SEC, RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE REGARDING MUTUAL FUND COST DISCLOSURE (Apr. 14, 2016).

In addition, financial advisors have been the subject of regulatory action for failing to properly apply breakpoints to investors. This has resulted in additional fees being incurred by investors - and reduced account balances.

Investors often pay internal mutual fund fees that can exceed two percent per year, which combined with other fees (advisory/management fees, commissions, etc.) can be between 3% and 4% per year.

As noted above, every additional dollar an investor pays in fees can have a significant impact on their financial plan, especially after the compounding effect of interest is taken into consideration. As the SEC notes, cost can vary considerably from one mutual fund to another.[11]

Other fees

There are other fees that are charged by brokerage firms that also negatively impact investment plans. These include, but are not limited to ACAT/Transfer fees, activity/inactivity fees, and custodial fees. In some cases, brokerage firms can also receive "rebates" from stock exchanges to encourage the firms place their trades through them. One study in 2012 indicated that these rebates could be "costing mutual funds, pension funds, and ordinary investors as much as $5 billion per year."[12] The SEC has also prepared some information for investors to understand brokers' fees.[13]

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11. *Id*.

12. Nathaniel Popper, *Study Says Broker Rebates Cost Investors Billions*, N.Y. TIMES (May 6, 2012) *available at* http://www.nytimes.com/2012/05/07/business/rebates-to-brokers-are-seen-as-a-conflict-of-interest.html?pagewanted=all&_r=0.

13. SEC, INVESTOR BULLETIN: BROKERS' MISCELLANEOUS FEES (Dec. 15, 2014) *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_brokersmisc fees.html; *see also* SEC, INVESTOR BULLETIN: HOW FEES AND EXPENSES AFFECT YOUR INVESTMENT PORTFOLIO (Feb. 2014) *available at* https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf.

Ignorance of Fees

The SEC acknowledged that "[o]ver time, even ongoing fees that are small can have a big impact on [an investor's] investment portfolio."[14] That being said, the SEC also acknowledges that, despite its requirement that mutual funds disclose "all fees and charges associated with a mutual fund investment as a percentage of net assets," that "many mutual fund investors do not have a good grasp of the amount they pay annually in mutual fund fees or the long-term impact of those fees on their portfolio's performance."[15] One study cited by the SEC found that "about half of investors who own mutual funds say they know roughly how much they pay in mutual fund fees;" however, "when asked to provide an estimate, the majority of respondents greatly under-estimated the costs."[16]

What is concerning about this information gap is that, as noted above, mutual funds are *required* to provide a table in their prospectus that discloses these fees to investors. Many of the other fees discussed above are either buried in account agreements with broker dealers or hidden in offering documents of securities. The likelihood that an investor will read - or understand - these fees is far less likely. In fact, the SEC has also noted that while only 6.2 percent of investors polled stated that the prospectus was the most important source of information in making a mutual fund purchase, that "[i]nvestors appear to be even less likely to rely on disclosures in shareholder reports."[17]

What is just as concerning as the amount of fees that brokers/advisers charge their clients is the fact that a large number of investors do not understand that they are even paying these fees. A survey by Rebalance IRA in 2014 revealed that 46% of the baby boomers they polled did not believe they paid any fees in their retirement accounts.[18] That survey revealed that

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14. SEC, RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE REGARDING MUTUAL FUND COST DISCLOSURE 1 (Apr. 14, 2016), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-mf-fee-disclosure-041916.pdf.

15. *Id.*

16. *Id.* at 1-2.

17. *Id.* at 2-3.

18. REBALANCE IRA, *Nearly Half Of Americans Surveyed Falsely Think They Pay Zero Retirement Investment Fees* (Oct. 15, 2014) *available at* http://www.rebalance-ira.com/news/nearly-half-americans-surveyed-falsely-think-pay-zero-retirement-investment-fees/.

another 19% believed their fees were less than 0.5% per year.[19]

In late 2015, a study was conducted by online advisory firm Personal Capital. It looked at the average fees charged by 11 different brokerage companies and found a wide variance between the costs of investing with these firms over a 30-year period. The firm found that the total costs for an average account of $500,000 over a 30-year period ranged from a total of $502,407-$936,390.[20]

Disclosure

While the information is available for investors to learn how much they pay in fees, the problem is that investors are often discouraged against learning about these fees, investors are not given the documents containing the fee disclosures prior to purchase (or, in some cases, at all), and/or brokers and advisers deceive investors about the various fees associated with their investments and/or accounts.

Investors often do not receive prospectuses prior to the purchase of investments in their accounts. When they do, they are generally discouraged from reviewing the information in the prospectuses by their advisors - and probably would not understand the information if they did read it.

Investors need—and deserve—to understand the fees they are paying - and the impact those fees can have on their investment plans.

19. *Id.*

20. PERSONAL CAPITAL, THE REAL COST OF HIDDEN FEES, *available at* https://www.personalcapital.com/assets/whitepapers/PC_Fees_WhitePaper.pdf (last visited Sep. 19, 2016).

EXPERT'S CORNER: BROKERAGE FIRM LIABILITY FOR SELLING AWAY TRANSACTIONS AND THE DUTY OF SUPERVISION

Richard M. Phillips[1]

Registered representatives, acting under the imprimatur of a well-established brokerage firm, often establish a close relationship with their customers who rely on them for investment and other financial advice. Registered representatives sometimes take advantage of these relationships by persuading their customers to enter into securities and other transactions that are not authorized by their firm. These so-called "selling away" transactions are a common source of fraud and other abuses that give rise to investor claims against the brokerage firm.

Liability for selling away transactions of registered representatives has long been a serious problem for brokerage firms in the securities industry. Since the registered representative in such situations usually is incapable of covering customer losses, a claim against the brokerage firm constitutes the investor's only hope of recouping the losses. The customer often asserts that he or she relied on the reputation of the firm in entering into the transaction. The firm, on the other hand, claims it was entirely unaware of the transaction, and the customer had no basis for believing that the firm has any responsibility for it.

Plaintiffs have used a variety of theories under state and federal laws in seeking to hold brokerage firms liable for the selling away activities of their registered representatives. These include respondeat superior, apparent authority, negligence and controlling person liability under state and federal securities laws. Vicarious liability claims based on respondeat superior generally have not been successful against a brokerage firm employer who often can convincingly argue that the selling away transactions were outside the scope of employment.[2] For similar reasons, plaintiffs also have had

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1. Mr. Phillips is recently retired after practicing securities regulation for more than fifty years as a founding partner of the Washington, D.C and San Francisco offices of K&L Gates LLP, and as a member of the staff of the Securities & Exchange Commission in Washington, D.C.

2. *See e.g.*, Smith v. Merrill Lynch Pierce Fenner & Smith, 155 Mich App. 230 (1986).

difficulty in pursuing selling away claims against brokerage firms under the agency doctrine of apparent authority.[3]

Plaintiffs have had more success when they prosecuted their selling away claims against brokerage firms on the basis of common law negligence or under the controlling person liability provisions of state and federal securities laws. Under both approaches, plaintiffs can rely on evidence indicating a breach of the brokerage firm's duty of supervision over its employees created by state and federal securities laws.

The SEC staff has emphasized that effective supervision of registered representatives and other employees is a "critical component of the federal regulatory scheme" for broker-dealers in securities.[4] Indeed Sections 15(b)(4)(E) and 15(b)(6)(F) of the Securities Exchange Act of 1934 ("Exchange Act") authorize the Commission to suspend or revoke the registration of brokerage firm, among other things, for failure to reasonably supervise a person subject to its jurisdiction who violates the federal securities laws unless the firm affirmatively can show that it had effectively implemented a reasonable supervisory system.

Similarly, the Financial Industry Regulatory Authority ("FINRA"), the SEC supervised self-regulatory agency for the brokerage industry, has characterized supervision as "the basic duty" of a member firm and requires each of its members "to establish, maintain, and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws and regulations and the rules of FINRA.[5]

FINRA also has adopted specific "selling away" and "outside business activity" rules that require the registered representative and other employees to provide their brokerage firm with prior notice of a proposed transaction or activity and places explicit responsibility on the firm for supervising such activities.[6] Virtually all brokerage firms required to be registered with the SEC must become members of FINRA.[7]

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3. Harrison v. Dean Witter Reynolds, lnc., 974 F 2d 873 (7th Cir. 1992); Kohn v. Optik, 1993 U.S. Dist. LEXIS 7298 (C.D. Cal. Mar. 30, 1993); Carsten v. N. Bridge Holdings, Inc., 2006 Mich. App LEXIS 230 (Jan. 24, 2006).

4. *In re* John H. Gutfreund, 51 S.E.C. 93, 108 (Dec. 3, 1992).

5. FINRA, NOTICE TO MEMBERS 86-65 (1986).

6. FINRA, RULE 3280 (2015) (selling away securities transactions); FINRA, RULE 3270 (2015) (outside non-securities business activities).

7. 15 U.S.C. §78o (2015).

The courts have made clear that there is no implied right of action for violations of FINRA rules.[8] While the courts have not ruled specifically on the FINRA selling away and outside activity rules, there is no reason to believe that these rules would be treated differently. Nevertheless, these FINRA rules, together with the FINRA Rule supervisory rules, provide a relatively well charted path for imposing liability on brokerage firms for the violative conduct of their registered representatives in selling away transactions with their customers.[9] This is true whether the investor institutes an action under common law negligence theories or under the provisions of federal and state securities laws that impose liability on brokerage firms for securities law violations, including FINRA rules, as the controlling persons of their registered representatives and other employees.

Section 20(a) of the Securities Exchange Act of 1934 ("Exchange Act") provides that controlling persons such as employers are jointly and severally liable for violations of that Act, including the FINRA rules, by their employees unless they sustain the burden of showing that that they acted in good faith and did not directly or indirectly induce the violations.[10] State blue sky laws often have similar provisions.[11] A failure of adequate supervision over conduct that violate the securities laws, including FINRA selling away and outside business activity rules, can undercut the good faith defense provided by Section 20(a).[12] It can also vitiate any claim in a selling away action based on a negligence theory that the brokerage firm acted reasonably according to industry standards to prevent the misconduct of its registered representatives.

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8. *See e.g.*, Hoxworth v. Blinder, Robinson & Co., 903 F. 2d 186 (3rd Cir. 1990); Craighead v. E. F. Hutton & Co., 899 F.2d 485 (6th Cir. 1990).

9. FINRA Rule 3110(a) requires brokerage firms to "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations and applicable FINRA rule. FINRA, RULE 3110(a) (2015).

10. Section 20(a) of the Exchange Act imposes joint and several liability on controlling persons for violations of the Act, which includes FINRA rules, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation. 15 U.S.C. §78t (2015).

11. *See e.g.*, MICH. COMP. LAWS § 451.2509(7) (2015).

12. *See e.g.*, Hecht v. Harris Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968).

The courts generally regard the brokerage firm as the controlling person of its registered representatives.[13] The Second and Third Circuit Courts of Appeals as well as some decisions in the Fourth and Fifth Circuits, hold that brokerage firm liability under Section 20(a) also requires proof that the brokerage firms was a "culpable participant" in the transaction that gave rise to the claim of liability.[14] Inaction on the part of the brokerage firm is insufficient to prove culpable participation unless the actions done to further the activity.[15]

Other courts hold that if the customer can simply show that a registered representative engaged in the violative conduct while employed by the brokerage firm, the burden shifts to the firm to show good faith and absence of inducement.[16] In the view of these courts, there is no need for the plaintiff to show that the brokerage firm actually exercised some form of control over the particular transaction that caused the losses.[17] Still other courts allow the brokerage firm to avoid liability if the transaction was "outside the statutory control" of the brokerage firm in the sense that it was not the type of transaction that the firm would normally engage in. Under such circumstances, these courts reason that the customer could not have reasonably relied on the brokerage firm in entering into the transaction.[18]

But regardless of the Section 20(a) test of controlling person liability employed by the court, the adequacy of the brokerage firm's supervisory rules

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13. Martin v. Shearson Lehman Hutton, Inc., 986 F.2d 242 (8th Cir. 1993); Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) *cert. denied* 111 S. Ct. 1621; *but see* Burns v. Rudolph, 2005 Ohio 6918 (Ohio Ct. App. Dec. 28, 2005).

14. Boguslavsky v. Kaplan, 159 F.3d 715 (2nd Cir. 1998); SEC v. First Jersey Secs., Inc., 101 F.3d 1450, 1472-73 (2nd Cir. 1998); Sharp v. Coopers & Lybrand, 649 F.2d 175 (3rd Cir. 1981); Rochez Bros. v. Rhoades, 527 F.2d 880 (3rd Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); Gordon v. Burr, 506 F.2d 1080 (2nd Cir. 1974); Carpenter v. Harris Upham & Co., 594 F.2d 388 (4th Cir. 1979).

15. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3rd Cir.1981) Rochez Bros. v. Rhoades, 527 F.2d 880 (3rd Cir. 1975) *cert. denied* 425 U.S. 996 (1976); Gordon v. Burr, 506 F.2d 1080 (2nd Cir. 1974).

16. SEC v. First Jersey Secs., Inc., 101 F.3d 1450 (2nd Cir. 1998); Marbury Mgmt. Inc. v. Kohn, 629 F.2d 705 (2nd Cir. 1980), *cert. denied* 1449 U.S. 1011 (1981); Lorenz v. Watson, 258 F.Supp. 724 (E.D. Pa. 1966).

17. Metge v. Baehler, 762 F.2d 621 (8th Cir. 1981); Lustgraaf v. Behrens, 619 F.3rd 867 (8th Cir. 2010).

18. Hauser v. Farrell, 14 F.3d 1338 (9th Cir. 1994), *overruled on other grounds*, Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

and procedures and their maintenance and enforcement against selling away activities of their registered representatives is critical to the brokerage firm's controlling person liability. Even in the jurisdictions that apply the culpable participant test an absence of adequate supervision can be proof of participation in the wrongdoing of its registered representative.[19] Since the courts find that a failure to take precautionary steps to prevent the violation through effective supervision undercuts the defense of good faith.[20] and also is evidence of negligence, litigation in selling away cases seeking to establish brokerage firm liability often revolves around the adequacy of the supervision that might have prevented the selling away transaction.

Under the Supreme Court's 1976 decision in the *Hockfelder* case, plaintiffs arguably must show more than simple negligence to prevail on the issue of inadequate supervision.[21] Nevertheless, at least in the setting of FINRA arbitrations where most selling away claims against brokerage firms are litigated, this burden seems to have been readily surmountable. A recent survey found that in 60 selling away cases during a five and one-half year period the customer prevailed in 44 of them, and punitive damage awards were granted in 12 cases.[22]

FINRA Rule 3280 generally defines selling away transactions covered by the Rule as securities and investment banking activity that is outside the regular course of employment with the brokerage firm. The Rule applies to all associated persons of the firm. Importantly, the Rule distinguishes between transactions where the associated person receives or has the possibility of

19. *See e.g.*, First Jersey Secs. Inc., 101 F.3d 1450 (2nd Cir. 1998).

20. Henricksen v. Henricksen, 640 F.2d 880 (7th Cir.), *cert. denied* 454 U.S. 1097 (1981); Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir. 1975) *cert. denied* 423 U.S. 1025 (1975); Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968) *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); Lorenz v. Watson, 258 F.Supp. 724 (E.D. Pa. 1966).

21. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 209 n. 28 (1976) (observing that negligence is insufficient to prove securities fraud under Rule 10b-5 (1) and (3) of the Exchange Act).

22. *FINRA Stats., 5/16: New Filings Still Ahead of Last Year, but Gap Tapering*, SECURITIES ARBITRATION COMMENTATOR (June 27,2016), http://www.sac arbitration.com/blog/finra-stats-516-new-filings-still-ahead-last-year-gap-tapering/. Under FINRA rules, a claimant against a member brokerage firm has a right to obtain arbitration of their claim if deemed to be a "customer" of the firm. *See* FINRA, RULE 12101 (2008).

receiving selling compensation and where no such compensation is involved.[23] Compensation is broadly defined to include not only fees and commissions but any kind of profit participation and even expense reimbursements.[24]

Rule 3280 requires that the member firm specifically approve or disapprove in writing any securities or investment banking transaction cover by the Rule in which an associated person of the firm may receive compensation. If the participation is approved, the member firm must essentially treat it as its own by recording the transaction on its books and records and supervising it as if the firm itself were executing the transaction. In the case of transactions not involving any compensation to the associated person, the firm must still evaluate it to determine whether any conditions are appropriate.[25] Thus, even in the case of a securities transaction not involving compensation to an associated person, the firm must have a supervisory system that provides reasonable assurance that the notices required by the Rule are being given on a timely basis, that the noticed transactions are being properly evaluated to determine what conditions might be appropriate and that any conditions imposed are being satisfied by the associated person.

FINRA Rule 3270, relating more generally to outside non-securities related outside business activities, applies only to registered representatives and other registered persons. Unlike the provisions of Rule 3280, it does not apply to all persons associated with the brokerage firm. Rule 3270 requires that registered persons give prior notification to the brokerage firm of any outside business activities. The notice provides the brokerage firm an opportunity to determine whether the proposed activity is properly classified as non-securities related and in any event to determine whether the activity will compromise or interfere with the registered person's responsibilities to the firm and whether its customers would view the proposed activity to be part of the firm's business.

Based on this evaluation the firm must determine whether to impose specific limitations or conditions to the proposed business activity.[26] Thus, to properly supervise compliance with the outside business activity rule, brokerage firms must adopt and maintain supervisory systems similar to those maintained for securities transactions not involving selling compensation, i.e., namely that required notifications are being given, that the proposed activities

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23. FINRA, RULE 3280(c), (d) (2015).

24. FINRA, RULE 3280(e)(2) (2015).

25. FINRA, RULE 3280(c), (d) (2015).

26. FINRA, RULE 3270.01 (2015).

are being properly evaluated and that any conditions imposed by the firm are being observed.

Although FINRA's general supervision rule, Rule 3110, places emphasis on the need of each brokerage firm to tailor its supervisory system to the individual risk profile of its particular business or businesses, the Rule itself as well as the Supplementary Materials to the Rule contain a number of specific requirements considered necessary for an adequate supervisory system. These are augmented from time to time by SEC and FINRA regulatory notices and alerts, disciplinary and enforcement actions, and speeches of both FINRA and SEC officials.

While the views of agency officials usually carry a disclaimer that they do not represent the agency's position, these views often reflect current regulatory thinking and tend to be treated as "pure gospel" by their subordinates who conduct inspections and enforcement investigations. In any event, these materials provide extensive regulatory guidance as to may constitute supervision sufficient to show the good faith for purposes of protecting the brokerage firm against controlling person liability. They also provide plaintiffs and their counsel with a blueprint of the proof needed for brokerage firm liability.

Thus, these informal articulations of supervisory standards can be ignored only with peril by both brokerage firms seeking to avoid liability and plaintiff's counsel seeking to find liability for selling away transactions on the part of the brokerage firms. In particular cases these generalized standards may be supplemented any brokerage firm files which sometimes contain the comments of SEC and FINRA examiners in their inspection reports of the brokerage firm as well as the comments of the firm's compliance and management personnel on the adequacy of their efforts to protect customers against selling away activities of its registered representatives.

A brokerage firm's files may also indications of non- compliance with the detailed supervisory requirements of FINRA Rule 3190. These requirements include, among other things, a mandate that a principal of the brokerage firm evidence in writing his or her review of all transactions relating to the firm's business as well as a review of all internal communications and external communications with customers (including electronic) and all written customer complaints. The supervisory procedures must be adequate to capture, acknowledge and respond to all such complaints.[27] In addition, FINRA Rule 3190 requires that supervisory procedures contain a process for review of transactions that is reasonably designed to identify trades that may violate Exchange Act provisions and FINRA rules prohibiting fraud and

27. FINRA, RULE 3110(b) (2015).

manipulation. The member firm, under FINRA rules is required to conduct a prompt internal investigation into any questionable trade and to file a report with FINRA if a violation has been found.[28]

Both the SEC and FINRA have emphasized that a brokerage firm's supervisory procedures must be appropriate for the type of the firm's businesses, size, structure, and type of customers.[29] Thus, for example, the procedures for a brokerage firm that has many representatives in remote locations would be very different than those of a firm that houses its representatives in large offices with many onsite supervisory and compliance personnel. Similarly, a brokerage firm that has representatives engaged in authorized outside securities or other business activity should have robust procedures that reasonably assure compliance with the limitations and conditions of the authorizations as well as procedures that provide adequate supervisory controls designed to protect the customer against wrongdoing in these outside activities.

Both the SEC and FINRA also place heavy emphasis on the need for physical inspections of branch offices and all other locations that house the activities of its registered representatives.[30] The SEC has repeatedly observed that" such inspections are a vital component of a supervisory system" for a securities brokerage firm.[31] FINRA Rule 3110(c)(1) requires each member firm to conduct a review of each of its business at least annually. A physical inspection of all supervisory offices must be conducted at least annually, at least every three years in the case of a non- supervisory branch offices and on a periodic regular schedule for non- branch offices, taking into account the nature and complexity of the securities transactions for which the location is responsible and its contacts with customers.

FINRA Rule 3110(c)(1) specifies that the annual reviews must be conducted a manner which is "reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and applicable FINRA rules." Each review as well as each inspection also must be the subject of a written report

28. *Id*.

29. *See e.g.*, SEC Division of Market Regulation Staff Legal Bulletin No. 17 (Remote Office Supervision) (Mar. 19, 2004) (Hereinafter referred to as SEC Staff Bulletin No. 17); FINRA, RULE 3110.12 (2015) (Standards for Reasonable Review).

30. *See e.g.*, SEC Staff Bulletin No. 17, *supra* note 29; FINRA, RULE 3110(c) (2015) (Internal Inspections).

31. Signal Securities, Inc., Exchange Act Release No. 43350 (Sept. 26, 2000): Royal Alliance Assoc., Exchange Act Release No. 38174 (Jan. 5, 1997).

which is to be kept on file for at least three years. The report must include, among other things, testing and verification of the firm's policies and procedures in specific areas, including transmittal of securities and funds between customers and registered representatives and from customer accounts to third parties or locations other than the customer's primary address. The inspection should verify that the policies and procedures include means of customer confirmation, notification or other documented follow up.[32] Compliance with these specific requirements is important to the protections against brokerage firm liability for selling away transactions and unauthorized outside business activities.

To protect against conflicts of interest, the office inspections must not be conducted by persons assigned to the location or supervised by someone who is assigned. Heightened inspection procedures, i.e., procedures designed to avoid conflicts of interest that serve to undermine complete and effective inspections are required in certain instances. A failure to comply with any of FINRA's specific inspection requirements could be grounds for a lack of good faith by the brokerage firm if it might possibly have prevented a violtive selling away transaction that caused customer losses.

FINRA has been especially concerned with selling away transactions effected by registered representatives in non- branch offices and other off-site locations. FINRA\ has observed that "[b]ecause of their location and other circumstances of their employment, off-site personnel have a greater opportunity than on-site personnel to engage in undetected selling away transactions."[33] It has specifically reminded its members of their obligation, to ensure compliance with the limits imposed by the FINRA rule on selling away" transactions. It also has reminded its member firms that selling away compliance obligations are in no way lessened by the fact that the representative in the location is compensated as an independent contractor.[34]

Thus, FINRA specifically warns in paragraph .7 of the Supplementary Materials to Rule 3110 describing its standards for reasonable review that brokerage firms be especially diligent in establishing compliance procedures for, and conducting reviews of, non-branch offices and other off-site locations where a registered representative engages in securities transactions. Such situations, FINRA cautions, may require, among other things, more frequent reviews and inspections as well as other supervisory procedures appropriately

32. FINRA, RULE 3110(c)(2) (2015).

33. FINRA, NOTICE TO MEMBERS 86-65 (1986).

34. *Id.*

tailored to the type and volume of securities transactions engaged in by particular off-site offices.

FINRA has particularly focused on sales of limited partnership interests in selling away transactions and has emphasized the need to assure compliance with applicable requirements such as disclosure, due diligence and suitability. It has "suggested" that the firms maintain records that allow regulators to ascertain all relevant information regarding a firm's participation.[35] Non-adherence to such a "suggestion" is a telltale sign of compliance laxity in view of the well- known tendency of regulators to believe that if a compliance event is unrecorded, it never happened.

The SEC staff also has evidenced a serious concern with the potential for selling away and other abuses by registered representatives in remote offices and has emphasized the importance of "a combination of onsite and offsite monitoring, including the use of unannounced inspections."[36] According to the SEC itself, "broker-dealers that conduct business through remote offices have not adequately discharged their supervisory obligations where there are no inspections of those offices."[37] The SEC staff has articulated specific guidelines for such inspections. According to the staff, even a routine inspection should at least include a sampling of customer files, including trading and other business records, a review of correspondence and other customer communications, an examination of advertisements and sales literature made available at the office, in-personal questioning of the representative as well as any assistants or other support staff located in the office, including inquiry about unusual activity and in-depth review of any deficiencies.[38]

The SEC also has made repeated references to the importance of unannounced inspections of off-site office and considered them to be among the most effective tools to expose and deter misconduct. According to the Commission, a surprise inspection is a compliance tool necessarily available to securities firms in carrying out its super visionary responsibilities" and is more likely to uncover misconduct than an announced inspection.[39] The SEC staff recognized, however, that on-site inspections is not a substitute for the

35. SEC Staff Bulletin No.17, *supra* note 29.

36. *Id.*

37. Consolidated Investment Services, Inc., Exchange Act Release No. 36687 (Jan. 5, 1996).

38. SEC Staff Bulletin No. 17, *supra* note 29.

39. *Id.*

use of centralized technology to monitor the trading and handling of funds in remote offices as well as the use of personal computers to detect selling away transactions and other abuses.[40]

The SEC staff also emphasized the need for adequate procedures to monitor outside business activities. It urged that brokerage firms to be alert to possible "red flags" indicating unauthorized outside activity by registered representatives ranging from a lavish life style to the existence of bank accounts or companies owned by the representative or his or her family with a name similar to the brokerage firm, thereby indicating the potential for altering customer checks and communications to the firm. It also pointed to cases where a more diligent investigation of a customer complaint might have detected serious fraud.[41]

In recent years, the brokerage industry has responded vigorously to regulatory pressures and liability concerns, including those raised by selling away transactions by making heightened efforts to comply with increasing complex regulatory requirements by adding better trained and compensated compliance personnel, increasing the sensitivity of both management and registered representatives to compliance concerns and enhancing its technology capabilities to better monitor compliance with SEC and FINRA requirements, including the rules concerning selling away and unauthorized outside business activities.

In the end, however, even a well-constructed and implemented supervisory system depends on fallible human beings and technology and is subject to inevitable second guessing with the wisdom of 20/20 hindsight in the context of customer claims litigation. For these reasons, the liability of brokerage firms for customer losses due to selling away and unauthorized outside business activity is likely to remain a serious problem for the brokerage industry as well as a significant source of business for those who represent investors injured by the misconduct of those who participate in that industry.

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40. *Id.*

41. *Id.*

RECENT ARBITRATION AWARDS

Robert Van De Viere

Any attorney who has represented claimants in FINRA arbitration has most likely heard the questions, "Do I get pain and suffering? What about my emotional distress?"

Investors who have lost money as a result of their broker's negligence and/or misconduct often feel entitled to be compensated for the stress and anguish that the loss of their assets has caused them. These stories can include being forced to sell a home as a result of no longer being able to pay the mortgage or withdrawing a child from school since the tuition was no longer affordable.

Similarly, industry professionals who have been improperly terminated or discriminated against may suffer similarly. The stresses of losing one's job and being forced to worry about how basic expenses will be met or the humiliation and indignity of facing discrimination or defamation can equally lead to sleepless nights.

This article will review a few recent arbitration awards in which damages tied to emotional distress have been awarded. The aim will be to provide a better idea of the circumstances under which Claimants have received such damages, whether they be based in statute, common law, or equity.

Jean Carlo Hernandez-Rosales, Claimant v. Santander Securities LLC, Santander Securities Corporation, Respondents
Case No. 15-00845[1]

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1. Claimant asserted the following causes of action: retaliation in violation of Act No. 115 of December 20, 1991, P.R. LAWS ANN. tit. 29, §§194-194b (1991), Puerto Rico's Local Anti-Retaliation in the Workplace Statute; unlawful discharge in violation of Act No. 80 of May 30, 1976, as amended, P.R. LAWS ANN. tit. 29, §§185a-185m (1976); and tort in violation of Article 1802 of the Civil Code of the Commonwealth of Puerto Rico, P.R. LAWS ANN. tit. 31, § 5141 (1956). The causes of action relate to Claimant's termination of employment with Respondent Santander Securities, LLC, formerly known as Santander Securities Corporation.

Unless specifically admitted in their Answer, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested: actual damages in the amount of $500,000.00 for mental anguish, mental and emotional suffering, distress and loss of

San Juan, Puerto Rico

Claimant's Counsel: Anibel Escanellas-Rivera, Esq., Escanellas & Juan PSC.

Respondents' Counsel: Carlos George, Esq. and Cristina S. Tamayo Perez, Esq., O'Neill & Borges LLC.

Arbitrators: Donald Theodore Ryce, Jr., Public Chairperson; Jaime Rosario, Public Arbitrator; Hector R. Diaz-Olmo, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, and the post-hearing submissions (if any), the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. The Panel found that Claimant's emails of February 25 and 26, 2010, constituted protected conduct under Act No. 115[2].
2. Respondents are jointly and severally liable for violation of P.R. LAWS ANN. tit. 29, §§185, 194 (1991) and shall pay to Claimant compensatory damages in the amount of $213,000.00, comprised of $200,000.00 for back-pay, $10,000.00 for mental distress, and $3,000.00 for wrongful termination. Post-judgment interest, if applicable, shall be paid in accordance with the Code.
3. Pursuant to P.R. LAWS ANN. tit. 29, §194 (1991), Respondents are jointly and severally liable for and shall pay to Claimant attorneys' fees in the amount of $50,000.00. In addition, pursuant to P.R. LAWS ANN. tit. 29, §185 (1991), Respondents are jointly and severally liable for and shall pay to Claimant attorneys' fees in the amount of $750.00.
4. The explanation of the Panel's decision is for the information of the parties only and is not precedential in nature.
5. Any and all relief not specifically addressed herein is denied.

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self-esteem; damages for loss of income, back-pay, front-pay and loss of benefits in the amount of not less than $550,000.00; compensatory damages caused by the illegal actions and omissions of Respondents in the amount of $500,000.00; double damages; costs; reasonable attorneys' fees; reinstatement; post-judgment interest; and such other and further relief deemed fair and appropriate by the Panel.

At the close of the hearing, Claimant requested the following damages: $441,148.00 representing loss of income; $70,000.00 representing loss of savings; $150,000.00 for mental anguish; and $3,000.00 for violation of Act No. 80. of May 30, 1976, as amended, P.R. LAWS ANN. tit. 29, §§185a-185m (1976).

In the Statement of Answer, Respondents did not specifically delineate a relief request.

2. Act No. 115 of December 20, 1991, P.R. LAWS ANN. tit. 29, §194 (1991).

This award represents an example of an award of "mental distress" damages by an arbitration panel related to violation of specific employment statutes. P.R. LAWS ANN. tit. 29, §185, 194 (1991). Both statutes protect the rights of employees against termination without just cause and discrimination. Clearly finding that the Claimant in this case was treated improperly at the workplace and wrongfully terminated, this Panel saw fit to compensate them not only for their lost wages (in this case "back-pay") but also for the mental distress suffered from losing his job illegally. It is notable that the panel's award of attorneys' fees was made expressly pursuant to statute.

H. Peter Petrosky, Claimant v. Morgan Stanley, Respondent
FINRA Case No. 13-00514[3]

Boca Raton, Florida

Claimant's Counsel: Andre R. Perron, Esq. and Katherine E. Mott, Esq., Barnes Walker Goethe Hoonhout and Perron.

Respondent's Counsel: Tracy L. Gerber, Esq. and Elizabeth E. Moum, Esq., Greenberg Traurig, PA.

Arbitrators: Harold S. Stern, Public Chairperson; Marle G. Peterson, Public Arbitrator; Jay Stewart Zelf, Non-Public Arbitrator.

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3. Claimant asserted the following causes of action: 1) wrongful termination; 2) slander and disparagement on his Central Registration Depository ("CRD") record and to his business reputation; 3) interference with advantageous business relationships; and 4) breach of implied contract and duty of good faith and fair dealing. The causes of action relate to Claimant's employment relationship with Respondent.

Unless specifically admitted in its Answer, Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, as amended, Claimant requested compensatory damages pertaining to loss of sign-on bonuses in the amount of $846,200.00; compensatory damages for loss of Claimant's book of business in the amount of $1,339,800.00; compensatory damages for emotional distress in the amount of $250,000.00; other unspecified compensatory damages for deferred compensation; stock options; bonuses or other related compensation; punitive damages in the amount of $750,000.00; a declaration that Claimant is the prevailing party so Claimant may seek an award of attorneys' fees; costs; and expungement of his CRD Form U5.

In its Statement of Answer, Respondent requested that the Statement of Claim, as amended, be dismissed in its entirety.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. The Panel has ruled that while Respondent had the legal right under the rules of employment at will to terminate Claimant's employment, the manner in which it was carried out was a "rush to judgment" and caused unnecessary harm and damage to Claimant's relationships with his clients and financial position.
2. The Panel finds that Respondent is liable for causing humiliation, emotional distress and loss of book of business and shall pay to Claimant compensatory damages in the amount of $150,000.00.
3. Respondent is liable and shall pay to Claimant the amount of $600.00 representing reimbursement of the non-refundable portion of the claim filing fee previously paid by Claimant to FINRA Dispute Resolution.
4. Claimant's request for expungement of his CRD Form U5 is denied.
5. Claimant's requests for compensatory damages for deferred compensation, compensatory damages pertaining to loss of sign-on bonuses, stock options, bonuses or other related compensation, costs and a declaration that Claimant is the prevailing party in order to seek an award of attorneys' fees are denied.
6. Any and all claims for relief not specifically addressed herein, including Claimant's request for punitive damages, is denied.

Here again we see a case being brought in the context of a wrongful termination and also U5 defamation claims.

For those uninitiated to the workings of FINRA registration, when a firm and a broker separate, a Form U5 must be filed. In certain circumstances, such as involuntary termination, the form requires an explanation of the circumstances surrounding the termination. Generally, this will become public through the CRD system, including FINRA's BrokerCheck. As one can imagine, this creates a setting ripe for the publication of defamatory or potentially defamatory remarks.

A review of BrokerCheck indicates that, presently, the reason for Mr. Petrosky's termination per Morgan Stanley, is stated as follows:

> CONCERNS REGARDING FA'S SOLICITATION AND HANDLING OF A CLIENT ACCOUNT, INCLUDING RECOMMENDATION OF THIRD PARTIES TO CLIENT. THESE CONCERNS WERE NOT RELATED TO INVESTMENT ACTIVITY, BUT RATHER REGARDING WHO ULTIMATELY CONTROLS CLIENT'S AFFAIRS

This decision proves curious as the panel found that Mr. Petrosky was the victim of a "rush to judgment" and entitled to recompense for "humiliation, emotional distress and loss of book of business," yet chose to deny his request for expungement of his U5.

Lucy Patriarca, Claimant v. C. L. King & Associates, Peter Edward Bulger, Louis A. Parks, Respondents
FINRA Case No. 11-03524[4]

New York, New York

Claimant's Counsel: Gary E. Roth, Esq., Javerbaum, Wurgaft, Hicks, Kahn, Wikstrom & Sinins.

Respondents' Counsel: Lisa F. Joslin, Esq., Gleason, Dunn, Walsh & O'Shea.

Concurring Arbitrators: David J. Weisenfeld, Public Chairperson; Keely D. Parr, Public Arbitrator; Ernesto V. Luzzatto, Public Arbitrator

Award: After considering the pleadings, the testimony and evidence presented at the hearing, and the post-hearing submissions, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

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4. Claimant asserted the following causes of action: sex discrimination and disability discrimination in violation of New Jersey's Law Against Discrimination, N.J. REV. STAT. § 10:5 (2010), quid pro quo sexual harassment, retaliation for complaining about sexual harassment, retaliation for forcing Respondents to continue to accommodate restrictions of Claimant's disability, failure to investigate and take corrective action, failure to reasonably accommodate the restrictions of Claimant's disability, and wrongful discharge.

Unless specifically admitted in their Answer, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested unspecified damages, damages for emotional distress and pain and suffering, punitive damages, attorneys' fees, a "Rendine" enhancer, costs, pre-judgment interest, and all other relief deemed appropriate by the arbitrators.

At the close of the hearing, Claimant requested $187,500.00 in back pay, $589,182.00 in front pay, $114,220.00 for tax relief, $191,997.00 in attorneys' fees, $10,688.00 in costs, plus unspecified emotional distress damages and unspecified punitive damages.

Respondents requested the Statement of Claim be dismissed in its entirety, attorneys' fees, costs and disbursements incurred in the defense of this action, and such other and further relief as the Panel deems just and proper.

1. The Panel finds that Claimant was retaliated against based upon her disability complaints.
2. Respondent C. L. King & Associates, Inc. is liable for and shall pay to Claimant $46,937.00 for back pay.
3. Respondent C. L. King & Associates, Inc. is liable for and shall pay to Claimant $93,873.00 for front pay.
4. Respondent C. L. King & Associates, Inc. is liable for and shall pay to Claimant $20,000.00 for emotional distress.
5. Respondent C. L. King & Associates, Inc. is liable for and shall pay to Claimant $122,463.00 for attorneys' fees pursuant to the New Jersey Law Against Discrimination.[5]
6. Respondent C. L. King & Associates, Inc. is liable for and shall pay to Claimant costs in the amount of $8,500.00.
7. Claimant's claims of disability discrimination are denied.
8. Claimant's claims against Respondents Peter Bulger and Louis Parks are denied.
9. The Panel recommends the expungement of Termination Explanation on Claimant Lucy Patriarca's (CRD # 1267474) registration records filed by C. L. King & Associates, Inc. on April 27, 2011, and maintained by the Central Registration Depository ("CRD") based on the defamatory nature of the information. The Termination Explanation on Claimant's Form U5 shall be expunged and replaced with the following language: "Disagreement concerning application of newly implemented compensation plan, which greatly impacted Ms. Patriarca's earnings due to the loss of main contacts at one of the firm's largest accounts." The Reason for Termination shall remain "Discharged." The Form U5 is not automatically amended to include the changes indicated above. Claimant Lucy Patriarca must forward a copy of this Award to FINRA's Registration and Disclosure Department for the amendments to be incorporated into the Form U5.
10. Any and all relief not specifically addressed herein, including punitive damages, is denied.

In this case, we see another wrongful discharge claim – this one including allegations of sexual discrimination/harassment along with disability discrimination and retaliation. Despite the numerous allegations, the panel in this case chose to focus on and award damages based upon the Claimant's disability retaliation claims.

This case is interesting because the panel awards a whole plethora of damages including compensatory damages, attorneys' fees and costs for the Claimant based upon a finding that "Claimant was retaliated against based

5. N.J. REV. STAT. § 10:5 (2010).

upon her disability complaints." However, the panel curiously denied her claims for "disability discrimination."

Also noteworthy is the delineation of damages. The panel does not indicate the grounds for the award of damages of $20,000 for emotional distress, though they make clear that the award of attorney's fees is pursuant to statute.

Rick Cooper, The Estate of Lauretta Kupperman, and Kupperman Family Limited Partnership, Claimants v. Debbie Michelle Saleh, Wedbush Morgan Securities Inc., Wells Fargo Advisors, LLC f/k/a Wachovia Securities, LLC f/k/a First Union Securities, Edward W. Wedbush, Respondents, Wedbush Morgan Securities Inc., Cross-Claimant, Wells Fargo Advisors, LLC f/k/a Wachovia Securities, LLC f/k/a First Union Securities, Cross-Respondent,
FINRA Case No. 09-04522[6]

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6. In the Statement of Claim and Amended Statement of Claim, Claimants asserted the following causes of action: 1) negligent misrepresentation; 2) fraud and intentional misrepresentations and/or omissions; 3) failure to supervise; 4) breach of fiduciary duty; 5) unsuitable transactions; 6) unauthorized transactions; 7) churning; 8) elder abuse; 9) emotional distress; and 10) breach of contract. The causes of action relate to multiple investments in unspecified variable annuities.

In their Amended Statement of Claim, Claimants added Edward Wedbush as a Respondent.

Unless specifically admitted in its Answer, Wells Fargo denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

Unless specifically admitted in its Answer, Wedbush Securities denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In its Cross-Claim against Wells Fargo, Wedbush Securities asserted the following causes of action: 1) implied indemnity; 2) comparative indemnity; 3) equitable indemnity; and 4) contribution. The causes of action relate to the alleged conduct of Saleh while she was employed with Wells Fargo and Wedbush Securities.

Unless specifically admitted in its Answer to Wedbush Securities' Cross-Claim, Wells Fargo denied the allegations made in the Cross-Claim and asserted various affirmative defenses.

Unless specifically admitted in his Statement of Answer to the Amended Statement of Claim, Edward Wedbush denied the allegations made in Claimants' Amended Statement of Claim and asserted various affirmative defenses.

In their Statement of Claim and Amended Statement of Claim, Claimants requested:

1. Compensatory damages of at least $1,000,000.00;
2. Disgorgement of all commissions;
3. Reimbursement of all surrender, penalty, and other fees and costs associated with the purchase and sale of unsuitable and/or unauthorized securities;
4. Interest on all damages;
5. Exemplary, punitive, and emotional distress damages;
6. Attorneys' fees and costs; and
7. Such other and further relief as the Panel deems just and proper.

In its Statement of Answer, Wells Fargo requested that:

1. Upon a proper accounting of Claimants' accounts with Respondent Wells Fargo, that if the alleged wrongdoing by Saleh does not result in damages caused by Respondent Wells Fargo, that the claims be dismissed;
2. Respondent Wells Fargo be awarded its out-of-pocket costs incurred as a result of the initiation and prosecution of this claim; and
3. All forum fees be assessed against Claimants.

In its Statement of Answer, Wedbush Securities requested that:

1. Claimant take nothing by reason of their Statement of Claim;
2. An award be entered in favor of Wedbush Securities; and
3. Such other and further relief as the Panel deems appropriate.

In its Cross-Claim against Wells Fargo, Wedbush Securities requested:

1. An order of the Panel declaring the percentage of fault, if any, between Wedbush Securities and Wells Fargo for damages and losses, if any, allegedly caused to Claimants;
2. An order of the Panel awarding judgment in favor of Wedbush Securities against Wells Fargo based upon the relative percentage of fault of each party including the Claimants;
3. An order of the Panel that Wedbush Securities is entitled to be fully indemnified by Wells Fargo, for any and all settlements or compromise entered into by Wedbush Securities as a result of this action;
4. Attorneys' fees, forum fees, and other expenses incurred in the defense of this arbitration claim according to proof; and
5. Such other relief as the Panel may deem just and proper.

In its Answer to Wedbush Securities' Cross-Claim, Wells Fargo requested that Wedbush Securities take nothing by its claims for indemnity and contribution against Wells Fargo and that Wedbush Securities' claims be dismissed in their entirety.

Los Angeles, California

Claimants' Counsel: Robert C. Rosen, Esq. and Kirsten Anderson, Esq., Rosen & Associates, PC.

Respondent Wells Fargo's Counsel: Geoff S. Beckham, Esq., Bingham McCutchen LLP.

Respondent Wedbush Morgan Securities Inc. and Edward W. Wedbush's Counsel: Charles LaChaussee, Esq., and John Erikson, Esq., Wedbush Morgan Securities Inc.

Respondent Debbie Michell Saleh did not enter an appearance in this matter.

Arbitrators: Robert C. Albini, Public Chairperson, Howard B. Brown, J.D., Public Arbitrator, Linda L. Drummond, Non-Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, and the post-hearing submissions, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents Saleh and Wedbush Securities are jointly and severally liable for and shall pay to Claimants compensatory damages in the amount of $470,885.00.
2. Respondents Saleh and Wedbush Securities are jointly and severally liable for and shall pay to Claimants interest on the amount of $470,885.00 at the rate of 10% per annum from September 30, 2008 until the date the Award is paid in full.
3. Respondent Saleh is solely liable for and shall pay to Claimants $500,000.00 in special damages for emotional distress.
4. Respondent Webush Securities is solely liable for and shall pay to Claimants $300,000.00 in special damages for emotional distress.
5. Respondent Edward Wedbush is solely liable for and shall pay to Claimants $200,000.00 in special damages for emotional distress.
6. Respondent Saleh is solely liable for and shall pay to Claimants $1,000,000.00 in punitive damages pursuant to California's Elder Abuse and Adult Civil Protective Act, Welfare and Institutions Code, Section 15600, et seq.[7]

In his Statement of Answer to the Amended Statement of Claim, Edward Wedbush requested that:

1. Claimants take nothing by reason of their Amended Statement of Claim;
2. An award be entered in Edward Wedbush's favor; and
3. Such other and further relief as the Panel deems appropriate.

7. CAL. WELF. & INST. CODE §15600, et seq. (West 1998).

7. Respondents Saleh and Wedbush Securities are jointly and severally liable for and shall pay to Claimants attorneys' fees in the amount of $390,000.00 pursuant to California Welfare and Institutions Code Section 15657.5. [8]
8. Respondents Saleh and Wedbush Securities are jointly and severally liable for and shall pay to Claimants costs in the amount of $5,000.00.
9. Based upon the evidence presented at the hearing in this matter, the Panel determined that Respondent Saleh's conduct was premeditated, egregious, and unconscionable and part of a plan or scheme to defraud her customers. Respondent Saleh's actions, including forging the client's signature on various documents, making gross misrepresentations about the securities in the client's account and the value of those securities, providing the client with false monthly account statements and executing unauthorized redemptions and/or partial withdrawals in the client's annuities in violation of her fiduciary duties. Respondent Saleh's conduct certainly borders on criminal misconduct, if not actually elevating her actions to actual criminal misconduct.
10. Any and all relief not specifically addressed herein is denied.
11. The Panel provided an explanation of their decision in this award. The explanation is for the information of the parties only and is not precedential in nature.

First, one must call this case what it is: a clean sweep for the Claimants. This award has punitive damages, attorneys' fees, and costs. However, this case is noteworthy as it is a recent customer case in which the customer was awarded emotional distress damages, which the panel categorizes as "special damages."

The misconduct cited by this panel clearly illustrates the panel's rationale for throwing the proverbial book at the respondents. Rarely, if ever, does one see an arbitration go so far as to categorize the misconduct in the award as "criminal."

8. CAL. WELF. & INST. CODE §15657.5 (West 1998).

CASES & MATERIALS

Joseph Wojciechowski

Merrill Lynch v. Manning, 578 U.S. ______; 136 S. Ct. 1562 (May 16, 2016).

In an 8-0 decision, the SCOTUS ruled the jurisdictional test under Section 27 of the Exchange Act, 15 U.S.C. §78aa(a), is the same as the test used to determine whether an action "arises under" federal law, pursuant to 28 U.S.C. §1331. Respondent Manning, along with six other shareholders of Escala Group, Inc., brought an action against Merrill Lynch and several other financial institutions alleging the firms' naked short sales of the stock violated New Jersey law and drove the value of Escala's shares down, thereby damaging the shareholders. The shareholders alleged violations of the New Jersey civil RICO statute, violations of the New Jersey Uniform Securities Law, along with common law negligence, unjust enrichment, and interference with contractual relations. No claims were made under Federal law or rules. However, the complaint did explicitly refer to Regulation SHO. The case was originally filed in New Jersey state court. Merrill Lynch successfully removed the case to Federal Court, asserting federal jurisdiction on two grounds: that the action "arises under" federal law and that Section 27 of the Exchange Act conferred exclusive jurisdiction to federal courts. The shareholders sought remand to state court, which was denied. The Third Circuit court of appeals reversed, finding all of Manning's claims were grounded in state law, and therefore, did not "arise under" federal law. The Third Circuit also ruled that Section 27 only confers jurisdiction in cases involving the Exchange Act that would satisfy the "arising under" standard. Merrill Lynch sought review on the question of whether Section 27 confers federal court jurisdiction.

The SCOTUS affirmed the Third Circuit, remanding the case back to New Jersey state court. In so doing, the SCOTUS held that Section 27 of the Exchange Act only confers jurisdiction in those cases "arising under" the Exchange Act. Merrill Lynch argued that by referencing Regulation SHO in its complaint, Manning invoked the Exchange Act and therefore Section 27 applied. SCOTUS disagreed, holding if the success of a state law cause of action depends on a showing that the defendant breached the Exchange Act, then the suit could fall within Section 27's compass.

Citigroup, Inc. v. AHW Inv. P'ship, 140 A.3d 1125 (Del. 2016).

The Second Circuit Court of Appeals certified the following question to the Delaware Supreme Court arising from a decision of the United States District Court for the Southern District of New York, *AHW Inv. P'ship v, Citigroup, Inc.*, 806 F.3d 695, 705 (2d Cir. 2015):

> Are claims of a plaintiff against a corporate defendant alleging damages based on the plaintiff's continuing to hold the corporation's stock in reliance on the defendant's misstatements as the stock diminished in value properly brought as direct or derivative claims?

PIABA filed an *amicus curiae* brief in support of the position that the claims here were direct. SIFMA filed an *amicus curiae* brief in support of opposite position, that the claims are derivative. The Delaware Supreme Court ruled that the holder claims in this case were direct because under either Florida or New York law, the laws governing the claims, the claims belong to the stockholder who allegedly relied on the corporation's misstatement to their detriment. Under those state laws, the holder claims are not derivative because they are personal to the stockholder and do not belong to the corporation itself.

The Court ruled that the familiar two-pronged test articulated in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) is not relevant to the analysis of whether the holder claims at issue were direct or derivative. The court explained that *Tooley* and its progeny deal with the narrow issue of whether a claim for breach of fiduciary duty or otherwise to enforce the corporation's own rights must be asserted derivatively or directly. The court held that before performing the *Tooley* test, a "more important initial question has to be answered: does the plaintiff seek to bring a claim belonging to her personally or one belonging to the corporation itself?" (internal citation omitted).

The simplified version of the facts before the court were as follows: Williams came to own 17.6 million shares of Citigroup stock after the merger of Citicorp and Travelers Group in 1998, valued at $35 per share. In May 2007, the Williamses, along with their financial advisors, developed a plan to sell their shares. On May 17, 2007, they sold one million shares for $55 per share. But they stopped their plan to sell the remaining 16.6 million shares based on Citigroup's public filings and financial statements, concluding in reliance on those statements, that there was little risk in continuing to own Citigroup stock. The Williamses held these shares until March 18, 2009, selling them for $3.09 per share. Williams sued Citigroup in the S.D. of New York alleging Citigroup failed to disclose material information about its true financial condition from 2007 into 2009. The claims sounded in common law fraud and negligent misrepresentation under Florida law. They sought $809,950,000 in damages, the difference between what they otherwise would have received had they sold and what they received when they finally did sell for $3.09 per share.

Citigroup moved to dismiss, arguing Williams' claims were derivative and that under New York law, which Citigroup argued applied, and not Florida law, Williams failed to state claims for which relief could be granted. The District court decided the claims were direct, not derivative under Delaware law, but ultimately granted the motion and dismissed the amended complaint. Williams appealed and Citigroup cross-appealed on the issue of whether the claims were derivative or direct. Because of recent decisions issued in Delaware germane to the issue, the Second Circuit certified the question to the Delaware Supreme Court. The court determined that under either New York or Florida state law, a holder claim belongs to the individual shareholder and derives directly from the shareholder's individual rights, and does not belong to the corporation. The claims do not belong to the issuer and do not invoke the internal affairs doctrine because holder claims are "analytically indistinct from seller and purchaser claims, which are direct claims that are personal to the holder." Although the court spent some time criticizing the claims and the difficulty inherent in proving inducement in holder claims, the court determined those issues "did not transmogrify a common law fraud or negligent misrepresentation claim belonging to the security holder under state law into one belonging to the issuer."

Royal Alliance Assocs. v. Mora, 2016 U.S. Dist. LEXIS 31895 (N.D. Cal. Mar. 10, 2016)

Investors originally filed separate FINRA arbitration actions against Royal Alliance. Lewis filed the first case on July 3, 2013 and two weeks later, Mora and Gonzalez filed a second claim, making similar allegations as the Lewis complaint. On September 5, 2014, Lewis and Mora/Gonzalez filed a motion to consolidate the cases with the Mora/Gonzalez panel. The motion was granted and the two cases were consolidated. Royal Alliance sought to vacate the order with the director, arguing the cases should have been consolidated under the Lewis Panel because it was the lower-numbered case and that what the investor-plaintiffs had done was blatant panel shopping. After Royal Alliance filed its motion, but before the Director made a decision, "The Neutral Corner" published a "refresher" on FINRA Rule 12312, the rule governing joinder of claims. The "Neutral Corner" article stated "if a party files a motion to consolidate or sever, the panel in the lower-numbered case will decide the motion, unless the parties agree otherwise."

The Director denied Royal Alliance's motion, because at the time of the original consolidation, Royal Alliance never requested that FINRA assign the motion to the lower-numbered panel." Royal Alliance sought reconsideration and it was denied. On July 15, 2015, the Mora/Gonzalez panel awarded the investors $1,085,456, punitive damages of $75,000, attorney's fees of $184,000 and costs of $57,231. Royal Alliance sought to vacate the Lewis portion of the award based on the consolidation issue, and to vacate the award of attorney's fees.

Royal Alliance relied on the Neutral Corner article for its basis to overturn the award insofar as the consolidation was concerned. The court stated "Royal Alliance's position borders on the frivolous." The Court ruled the Neutral Corner article was not a rule, was not binding, and if it were, was released AFTER the decision to consolidate. Further, in line with the standard of review of arbitration awards, Royal Alliance failed to establish that the Panel understood the correct standard and decided to ignore it. As to the arbitrator-shopping allegation, the court utterly dismissed it, citing to the same procedures used to rank and strike both panels. With respect to Royal Alliance's motion to vacate the award of attorney's fees, the court similarly found Royal Alliance's positions to be faulty because there was nothing establishing the decision to be "completely irrational" and did not manifestly disregard the law. The Court granted the investor-plaintiff's motion and ordered Royal Alliance to pay their post-arbitration attorney's fees. The case is a clear reflection that courts, at least in the Ninth Circuit, are still using the manifest disregard of the law standard in ruling on petitions to vacate arbitration awards.

Rogers v. Ausdal Fin. Partners, 2016 U.S. Dist. LEXIS 30140 (Dist. Mass. Mar. 9, 2016)

Ausdal sought to vacate a FINRA arbitration award, which found for an investor in the amount of $1.24 million plus costs in connection with the advice to accept a retirement pension in a lump-sum from Verizon and to invest the proceeds into an annuity, which according to the investor-claimant, could sustain withdrawals of $3,765 per month. Further, because the investor-claimant retired at 49 years old, each annuity disbursement was subject to a 10% income tax penalty.

The arbitration proceeded without incident, with one exception. Ausdal filed a motion for the issuance of subpoenas for documents and testimony from twelve non-parties, including the investor-claimant's previous employer, Verizon. The Panel chair denied the motion with exception of a subpoena to Prudential. In his ruling, the Chairperson specifically cited to the simplified and expedient discovery procedures in arbitration. Ausdal sought reconsideration on its motion which was denied coupled with a threat of sanctions from the Chair if they asked again.

The arbitration hearing was conducted over four days. One exchange is particularly relevant to Ausdal's motion to vacate. The Panel asked the parties about documents specific to the retirement package offered by Verizon to the investor-claimant. One of Ausdal's core defenses was that it was Verizon, not Ausdal, who advised the Claimant that she could retire at 49 years old and be financially stable. Ausdal's attorney reminded the Chairperson that one of the subpoenas he denied was to Verizon. The Panel specifically stated documents regarding the claimant's Verizon retirement package would be relevant and were something they wanted to review. Because Claimant did not have them and because it was too late to issue a subpoena, the hearing continued and resulted in the substantial award to Claimant.

Ausdal moved to vacate the award because the amount of the award was not supported by the evidence or even requested; that the damages awarded were contrary to the law; and denied Ausdal a fair opportunity to obtain material evidence through discovery. The court denied the petition to vacate and confirmed the award. The court cited the arbitrators' broad authority under the FINRA code to rule on discovery matters and the broad discretion arbitrators have in rendering decisions. The court noted that the simple award, with no reasoning, made it impossible to determine what the arbitrators' reasoning or motives were in issuing the award, leaving the court to speculate. The court questioned whether "manifest disregard" was still alive in the First Circuit after *Hall Street Associates, LLC v. Mattel, Inc.*, 552 U.S. 576 (2008). Even if the doctrine survived, there were insufficient grounds to conclude the arbitrators manifestly disregarded any law in issuing the award.

Aronstein v. Mass. Mut. Life Ins. Co., 2016 U.S. App. LEXIS 54190 (D. Mass. Apr. 22, 2016)

A class action was filed against Massachusetts Mutual Life Insurance Company in connection with the sale of annuities to class members who alleged causes of action for unjust enrichment, fraud, and violations of Massachusetts consumer protection statutes. (Mass. Gen. Laws ch. 93A). The class plaintiffs alleged the written marketing materials distributed by the insurance company regarding the fixed deferred annuity at issue misrepresented the "minimum guaranteed interest rate". In January 2015, the Plaintiff realized the rate of return he received in 2014 was actually 2%, not the 3% guaranteed in the marketing materials. After further examination, Plaintiff realized since 2011, the rate was never 3% but not less than 1.5%.

Defendant moved to dismiss under Fed. R. Civ. P. 12(b)(6) arguing 1) statute of limitations bars all claims; 2) unjust enrichment claim fails because the matter is governed by a valid contract; and 3) New York substantive law applies, not Massachusetts. The court granted the motion to dismiss the unjust enrichment and statutory claim, agreeing with Defendant's arguments regarding the validity of the underlying contract. The court also ruled that New York substantive law applied because plaintiff lived in New York, bought and received the annuity while in New York, and New York law controls the regulation of the annuity. The court denied the motion to dismiss the fraud claim, ruling that under either New York or Massachusetts law, the "discovery rule" saves the claims from dismissal based on statutes of limitation. The court concluded the determination of the triggering event for purposes of the discovery rule does not lend itself to dismissal under Fed. R. Civ. P. 12(b)(6) because it is a fact intensive determination more suited for either summary judgment or a jury.

Pershing LLC v. Kiebach, 2016 U.S. App. LEXIS 6308 (5th Cir. Apr. 6, 2016).

Before the court was an interlocutory appeal of the district court's order denying Kiebach's motion to dismiss for lack of subject matter jurisdiction Pershing's motion to confirm an arbitration award. Appellants are a group of investors who allegedly suffered $80,000,000 in losses as a result of Allen Stanford's Ponzi scheme. The investors brought an action in FINRA arbitration against Pershing, the clearing broker for Stanford Group Company, alleging Pershing failed to disclose adverse financial information. After a two week FINRA hearing, the Panel awarded the investors $10,000 for arbitration related costs. The investors moved to vacate in New York federal court, which was voluntarily dismissed and refiled in Louisiana state court. That case was removed to Louisiana federal court and was stayed pending the outcome of this appeal. Pershing moved to confirm and the investors sought dismissal arguing that the amount in controversy - the amount of the arbitration award - fell below the amount in controversy for federal jurisdiction. The district court denied the motion, *Pershing, LLC v. Kiebach*, 101 F. Supp. 3d 568 (E.D. La. 2015), but noted there is disagreement amongst the courts about the proper standard for determining the amount in controversy in context of confirming an arbitration award. The issue was whether the amount in controversy for establishing diversity over a petition to confirm an arbitration award is the amount of the award or the amount sought in the arbitration proceeding. The court held that the demand approach - the amount sought in the underlying arbitration - is the proper measure of the amount in controversy for jurisdictional purposes.

Nat'l Football League v. Nat'l Football League Players Assoc., 2016 U.S. App. LEXIS 1354 (2d Cir. Jan. 28, 2016)

The District Court decision vacating arbitrator/Commissioner Roger Goodell's ruling suspending Tom Brady for four games for his role in "deflategate" was profiled in a previous edition of the PIABA Bar Journal. *See* 22 PIABA B.J. 347-48 (2015), and *Nat'l Football League Mgmt. Counsel v. Nat'l Football League Players Assoc.,* 2015 U.S. Dist. LEXIS 117662 (S.D.N.Y. Sep. 3, 2015). On appeal, the Second Circuit reversed the District Court, ruling that the collective bargaining agreement between the NFL and the NLFPA granted the arbitrator broad discretion on all issues in connection with league rules and policies. The Court declined to examine the facts of the underlying case, ruling the District Court overstepped the extremely narrow grounds for vacating an arbitration award or ruling. Even still, the Court could not resist the urge to delve into the facts and spin them in a manner which made Commissioner Goodell's ruling seem to fall clearly within the broad discretion of any arbitrator, especially one vested with so much bargained-for authority. The court also determined that the process did not deprive Brady of fundamental fairness and that the arbitrator's conduct did not exhibit evident partiality under the Federal Arbitration Act. 9 U.S.C. § 10(a)(2).

Notably, Chief Judge Katzmann dissented. In a thorough rebuke of the majority decision he argued Commissioner Goodell dished out his "own brand of industrial justice" and that by changing the factual basis for the discipline meted out against Brady, he went beyond his authority as collectively bargained, warranting vacatur.

Waddoups v. Nationwide Life Ins. Co., 2016 Wash. App. LEXIS 508 (Wash. Ct. App. Mar. 15, 2016)

Plaintiff, as personal representative of his father's estate, sued Nationwide and a financial planner who was a registered investment advisor in connection with a single premium immediate annuity. The Plaintiff alleged that defendants breached their fiduciary duty, engaged in unfair insurance practices in violation of WASH. REV. CODE § 48.30.010 (2007) and violated the Washington

Consumer Protection Act. The Plaintiff asserted that the single premium immediate annuity was unsuitable in that it did not have a death benefit, and was sold to the annuitant when he was 85 years old and in poor health. The trial court dismissed all claims on summary judgment, ruling that the Plaintiff did not carry the burden to show the financial advisor failed to warn Mr. Waddoups that the annuity had no death benefit. The trial court concluded the only reasonable inference from the undisputed facts was that the financial advisor warned Mr. Waddoups that there was no death benefit. Other issues examined by the court involved standing, the Dead Man Statute, and admissibility of expert testimony.

The Appellate court reversed, holding that there were issues of material fact regarding the advisor's warning to Mr. Waddoups that the annuity he sold to him did not have a death benefit. Much of this ruling was based on the fact that the trial court relied extensively on the advisor's testimony about conversations he had with the now deceased Mr. Waddoups. As such, the court held, the trial court should ignore the testimony of the financial advisor about conversations he had with Mr. Waddoups at the summary judgment stage because of the inability for that testimony to be refuted. The court also held that the expert testimony presented by Plaintiff established a standard of care that was violated by the financial advisor, who admitted he owed Mr. Waddoups fiduciary duties. The expert testified that the advisor had a legal duty to advise Mr. Waddoups that he should not buy the annuity that he sold to him because it was unsuitable. Thus, the case boiled down to a failure by the advisor to warn the investor and by failing to do so, could have breached his fiduciary responsibility.

In re Equity Trust Co., S.E.C. Release No. 1030, 2016 WL 4035556 (June 27, 2016)

For the first time, the SEC brought an Order Instituting Proceedings against Equity Trust on June 16, 2015. After an eight day hearing in December 2015, which included testimony from twenty-six witnesses, five of whom offered expert testimony, the ALJ dismissed all charges against Equity Trust.

The charges brought by the SEC were in connection with fraudulent investment schemes that utilized investments held in self-directed IRA accounts held in custody by Equity Trust. An Equity Trust salesperson was in direct contact with the architect of the fraudulent schemes and assisted in obtaining paperwork necessary to allow customers and other salespeople to invest client funds in Capital City - the first fraudulent investment. This Equity Trust employee traveled to Capital City headquarters and put on a seminar about opening accounts at Equity Trust. He also communicated with Taylor, the architect, informing him when investor funds were deposited. Equity Trust also created a "landing page" on its website for City Capital, which was a personalized website sponsored and created by Equity Trust for City Capital Investors. It was disputed whether this landing page was ever actually launched. The Equity Trust employee was present at a massive City Capital event at a Baptist mega-church in Atlanta, where he was introduced by Taylor as the "personal banker".

The SEC's allegations also included facts about a separate scheme, Poulson Investments, facilitated in a similar manner by Equity Trust. The SEC charged Equity Trust was a cause of Taylor's and Poulson's violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, 15 U.S.C. § 77q(a)(2)-(3). Equity Trust was not charged as a primary-violator. The ALJ determined that the SEC's charges did not meet the negligence standard required that Equity Trust "knew or should have known" that either Taylor or Poulson were running fraudulent schemes. Both appeared to be legitimate businessmen running legitimate business enterprises. With no independent duty to perform due diligence, Equity Trust had no obligation to investigate.

U.S. v. Sean Stewart, Case No. 15-cr-00287-LTS Document 141 (S.D.N.Y. July 22, 2016)

In a criminal case, the Government filed a motion to compel a former J.P. Morgan Chase & Co. in-house attorney to give testimony and produce documents concerning communications the Defendant made during a FINRA inquiry. J.P. Morgan and the former attorney objected to producing documents or providing testimony on the grounds of attorney-client privilege and work product doctrine. The case involves an ongoing criminal prosecution in connection with trading of Kendle International stock.

J.P. Morgan represented Kendle in negotiations leading up to an announcement by INC Research that it intended to acquire Kendle. FINRA initiated an inquiry into pre-announcement trading in Kendle stock and requested that J.P. Morgan circulate a list of names to J.P. Morgan employees involved with the merger negotiations to see whether any employees recognized any of the names on the list. Defendant was an employee of J.P. Morgan, and made a statement through J.P. Morgan counsel to FINRA regarding Defendant's father appearing on the circulated list.

The government sought discovery into the letter and the representations made in it to FINRA. The court granted the motion to compel because Defendant's prior attorney at J.P. Morgan waived the attorney-client privilege because the communication to FINRA disclosed the substance of communications between attorney and client. The letter disclosed the contents of privileged communications, waiving its attorney-client privilege as to the disclosed communications. J.P. Morgan argued that there was no waiver because it was compelled to make the disclosures to FINRA. The Court held that the argument lacked any basis because FINRA is a private organization, and the information was not compelled by order of either a court of law or government order. The court also overruled the work-product objection because it was waived by J.P. Morgan, specific to any work product embodying, or constituting factual notes or summaries of the Defendant's communications that were disclosed to FINRA.

This ruling is important because it could open the door in civil suits or arbitration to discovery of otherwise privileged information disclosed to FINRA in the course of investigations.

Royal Alliance Assoc. v. Liebhaber, 2016 Cal. App. LEXIS 724 (Cal. Ct. App. Aug. 30, 2016)

Royal Alliance petitioned to confirm an arbitration award granting expungement from the allegations made by claimant-investor against Kathleen Tarr. The investor-claimant sought an order vacating the award because the arbitration panel refused to hear evidence or even allow the presentation of evidence or the cross examination of witnesses. FINRA joined in the motion. The trial court denied the petition to confirm and granted the petition to vacate. Royal Alliance appealed.

The underlying facts of this expungement hearing are exceptional. After the parties settled their dispute, Royal Alliance sought an expungement hearing. Claimant's Counsel, well known and widely respected PIABA member Robert Banks, informed the Panel that although he did not intend to submit a prehearing brief, that he intended to call Claimant and the broker, Kathleen Tarr, as witnesses. The telephonic hearing took place, during which time Royal Alliance's counsel was allowed to argue for expungement and Tarr was allowed to give unsworn testimony that amounted to nothing more than a speech. Mr. Banks then argued against expungement and requested leave to ask both Tarr and his client some questions. Royal Alliance's counsel objected, arguing that the hearing was for expungement and was not a hearing on the merits, which had been settled. The arbitrators deliberated and complained that allowing the testimony would mean they would have to be at the hearing for "another two hours." The Panel denied Mr. Banks' the opportunity to ask Ms. Tarr questions. The Panel granted expungement, specifically finding that Ms. Tarr's "statements offered…during the telephonic hearing were credible." The Panel did not stop there however. It went on: "In addition, there is no documentation or other evidence to support a claim that Claimant suffered losses as a result of non-party Kathleen Tarr's actions, or Respondent's action or inactions."

Royal Alliance sought to confirm the award under CAL. CIV. PROC. CODE § 1285. Liebhaber requested the award be vacated under CAL. CIV. PROC. CODE §§ 1286.2 and 1286.4. The three grounds argued to vacate the award were 1) that the panel's misconduct violated Liebhaber's rights; 2) that the panel exceeded its powers by denying Liebhaber's request to present evidence; and 3) Liebhaber's rights were substantially prejudiced by the refusal of the panel to hear evidence material to her claims. FINRA also sought to vacate the award because the arbitrators failed to follow FINRA rules governing expungement.

During the hearing, the trial court instantly voiced its preference to vacate the award because the underlying process just seemed wrong. On appeal, Royal Alliance argued that absent a finding that the underlying FINRA procedural rules were not complied with, that the court could not vacate the award. The court disagreed. The court determined that the arbitrators violated Ms. Liebhaber's rights by refusing to hear evidence and that as a result, her rights were substantially prejudiced and concluded "[s]imply put, the hearing was not fair. The arbitrators gave Royal Alliance an unfettered opportunity to bolster the written record but denied Liebhaber even a limited chance to do the same."

Notes & Observations

WHERE WE STAND

Historically, PIABA has commented on a number of issues,[1] on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority ("FINRA").

For example, among the issues that generated the most interest, from and/or on behalf of the members of our association, were proposed amendments to the rules concerning:

- Abusive pre-hearing dispositive motion practices; and
- The adoption of specific procedures that arbitrators will be required to follow before granting the extraordinary remedy of the expungement of prior customer complaints from the registration records of registered representatives.

In this section of the *PIABA Bar Journal*, we will share with our readers the comment letters and formal positions that have been submitted on behalf of our association, during the quarter, to the various regulatory authorities so that all of our constituents will know exactly where we stand.

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Hugh Berkson at hberkson@hcsattys.com, Marnie Lambert at mlambert@mclinvestlaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding the *Docket No. CFPB-2016-0020 or RIN 3170-AA51* was submitted to the Consumer Financial Protection Bureau by Marnie C. Lambert on August 22, 2016 (prepared with the assistance of Christine Lazaro and Darlene Pasieczny).

Ms. Monica Jackson
Office of the Executive Secretary
Consumer Financial Protection Bureau
1700 G Street, NW
Washington DC 205552

Re: Docket No. CFPB-2016-0020 or RIN 3170-AA51

Dear Ms. Jackson:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, such as arbitration of claims against brokers and broker-dealers through FINRA Dispute Resolution, while also advocating for public education regarding investment fraud and industry misconduct.

While PIABA's focus is primarily on advocating for investor protection in the securities industry, PIABA also has an interest in rules which impact forced arbitration. PIABA applauds the Consumer Financial Protection Bureau's (CFPB) goals of enhancing consumer protection by assuring the ability of consumers to participate in class action litigation. PIABA has long recognized the importance of class action litigation to provide economic relief to wronged investors, to correct the inherit power imbalances between an individual and the industry, to have access to the legal protections of a transparent, public court system and the constitutional right to a jury trial to adjudicate disputes, and to deter unlawful industry conduct.

PIABA generally supports the CFPB's proposal to ban class action waivers in mandatory pre-dispute arbitration agreements in consumer financial contracts. PIABA is also supportive of the CFPB's efforts to increase transparency in the consumer financial dispute resolution arena by requiring that industry participants submit certain records to the CFPB. As the CFPB has pointed out, class action waivers have been prohibited in securities arbitrations by FINRA for several decades. Additionally, several of the records the CFPB proposes to have industry participants disclose have been disclosed in the securities arbitration forum for many years. The CFPB's proposal actually would require *more* types of records be disclosed with respect to consumer financial disputes than the present rules for securities arbitrations. PIABA would welcome the additional disclosures in securities disputes as well, because, as discussed below, greater public disclosure of arbitration pleadings can help curtail abusive conduct by industry respondents.

The CFPB Should Not Exempt Investment Advisors or CFTC Regulated Entities.

The CFPB has specifically exempted brokerage firms from the coverage of its proposed rule precisely because brokerage firms are already prohibited from including class action waivers in their mandatory pre-dispute arbitration clauses under FINRA rules. The CFPB seeks comment on whether it should include an exemption for other SEC regulated entities, such investment advisers, who may at some point be covered by similar rules. A conditional exemption, ensuring that the entity is covered by a rule which similarly bans such waivers, would be appropriate. However, at this time, the SEC has not given any indication that it plans to take any action with respect to the authority it has been granted under Dodd-Frank section 921 to review arbitration agreements in the securities context. Presently, no such rules exist which governs the conduct of SEC-registered investment advisers. Accordingly, investment advisers should be covered by the CFPB's proposed rule to the extent they are offering products and services subject to CFPB oversight.

The CFPB also seeks comment on whether it would be appropriate to include entities which may be regulated by the CFTC. While the CFTC does require that pre-dispute arbitration agreements be voluntary, presently there are no rules governing class action waivers. A conditional exemption for CFTC regulated entities would be appropriate so long as it requires that the entity be covered by a rule which bans such waivers, similar to the conditional exemption for SEC regulated entities. If the CFTC chooses to adopt such a rule, there would be no need for the CFPB to regulate these entities under this rule making. However, CFTC regulated entities should otherwise be covered by the CFPB's proposed rule to the extent they are offering products and services subject to CFPB oversight.

Notice Language Should Be Clear and Simple.

The CFPB's proposed language would notify consumers in plain English that an arbitration agreement would not stop a consumer from being part of a class action in court. The CFPB has succeeded here in conveying the consumer's rights in easy to comprehend language. The language the CFPB proposes is much simpler than that required by FINRA with respect to the prohibition of class action waivers in securities pre-dispute arbitration contracts. *See* FINRA Rule 2268(f). PIABA supports language of the utmost clarity so a consumer is clear that they may still participate in class action litigation.

PIABA suggests that the CFPB require that the language be included as a part of *all* pre-dispute arbitration clauses, and a separate notice clearly containing this language be sent to consumers with existing covered agreements. PIABA further suggests that the CFPB require that such language by conspicuously placed, and not in a smaller font or in any way diminished in importance. Additionally, covered firms should be required to include such provisions on their websites.

Additional Arbitration Record Disclosures Benefit The Public At Large.

With respect to the second portion of the CFPB's proposal, PIABA supports the required disclosure of arbitration records and the subsequent publication of such records. There is a significant lack of transparency within the alternative dispute resolution process, with respect to both securities and consumer arbitrations.

It is important to understand the claims and defenses raised within an arbitration process. In the securities arbitration context, pleadings are not made public, although they are submitted to FINRA (who is both the regulator and the operator of the dispute resolution forum). In April, 2015, PIABA reviewed a number of Answers filed by brokerage firms in FINRA arbitrations. Overwhelmingly, firms deny that they have any fiduciary obligations to clients, notwithstanding state common law, the relationship between the customer and the firm, or the public position taken by the firm that they are to be viewed as a customer's trusted adviser. *See* Peiffer & Lazaro, "Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard," available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf. PIABA was able to obtain these Answer documents from its members; they were never made available publicly. It is possible the firms would have been more reluctant to plead defenses, sometimes improperly, which were so contrary to their public images if they knew their pleadings would have been publicly available. Likewise, if the firms so rely on the legal defense that their registered brokers have no fiduciary obligations to their clients, publication may help stop misleading marketing campaigns when public scrutiny reveals the contradictory messaging.

It may be helpful for the CFPB to collect other documents as well. For example, FINRA has just proposed a rule which would require that the arbitration parties submit discovery requests and objections to such requests to it. *See* SR-FINRA-2016-029 (Proposed Rule Relating to use of the Dispute Resolution Party Portal in Arbitration and Mediation). PIABA members have often seen cases where brokerage firms take advantage of the private nature of the forum and file objections to presumptively discoverable and standard discovery requests in bad faith. These delays prejudice investor claimants, who must then use time and resources to take additional steps to try to compel production of those documents, or unfairly lose the benefit of seeing documents that could be critical to their case. Greater forum oversight of discovery requests and objections should help prevent firms from exploiting the process to their advantage.

In addition to collecting and making public final awards in consumer financial arbitrations, it may also be helpful for the CFPB to collect information on whether firms have complied with awards and disclose this information. In February, 2016, PIABA studied the issue of unpaid awards in FINRA arbitrations, as this information is not made publicly available. *See* Berkson, "Unpaid Arbitration Awards: A Problem the Industry Created – A Problem the Industry Must Fix," available at https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20-%20A%20Problem%20The%20Industry%20Must%20Fix%20(February%2025,%202016).pdf. PIABA found that one out of three awards issued was not paid in 2013, or awards totaling $62.1 million. As an award is only meaningful if it is actually paid, PIABA suggest the CFPB collect information on the payment of awards in consumer financial arbitration as well. If the CFPB finds a systematic problem with unpaid awards such as PIABA discovered through its study of FINRA awards, PIABA encourages the CFPB to consider enforcement measures or other alternatives to ensure consumers who have won an award or settlement get paid in full.

Generally, the disclosure proposal is a step in the right direction. PIABA is hopeful that FINRA and the SEC will make similar changes with respect to securities arbitration.

PIABA is disappointed that the CFPB does not believe there is sufficient evidence to take any other action with respect to the mandatory nature of pre-dispute arbitration agreements. The CFPB study provides ample evidence that consumers do not understand that they are subject to arbitration agreements, nor do they understand the import of such agreements even when they do know they are subject to one. Mandatory pre-dispute arbitration agreements deprive consumers of substantial legal rights. Consumers should be given the option of agreeing to arbitration after a dispute arises. This would afford consumers the greatest protection of choosing between litigating in court with full rights preserved, or a potentially lower-cost and faster resolution through an arbitration forum. PIABA encourages the CFPB to revisit this issue, and promulgate rulemaking which would provide consumers with their choice of forum to resolve disputes.

Sincerely,
Marnie Lambert, PIABA
Executive Vice-President/President-Elect

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-022* was submitted to the Securities and Exchange Commission by Hugh D. Berkson on August 4, 2016 (prepared with the assistance of Adam Nicolazzo and Darlene Pasieczny).

Mr. Robert W. Errett, Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2016-022 Proposed Rule Changes for FINRA Rule 12403 Regarding Selection of Public Arbitrators in Customer Disputes

Dear Mr. Errett:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in the rules Financial Industry Regulatory Authority ("FINRA") promulgates to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in the fairness of the arbitration process, including the important step of the selection of arbitrators.

Pursuant to SR-FINRA-2016-022, FINRA sought comment on proposed changes to Rule 12403 regarding the selection of public arbitrators in customer disputes. Specifically, the rule change proposal would increase the number of proposed public arbitrator candidates from 10 to 15, as well as increase the number of strikes each party would have for each arbitrator candidate list from 4 to 6. FINRA made these rule change proposals after the FINRA Dispute Resolution Task Force recommended that parties be offered a new list of 10 additional potential public arbitrators if parties strike the non-public arbitrators.

PIABA generally supports this rule change proposal, but it also wants to alert the Commission to overarching problems with the arbitrator selection process that threaten to undermine and overshadow the process, even when otherwise sound modifications are made. Therefore, in addition to a few comments specific to the proposed rule change, PIABA suggests that other measures that should be undertaken as soon as possible to promote fairness in the arbitrator selection process.

The Rule Proposal May Help Limit Instances of "Cram-Down" Arbitrators

PIABA is generally supportive of the rule change proposal. First, it provides a total of 30 public arbitrator candidates to be ranked instead of the 20 now available when the non-public arbitrators are stricken. In theory, having the ability to consider more candidates helps both claimants and respondents. Second, by increasing the number of qualified public arbitrators to be ranked, the proposed rule change may help limit instances of "cramdown"[1] arbitrators appointed to panels when the parties strike all the proposed arbitrators. In an instance where there is one claimant and one respondent and the parties select an all-public arbitration panel (by collectively striking all the non-public list names), the rule proposal would guarantee that at least three public arbitrators would be ranked by the parties, as opposed to the current system that guarantees only two arbitrators would be ranked.

With the proposed rule change, in a perfect world where all three of the mutually ranked arbitrators from the initial list are initially qualified, willing and able to serve as arbitrators, FINRA would still have one "alternate" arbitrator the parties have already ranked that could be appointed in the too-common event one of the prior ranked and appointed arbitrators later becomes unavailable or is otherwise disqualified, unwilling, or unable to serve on the panel. Thus, the proposed rule change would hopefully help parties avoid instances where they may get a cram down arbitrator or have to utilize a "short-list" of new arbitrators from which FINRA will appoint one mutually acceptable to the parties (if that arbitrator is available).

While increasing the number of candidates from 10 to 15 for each of the chair-qualified and public lists sounds good in theory, in practice, it will likely lead to disastrous results for investors.

1. A "cram-down" arbitrator is a colloquial term for arbitrators who FINRA selects without the advance notice, disclosure or selection of the parties. Like all arbitrators, these arbitrators are supposed to be randomly selected from the arbitrator pool.

2. [sic]

Additional Recommendations to Promote Transparency and Fairness in the Arbitrator Selection Process

While adding additional public arbitrator candidates to the ranking lists stands to improves the process by decreasing the chances of cram-down or short-list arbitrator appointments, there is fundamental problem with the current list selection process that must be addressed if it is ever to become more fair for the participants, and especially investors.

When FINRA changed the Rule 12100 definitions of "non-public" and "public" arbitrators for customer cases effective in June 2015, it substantially reduced the number of arbitrators eligible to serve as chairpersons and public arbitrators.[3] Accordingly, and especially in the smaller and moderately sized cities, there are insufficient numbers of local candidates for the chair-qualified and public lists. Many, if not most, arbitrators on the chair-qualified lists today are from outside the state where the investors reside and where the dispute arose.[4] In all but the largest metropolitan cities, PIABA's members, who practice in FINRA's arbitration forum daily, have seen a disturbing trend by which local chair-qualified candidates are not appearing on the chair-qualified list, but instead, those lists are comprised primarily of foreign (*i.e.*, out-of-state or "traveling") arbitrators.

FINRA's regular use of foreign arbitrators as chairpersons has a dramatic impact on investor rights. For one thing, many investor claims are based upon violation of state securities laws, which vary from jurisdiction to jurisdiction. PIABA's members have experienced a trend whereby the foreign arbitrators have what appear to be histories of awards that substantially favor the industry, compared to the local arbitrators' records that tend to be more investor-friendly. Our members have also seen that, all too often, foreign arbitrators are less familiar with, and have less regard for, the laws of the forum state where the arbitration is taking place. Accordingly, investors are too often being denied rights afforded to them by their state legislatures.

PIABA members' concern about the effect of importing so many arbitrators is well founded. Since Rule 12100 and the definition of "public" arbitrators were amended (effective June 26, 2015), the percentage of awards

3. Regulatory Notice 15-18, regarding amendments to revise the definitions of Non-Public and Public Arbitrator in FINRA Rules 12100 and 13100, effective June 26, 2015.

4. While this problem has been noticed more often by PIABA members with chair-qualified arbitrators, it is not exclusive to them. It is not uncommon for customer cases, even in major metropolitan cities, to nonetheless have a majority of the arbitrators on the list be out-of-state names on chair qualified and public lists.

in which customers were awarded damages decreased from 47% in 2015 to 38% in 2016 in cases with three "public" arbitrators. *See* FINRA Arbitration Statistics Through June (https://www.finra.org/arbitration-andmediation/dispute-resolution-statistics#arbitrationstats, last visited July 27, 2016).

PIABA is concerned that the increase of proposed arbitrators to the public arbitrator selection list, without other necessary modifications to list generation and arbitrator selection, will only serve to further exacerbate the alarming increase of out-of-state arbitrators appearing on ranking lists. This is particularly a significant problem for locations in the country that have limited available chair-qualified and public arbitrators *(i.e.*, areas with "shallow" arbitrator pools).

Given the foregoing, rather than increasing the parties' overall satisfaction with the arbitration process, the proposed rule change will likely only increase customers' view that the mandatory arbitration process is not fair to them. Therefore, PIABA recommends that FINRA redouble its efforts to recruit suitable *local* individuals to serve as public and chair-qualified arbitrators. Having more local public arbitrators should increase the chances that arbitrators will take into account and apply their state's particular laws, including applicable "blue sky" laws, securities regulations, common law, and administrative rules. PIABA also urges FINRA to monitor and review the frequency of appearances of out-of-state arbitrators on chair-qualified and public lists in various localities to evaluate and measure the success of the recruitment efforts and whether the current arbitration selection rules are affording investors a fair selection process.

PIABA also urges FINRA to increase transparency regarding the list selection process including, but not limited to, the methods employed by the Neutral List Selection System to ensure that the inclusion of traveling out-of-state arbitrators in candidate lists is random (as FINRA has repeatedly represented), is a justified necessity given the number of local people in a specific locality's arbitrator pool, and actually results in the neutral selection of arbitrators. PIABA's members have long sought this same information with respect to local arbitrators that seem to disproportionately appear again and again on certain locations' selection lists. Now, the lack of transparency in the list selection process is also eroding PIABA members' confidence that FINRA's appointment of arbitrators from out-of-state is the result of a neutral and random process. While FINRA has steadfastly maintained that the list generation system is, in fact, random, pulling back the curtain on the process would go a long way toward promoting investor confidence in the system.

In sum, PIABA generally supports the implementation of SR-FINRA-2016-022, subject to concerns and recommendations set forth herein. Under no circumstances does PIABA want the implementation of the proposed rule change to make the arbitrator selection problem worse for investors, which seems to be a real possibility if not an outright certainty. Thank you for the opportunity to comment.

Sincerely,
Hugh D. Berkson,
PIABA President

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-018* was submitted to the Securities and Exchange Commission by Hugh Berkson on July 5, 2016 (prepared with the assistance of David P. Neuman and Adam Nicolazzo).

July 5, 2016

Robert W. Errett, Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: *SR-FINRA-2016-018 - Proposed Rule Changes for FINRA Rules 2210, 2213, and 2214 Regarding Communications with the Public*

Dear Mr. Errett:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to the information provided to investors.

Pursuant to Regulatory Notice 15-16, in 2015, FINRA sought comment regarding changes to Rules 2210, 2213, and 2214 regarding communications with the public. PIABA opposed these rules changes in 2015. Despite the numerous issues highlighted in our previous letter, FINRA has refused to consider the harmful implications that these rule changes will have on investor protection.

As detailed below, PIABA opposes these rule proposals, as they relax FINRA's regulatory oversight and would likely serve to harm investors.

New Firm Communications

FINRA rules currently require that, for a period of one year from the effective date of a new FINRA member firm's membership, all new firms file with FINRA "any retail communication that is published or used in any electronic or other public media . . ." at least 10 business days prior to the first use of communication. FINRA is proposing to drop this requirement and instead require that new members file retail communications within 10 business days of first use. FINRA's justification for the change is that the current rule predates the Internet and FINRA believes that member firms primarily reach customers and potential customers through the firms' websites. FINRA also believes that the long-standing requirement of filing retail communications 10 business days before using them "unnecessarily delays firms' abilities to communicate with the public" and there is no benefit to investors that cannot be accomplished by FINRA's post-use review of communications.

FINRA claims that the changes it is proposing are the result of a "retrospective review" of its rules regarding communications with the public that it launched in April 2014, the results of which were published by FINRA in a December 2014 report. The report found that the rules "could benefit from some updating to better align the investor protection benefits and the economic impacts." FINRA further claims that the rule amendments will result in significant cost savings that "may" encourage members to communicate additional information to investors.

Rather than "aligning the investor protections benefits" with "the economic impacts" (or anything else for that matter), FINRA's proposed rule changes eliminate the pro-active investor protection the current rule affords customers. If the proposed rule goes into effect, new FINRA member firms would not have to obtain any FINRA pre-approval for common retail communications such as those in newspapers, magazines, or other periodicals and/or those on the radio, television, telephone or audio recording, video display, signs or billboards or motion pictures.

Of course, as FINRA well knows, not every customer or potential customer uses the Internet as the primary source of information about financial advisors, brokerage firms or investments. Indeed, the "National Senior Investor Initiative" report that was released in April 2015, by the SEC and FINRA illustrates the different forms of communications that reach and are relied on by one growing segment of investors – seniors. The report contains the observations from examinations conducted by the SEC Office of Compliance Inspections and Examinations and FINRA as part of their "collaborative effort" to determine and report on issues pertinent to "senior investors" (age 65 and older).

In the "Marketing and Communications" section of the report, the SEC and FINRA observed that firms promoted senior-related investment themes "through various channels such as **brochures, print and electronic advertisement, newspaper columns, radio and television commercials, and seminars**."[1] Yet, under the proposed rule changes, FINRA will not review and approve any such communications prior to them going to senior investors. Moreover, with regard to certain communications (radio shows and seminars), the SEC and FINRA examinations revealed potential rule violations such as misleading advertisements and failure to properly supervise the content of the shows, as well as the potential failure to comply with a firm's written supervisory procedures for seminar materials.[2]

"Post-use" review of all retail communications by FINRA will not provide adequate investor protection for customers who lose their life savings after investing with an unknown start-up firm's broker featuring flashy television or radio ads or a fancy seminar presentation. Further, it is not clear that FINRA can effectively regulate advertising on a post-use basis. For example, according to the large defense firm, Sutherland Asbill & Brennan LLP ("Sutherland"), FINRA disciplinary actions in 2013 reflected a troubling enforcement trend – an "incredible slowdown in the amount of fines imposed in advertising cases."[3] This stood out to Sutherland because advertising had been on its "Top Enforcement Issues" list in 2010-2012 (based on the amounts of fines assessed), and yet in 2013, there was a seventy-three percent (73%) decrease in the total fines assessed in advertising cases (even though there were 53 cases in 2013 and only 50 in 2012).[4] Although advertising returned to Sutherland's "Top Enforcement Issues" list for FINRA disciplinary actions in 2014, there were only 31 advertising disciplinary cases.[5] It simply does not

1. *See* http://www.sec.gov/ocie/reportspubs/sec-finra-national-senior-investor-initiative-report.pdf, p. 13(last visited on June 20, 2016) (emphasis added).

2. *Id*. at 13-15.

3. *See* http://www.sutherland.com/NewsCommentary/Press-Releases/161244/Annual-Sutherland-Analysis-of-FINRA-Sanctions-Shows-27-Decrease-in-Fines-Number-of-Cases-Nearly-Identical. Sutherland generally only includes in its review those cases that resulted in fines of $200,000 or more.

4. *Id*.

5. *See* http://www.sutherland.com/NewsCommentary/Press-Releases/170501/Annual-Sutherland-Analysis-of-FINRA-Sanctions-Reveals-Blockbuster-Year-in-Fines-for-FINRA-but-Decrease-in-the-Number-of-Cases. Sutherland did note that

seem to be in the investing public's interest to rely on FINRA to effectively regulate retail communications only after-the-fact.

Further, requiring pre-approval for retail communications is worth the cost to members, because it provides a deterrent effect to potential bad actors. Permitting post-use filing may embolden risky retail communications from members, who may feel they can rely on "market adjustments" to explain away their advertising efforts.

In SR-FINRA-2016-018, FINRA acknowledged that "a higher percentage of new members' communications require revisions to be compliant with applicable standards as compared with all communications filed with FINRA." *See* SR-FINRA-2016-018, pg. 25. Accordingly, FINRA deems it necessary that only public media communications still be pre-approved, but this is a clear indication that minimal cost savings should not outweigh the need for investor protection at the advertising level.

In light of the importance of the existing retail communication rules, and the real potential for greater harm to investors without those rules, FINRA should not eliminate the need for pre-use oversight of all but one form of retail communication. FINRA has not provided sufficient evidence that brokerage firms will save enough money if they are not required to file for pre-use approval of retail communications to outweigh the resulting harm to investors who could have been protected by the current rule. Further, if it is too much of a financial burden on a new firm to comply with existing industry rules related to pre-use approval of communications with the public, then perhaps that firm should not be in the brokerage industry at this time.

Investment Company Shareholder Reports

FINRA currently requires firms to file the manager's discussion of fund performance ("MDFP") portion of a registered investment company's shareholder report if it to be made available or distributed to potential investors. FINRA has required the filing of MDFPs and treated them like any other retail communication even though shareholder reports are also required to be filed with the SEC. FINRA is proposing to specifically exclude MDFPs from the filing requirements of the retail communications rules if the shareholder's report containing the MDFP has been filed with the SEC. FINRA's rationale for this proposed rule change seems to be that the MDFP

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the large increase in amounts fined in 2014 (to $17.2 million) was largely attributable to a $15 million research analyst and research report case which included allegations related to improper promotions at IPO road shows. *Id*.

"presents less investor risk than other types of promotional communications" and excluding MDFPs would be consistent with the fact that FINRA has previously excluded other similar types of documents from the filing requirements.

In order for the proposed rule to offer any investor protection whatsoever, FINRA has to assume that the SEC adequately reviews regulatory filings when they are received and that the SEC will bring improper retail communications to FINRA's attention. The problem with these assumptions is that the SEC does not fully review all regulatory filings made on the EDGAR system, which is where such filings would be made.

On May 28, 2015, Reuters reported that the SEC "does not fact check or make corrections to filings," which makes sense if the SEC receives approximately 4,000 filings per day.[6] The Reuters article was prompted by a letter that Senator Charles Grassley, from Iowa, sent to the SEC about his concern with a "systemic vulnerability" exposed with the EDGAR system when a fraudster was able to use the EDGAR site to file documents that reflected a phony takeover bid for Avon Products Inc.[7]

FINRA's attempt to pass responsibility off to the SEC is unacceptable under these circumstances. Given that the SEC receives an estimated 4,000 filings per day and can't review that many, FINRA's estimate that the new rule would result in a decrease of 5,000 filings per year makes no appreciable difference in the SEC's workload. The best solution would be for FINRA to do its job and review the filings before publication.

FINRA acknowledged that "while the SEC may not review all securities-related filings contemporaneous with their submission, the staff can review higher risk communications as needed." *See* SR-FINRA-2016-018, pgs. 26-27. This comment confirms FINRA's intent to shift its review obligations to the SEC's limited staff and resources. To be sure, the rule proposal does nothing to aid investor protection, FINRA's overarching stated goal.

Filing Exclusion for Templates

Under the current rules, firms are not required to file retail communications that were previously filed with FINRA but changed only to update recent statistical or non-narrative information. FINRA proposes to expand this

6. *See* http://www.reuters.com/article/2015/05/28/senate-sec-avon-prdcts-idUSL1N0YJ21G20150528.

7. *Id*.

exemption and allow firms to include "non-predictive" narrative descriptions of market events covered by the communication without needing to re-file the template.

PIABA opposes this proposal, as FINRA should be reviewing any narrative descriptions included in retail communications for misleading information. Often, firms may blame decreases in NAVs on "market events" or other occurrences, although that is not necessarily accurate in some circumstances. One example is FINRA's investigation of the Morgan Keegan proprietary bond funds in 2010. According to FINRA's press release announcing the investigation, FINRA alleged that:

Morgan Keegan became aware, beginning in early 2007, of the adverse market effects on the bond funds, the firm failed to timely warn its brokers or revise its advertising materials to reflect the disproportionately adverse effect the market was having on the performance of the securities that comprised the bond funds – which Morgan Keegan brokers continued to sell widely. At this time, the firm reassured, rather than warned, its sales force about the riskiness of the bond funds. As a result, some of the firm's brokers were unaware of the then-turbulent market's effects on the funds and failed to disclose the negative effects caused by market forces.

See https://www.finra.org/newsroom/2010/finra-files-complaint-against-morgan-keegan-company-misleading-customers-regarding (last visited June 20, 2016). Other examples include the following:

a) FINRA fined Fidelity $375,000 in September 2012 for, among other things, using misleading materials its mutual funds marketing that "failed to accurately portray the negative impact of the sub-prime crisis on the value of the fund's portfolio investments and shares"[8];
b) FINRA fined Nuveen Investments $3 million in May 2011 for a failure to revise disclosures in its auction rate securities brochures about material changes in the auction rate markets in January 2008[9].

These examples show that any misleading narratives regarding the market condition could subject investors to further harm, and FINRA should be closely monitoring these narratives made in retail communications.

In response to PIABA's previous comments about this issue, FINRA simply argues that such narratives have "rarely generated comments from the staff and generally has been low-risk in nature." FINRA's flippant attitude

8. See https://www.finra.org/sites/default/files/DisciplinaryAction/p169615_0.pdf, at 5-6 (last visited June 20, 2016).

9. See https://www.finra.org/newsroom/2011/finra-fines-nuveen-3-million-use-misleading-marketing-materials-concerning-auction (last visited June 20, 2016).

towards this problem is disconcerting. FINRA seems content to allow this loophole to expand, despite its awareness of the existence of this on-going problem.

Bond Fund Volatility Ratings

Under FINRA's current rules, firms may use retail communications that include ratings provided by independent third parties that address the sensitivity of the bond fund's net asset value to changes in market conditions. These communications must be accompanied or preceded by the bond fund's prospectus and contain specific disclosures. Firms must file these communications with FINRA at least 10 days prior to use. The proposed rule seeks to modify the rule, requiring the filing of such communications *within* 10 days of first use, rather than 10 days *prior* to use. The proposed rule also eliminates the requirement that the rating must be accompanied or preceded by the prospectus.

In the interests of the investing public, FINRA should not enact these proposed rule modifications. There have been numerous bond fund scandals and regulatory investigations brought by FINRA and other regulators in the last five years, demonstrating that bond funds should be more highly regulated:

a) Morgan Keegan paid $200 million to settle with FINRA and several state regulators in June 2011 regarding claims on its proprietary bond funds;
b) Charles Schwab paid $18 million to settle with FINRA in January 2011 regarding claims on the YieldPlus Fund;
c) Oppenheimer paid $35 million to settle with the SEC in June 2012 regarding claims on the Champion Income Fund and Core Bond Fund;
d) In the Fall of 2015, UBS agreed to pay $34 million to settle claims with the SEC and FINRA, and Santander Securities agreed to pay $6.4 million to FINRA, related to each firm's sales of Puerto Rico bond funds;
e) In June 2012, the Attorney General of New York and the Massachusetts Attorney General began investigations into Citigroup's MAT, ASTA, and Falcon funds, which were municipal arbitrage bond funds.

As demonstrated from these numerous investigations, it is important for FINRA to increase its regulation over bond funds and any communications directed to public investors regarding bond funds or their volatility. Instead of trying to increase its regulation, FINRA ignored our previous concerns and wants to scale back its regulation to the detriment of investors.

In sum, PIABA opposes the implementation of these rule proposals, which are a step backwards in protecting investors. Thank you for the opportunity to comment.

Sincerely,
Hugh Berkson

The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-015* was submitted to the Securities and Exchange Commission by Hugh Berkson on June 13, 2016 (prepared with the assistance of David P. Neuman, Robert Van De Viere and Adam Nicolazzo).

Robert W. Errett
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: *SR-FINRA-2016-015, Proposed Rule Changes for FINRA Rules 12904 and 13904 Regarding Offsetting Damages*

Dear Mr. Errett:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to the information provided to investors and those that affect the fairness of FINRA's dispute resolution forum.

FINRA has proposed changes to Rules 12904 and 13904 regarding offsetting damages, in arbitration awards where arbitrators have awarded damages to both sides. In particular, the proposal would require that when opposing parties are each awarded monetary compensation, then the monetary awards offset each other, and the party that owes the larger amount shall pay the net difference, absent any specification to the contrary in the award. PIABA generally supports this rule proposal and believes that it makes common sense.

For example, in the context of a broker-dealer versus former broker case, the arbitrators may award damages to the broker-dealer if a broker failed to pay money pursuant to a promissory note but may also award a lesser amount to the broker as part of a counterclaim (such as for commissions withheld). In the event that the broker is unable to pay the award, the broker-dealer may still have to pay money to the broker pursuant to the counterclaim award, even where the broker-dealer is awarded more money. If the broker-dealer fails to pay (even though it is the net "winner"), it could be suspended under FINRA Rules. Requiring one party to pay money to the other, when the first party would actually be owed if the awards were offset creates an inequitable result.

FINRA has also indicated that this can occur in the context of a customer versus broker-dealer case involving margin balances. However, FINRA also notes that this only occurred in one case during 2013 and 2014 (out of 8,375 cases which were resolved during that timeframe).

While this rule seems to primarily fix an issue for intra-industry cases, it is a significant problem when a member firm or associated person cannot pay an award to a customer party. For example, the issue of an offset may also arise in a case where a customer leaves the broker-dealer with a debit balance accrued as a result of the complained of trading. A panel in that instance could issue an award in favor of the customer, but also order that the customer repay the lesser debit balance. If the broker-dealer were to go out of business, the customer could potentially find themselves (as the net "winner") being pursued by that firm's creditors and the like if there were no offset.

Courts have embraced the practice of offsetting damages. For example, the United States Supreme Court and Second Circuit Court of Appeals have recognized the right to a setoff:

> It makes little sense to have [Party A] pay [Party B] money that [Party B] will immediately return to [Party A]. Allowing [Party A] to pay just its *net* obligation avoids "the absurdity of making A pay B when B owes A."

ST Microelectronics, N.V. v Credit Suisse Sec. (USA) LLC, 648 F3d 68, 82 (2d Cir 2011) (quoting the United States Supreme Court decision in *Studley v. Boylston Nat'l Bank of Boston*, 229 U.S. 523, 528 (1913)).

The *ST Microelectronics* Court also astutely noted the potential for significant prejudice and inefficiency if there were no setoff:

> Such an arrangement also avoids the possibility — however remote it might be — that [Party B] might not immediately return the $75 million it would owe [Party A], forcing [Party A] to pursue enforcement efforts against [Party B] in Switzerland.

ST Microelectronics, N.V., 648 F3d at 82.

Additionally, a number of States address the issue in their statutes. For example, New York's Debtor Creditor Law, Sec. 151, *et seq*., states in relevant part:

> Every debtor shall have the right upon: . . . (b) the making of an assignment by a creditor for the benefit of its creditors; . . . to set

> off and apply against any indebtedness, whether matured or unmatured, of such creditor to such debtor, any amount owing from such debtor to such creditor.

PIABA encourages FINRA to follow suit. This rule proposal also highlights the inequities that exist with unpaid arbitration awards, whether the claimant is an investor, broker, or broker-dealer. As highlighted by PIABA's study of arbitration awards involving customers during 2013, over $62 million of arbitration awards went unpaid, which amounts to 1 out of 3 cases, or nearly 1 out of every 4 dollars awarded. The large number of unpaid awards undermines the integrity of the securities arbitration process and must be corrected.

While the concerns addressed by the rule proposal may more generally benefit FINRA's members, rather those members' customers, what's good for the goose is good for the gander. FINRA needs to use this opportunity to not only address a problem with unpaid awards for intra-industry disputes, but to address unpaid awards for investors as well. PIABA urges FINRA to implement a national recovery pool to address this important problem.

In sum, PIABA supports the rule proposal but asks that FINRA take more steps in ensuring that all arbitration awards are paid, regardless of whether they are customer or intra-industry disputes. Thank you for the opportunity to comment.

Sincerely,
Hugh Berkson

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-014* was submitted to the Securities and Exchange Commission by Hugh Berkson on June 2, 2016 (prepared with the assistance of Adam Nicolazzo and William B. Young, Jr.).

Robert W. Errett
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2016-014; Proposed Rule Change Relating to National Adjudicatory Council Composition, Member Terms and Election Procedures

Dear Mr. Errett:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to the information provided to investors and those that affect the fairness of FINRA's dispute resolution forum.

By the rule proposals enunciated in SR-FINRA-2016-014, FINRA seeks to amend the By-Laws of FINRA's regulatory subsidiary, FINRA Regulation Inc., to, *inter alia*, expand the size of the National Adjudicatory Council (NAC) to 15 members from its current 14, with the number of Non-Industry Members exceeding Industry Members. The number of Public Members would remain the same at three. The NAC presides over disciplinary matters, and therefore has a direct effect on protecting public investors and the markets.

In the rule proposal, FINRA recounts the definition of "Non-Industry Member" from the FINRA By-Laws as:

> [A]ny Public Member, an officer or employee of an issuer of securities listed on a market for which FINRA provides regulation, an officer or employee of an issuer of unlisted securities that are traded in the over-

> the-counter market, or any individual who would not otherwise fall within the definition of an Industry Member.

SR-FINRA-2016-014, note 12. In contrast, Public Members are defined as "having no material business relationship with a broker or dealer or a self-regulatory organization." *Id*. Industry Members include individuals who, among other things serve as an officer, director, employee or controlling person of a broker-dealer. *Id*.

At best, whether issuers are truly separate from Industry Members is a grey area. In fact, the Securities and Exchange Commission makes clear that under certain circumstances, issuers may need to register as a broker-dealer, including "issuers that purchase their securities from investors, as well as issuers that effectively operate markers in their own securities or in securities whose features and terms can change or be altered." *See* S.E.C. Guide to Broker-Dealer Registration (https://www.sec.gov/divisions/marketreg/bdguide.htm) last visited May 25, 2016. Employees of issuers may also be required to register as a broker-dealer under certain circumstances. *Id*.

PIABA is generally supportive of FINRA's efforts to modernize the composition of the NAC, including making the majority of the NAC comprised of individuals who are not Industry Members. However, because issuers and employees of issuers may be more closely aligned with Industry Members under certain circumstances, PIABA recommends that the rule proposal require that the minimum number of Public Members increase from three to four individuals, rather than requiring an increase in Non-Industry Members.

Thank you for the opportunity to comment.

Sincerely,
Hugh Berkson

The following PIABA Comment Letter regarding *California AB 2178* was submitted to Assembly Member David Chiu by Hugh Berkson on May 25, 2016 (prepared with the assistance of Scot Bernstein).

Via Email Only to assemblymember.Chiu@assembly.ca.gov

Honorable Assembly Member David Chiu
P.O. Box 942849
Sacramento, California 94249-0017

Re: AB 2178 (Chiu) –SUPPORT AS PROPOSED TO BE AMENDED AND REMOVING OPPOSITION

Dear Assembly Member Chiu:

The Public Investors Arbitration Bar Association (PIABA) believes that the attached proposed amendments to AB 2178 provide meaningful protections to the investing public. In view of those protections, PIABA supports AB 2178 (Chiu) as proposed to be amended and removes its opposition to the bill.

Sincerely,
Hugh D. Berkson, PIABA President

cc: Luke Reidenbach
Assembly Committee on Appropriations
Via Email Only to Luke.Reidenbach@asm.ca.gov

Eric Guerra
Office of Assembly Member David Chiu
Via Email Only to Eric.Guerra@asm.ca.gov

Scot Bernstein
Via Email Only swampadero@sbernsteinlaw.com

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The following PIABA Comment Letter regarding *The SEC Staff's December 18, 2015 Report on the Definition of "Accredited Investor"* was submitted to the Securities and Exchange Commission by Hugh D. Berkson on May 17, 2016 (prepared with the assistance of Christine Lazaro, Samuel B. Edwards and David P. Neuman).

Brent Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: The SEC Staff's December 18, 2015 Report on the Definition of "Accredited Investor"

Dear Mr. Fields:

Thank you for the opportunity to comment on the Securities and Exchange Commission ("SEC") Staff's December 18, 2015 report, which proposes changes to the definition of an "accredited investor". I write on behalf of the Public Investors Arbitration Bar Association ("PIABA")[1] to comment on this proposal. PIABA is a bar association whose attorneys are committed to representing investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the SEC and the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. In support of public investors, PIABA often comments on proposed changes to SEC rules and regulations to ensure protection of the rights and fair treatment of the investing public.

The current report and proposal concern "accredited investor" as defined under Rule 501 of Regulation D (17 CFR § 230.501 et seq.). Reg. D exempts certain transactions from registration requirements of the Securities Act of 1933. The purpose of providing exemptions from registration under Rules 504, 505, and 506 of Reg. D is to allow smaller, private companies to raise

1. PIABA is an international bar association, consisting of over 500 members, dedicated to the protection of investors' rights in securities arbitration proceedings.

capital without incurring the considerable expense and time of complete registration of the offering with the SEC. Since Reg. D investors do not receive the full protection of registration under the Securities Act of 1933, Reg D. private placements can generally only be offered to institutional and certain individual investors who are deemed "accredited" under the Rules. The assumption of Reg. D is that "accredited investors" have both the sophistication to comprehend the risks and characteristics of said limited offerings and also have the financial means to withstand the risks inherent in these securities.

Historically, income and net worth thresholds were used to define individual accredited investors. These thresholds were established in 1982, with few modifications since that time. An individual with a net worth in excess of $1 million, or with an individual income in excess of $200,000 or joint income with his or her spouse in excess of $300,000, is an "accredited investor." However, as more people become millionaires thanks to little more than inflation, there are more people than ever who qualify as "accredited investors," yet many of these people simply do not have the sophistication to understand the risks associated with private placements to sufficiently protect themselves. According to the SEC's review, the census data from 1983, a year after the thresholds were established, demonstrated that only 0.5% of households met the individual income threshold, only 1.7% met the net worth threshold, and only 1.8% met either threshold. As of 2013, those numbers have increased to 6.6% for the income threshold, 7.5% for the net worth threshold, and 10.1% for either threshold. Additionally, as a result of the growth of IRAs and similar retirement plans, a significant number of those who qualify on a net worth basis are older and retired.

The "accredited investor" definition is important to investors for several reasons. First, an issuer relies on the definition when choosing investors for the private placement. This is particularly important as offerings under Rule 506 may now engage in general solicitation so long as the securities are only sold to "accredited investors." Second, brokers rely on the definition of "accredited investor" when determining to which customers to recommend a private placement. Brokers often consider the "accredited investor" definition as synonymous with the suitability standard – if a customer qualifies for the private placement, many brokers wrongly believe the investment is, by definition, an appropriate investment for any investor who qualifies. As the issuer typically does no further due diligence with respect to the investors recommended by brokers, it is essential that an appropriate standard be adopted to protect unsophisticated investors who cannot bear the risk of loss inherent in private placements.

The SEC Staff made several recommendations in reviewing the definition of "accredited investor" as it applies to Reg. D offerings. Currently, there are several ways in which an investor can qualify as "accredited" to invest in Reg. D offerings. As described above, investors often qualify by meeting either the income or net worth thresholds. The SEC is now considering revising these thresholds, as well as other criteria, to qualify an investor as being "accredited":

a) The SEC proposes to keep these thresholds intact, but limiting the amount that one could invest by a percentage of his or her income or net worth – for example, being allowed to only invest 10% of income or net worth for any 12-month period;
b) As an alternative, the SEC proposes to raise the qualification thresholds to $500,000 for an individual's income; $750,000 for a couple's income; or $2.5 million for net worth, without any investment limitations based on percentage of net worth or income;
c) Additionally, the SEC is considering a review of the income and net worth thresholds on an on-going basis;
d) The SEC has also considered allowing couples to pool their assets to qualify under the net worth threshold;
e) The SEC also is considering whether to allow others to meet the definition of accredited investor, even if they do not meet the income or net worth threshold, if the investor has experience in investing in those types of securities or has professional experience (such as licensed securities salespersons).

PIABA understands that the current definition of "accredited investor" is outdated. The income and net worth thresholds were established in 1982, almost 35 years ago. The fact that so few households qualified under the original 1982 thresholds suggests that Reg. D investments were meant for a very small percentage of the investing public. The fact that the percentage of qualified households has increased more than five-fold in the last three decades supports increases to these thresholds. Accordingly, PIABA supports the proposal that raises the net worth threshold (to $2.5 million) and the income threshold (to $500,000 for individuals or $750,000 for couples) for accredited investors. We believe this is more appropriate than merely keeping the present thresholds and limiting the overall investment to a percentage of the income or net worth. The increases will undoubtedly shrink the pool of "accredited investors," and in so doing, will bring the definition back into line with the original intent of limiting Reg. D offerings to a very small set of American investors.

PIABA welcomes the proposal to increase these thresholds. Many investors are being solicited to invest in private placements or limited offerings when their total net worth is barely $1 million. As cited by the SEC, over $1.3 trillion Reg. D investments were issued during 2014 alone. That means that private companies were able to find enough investors to place over $1.3 trillion in private placements in 2014 alone. However, a large number of these investors cannot afford to take on the risks that are typically associated with Reg. D investments. Most private placements and limited offerings are substantially more illiquid than a publicly traded security, and these private placements often carry with them the risk of total loss of investor funds. One million dollars, while not an inconsequential sum, does not carry the weight that that sum did in 1982 when the accredited investor definition was set forth for the first time. An investor losing a significant portion of a $1 million thanks to ill-advised Reg. D investments will find it difficult to survive through the course of retirement. Increasing that threshold, while still placing some investor at risk, increases the potential for an investor to be able to withstand a poor Reg. D investment.

Moreover, it is important to note that the current accredited investor standard, in creating a comparatively large pool of investors qualified to be offered Reg. D securities, makes it a particularly attractive tool to promote fraudulent schemes. Investors have seen a string of Reg. D offerings in the last 5 to 10 years that have turned out to be nothing more than Ponzi schemes. Some that come to mind are Medical Capital, Provident/Shale Royalties, and DBSI – all which relied on Reg. D to issue securities. Many clients who were solicited to invest in these products lost their entire investment in these securities and could ill afford those losses. The change in the definition of an accredited investor would limit the number of investors who can invest in these products and will therefore discourage others from using Reg. D to promote fraud, and will accordingly help protect *all* investors from fraudulent offerings.

PIABA also supports a regular review and adjustment of these thresholds. These thresholds should be reviewed every few years and adjusted to account for inflation.

In addition, PIABA believes that there should be some sophistication qualification to be an accredited investor, in addition to the net worth or income thresholds. Investors who otherwise meet the requisite net worth threshold may not be sophisticated enough to appreciate the significant risks of investing in private placements and limited offerings. As such, it makes sense to include some qualification that the accredited investor is also sophisticated enough to gauge these risks, whether it be by their profession or through prior investing experience. However, this sophistication qualification should not replace the income or net worth qualification. Because of the speculative nature of private placements, it is important that investors have the financial means necessary to withstand the risks inherent in these securities.

Last, the SEC needs to make clear to brokers and others who manage client investments that the "accredited investor" definition is not a replacement to the obligation to only make suitable recommendations to clients. Advisors should not be allowed to conflate the suitability standard and the accredited investor standard, as is often done. A simple statement from the SEC that just because an investor qualifies as an "accredited investor" does not mean that the investment is suitable for that customer could go a long way in protecting public investors who, even with $2.5 million in net worth, still need protection from the SEC.

In sum, PIABA supports any proposal that raises the net worth and income thresholds to qualify as an accredited investor. I want to thank you for the opportunity to comment on these recommendations.

Sincerely,
Hugh D. Berkson, President

Notes & Observations