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CHALLENGING EXPUNGEMENTS AFTER SETTLEMENTS

David E. Robbins[1]

Introduction

Once a case has been settled on financial terms, should a broker be permitted to secure expungement relief of that case without any input from the individual who had, according to the Statement of Claim, been the victim of the broker's misconduct? Should customers challenge brokers' efforts to expunge settled arbitrations? These are questions central to the integrity of FINRA's securities arbitration process.

FINRA's October 2016 Expungement Training online program advises arbitrators that, "Investors rarely attend the required expungement hearing after a settlement. When the investor does not attend the hearing, arbitrators will hear only the position of the party requesting expungement."[2] At the October 2016 PIABA annual conference in San Diego, I was on a panel that dealt with the question of whether customer attorneys should challenge requests by brokers to expunge a settled arbitration from brokers' records.[3] I had written an article for the program – *Take the Money and Run*? – and our panel presentation gave rise to a serious discussion among attendees.

A number of PIABA members expressed reluctance to participate in expungement hearings to challenge expungement requests once a case was settled because, they said, their contingency retention compensation arrangements did not encompass such services after settlement. In other

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1. David E. Robbins is a founding member of PIABA and the recipient of its James Beckley Golden Bowtie Award. He is a member of Kaufmann Gildin & Robbins, LLP in New York City, is on the Board of Editors of the PIABA Bar Journal and is the author of the SECURITIES ARBITRATION PROCEDURE MANUAL (5th ed. 2016) and *The New York Practitioners Guide to Securities Arbitration and Mediation*, Supp. Prac. Comm., N.Y. GEN. BUS. LAW Ch. 20, Art. 23-A (McKinney 2016).

2. FINRA, *FINRA Office of Dispute Resolution Expungement Training* 13 (Oct. 2016) [hereinafter *FINRA Expungement Training*], https://www.finra.org/sites/default/files/FINRA-Expungement-Training.pdf.

3. During my panel session, I singled out a PIABA member in the audience who had appeared with his client to challenge the request of the broker (my client) to expunge the settled arbitration in which the broker had not been named as a Respondent; the arbitrators denied the broker's request.

words, they would not receive any additional compensation for preparation or participation in any expungement hearing. Based on our panel discussion, additional conversations I had with PIABA members during the conference,[4] and FINRA's update that same month to its Expungement Training program, I thought that further consideration of the subject should be given.[5]

This article will: highlight regulatory developments concerning expungement, with particular focus on FINRA's training of arbitrators; examine the required procedure for seeking expungement; and, explain the limited grounds for what FINRA has repeatedly said is *an extraordinary remedy*. I will then present four situations where a customer's attorney should consider participating in an expungement hearing after reaching a settlement, at a time when the customer's attendance is no longer mandatory under the Code of Arbitration Procedure.

1. Expungement - "An Extraordinary Remedy"

FINRA's October 2016 online Expungement Training and Exam[6] makes clear that:

> Expungement is an extraordinary remedy that arbitrators should recommend only under appropriate circumstances. Arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value. Once information is expunged from the CRD[7] system, it is permanently

---

4. One former PIABA president told me that she requires that all settlement agreements contain a provision stating that the broker will not thereafter request expungement.

5. I reached out for guidance to George Friedman, Fordham Law adjunct professor and former FINRA Director of Arbitration (who graciously then agreed to edit this article) and Rick Ryder, Editor-in-Chief of Securities Arbitration Commentator. A well-respected state securities commissioner who attended the PIABA conference also directed me to the section of the December 2015 FINRA Arbitration Task Force Report that concerned expungements. *See* FINRA, FINAL REPORT AND RECOMMENDATIONS OF THE FINRA DISPUTE RESOLUTION TASK FORCE 23-28 (Dec. 16, 2015), http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf.

6. FINRA Expungement Training, *supra* note 2, at 8.

7. According to its website, "FINRA operates Web CRD®, the central licensing and registration system for the U.S. securities industry and its regulators. The system contains the registration records of more than 3,865 registered broker-dealers, and

deleted and no longer available to the investing public, regulators or prospective broker-dealer employers.[8]

What does expungement mean? *Black's Law Dictionary* defines 'expungement of record' as the 'Process by which a record of criminal conviction is destroyed or sealed from the state or Federal repository.' In contrast to some criminal or civil processes where expunged material might be simply sealed according to Black's Law Dictionary, expungement of broker information from the CRD system purges the information and makes it unavailable to all, as described in FINRA's training materials.

Brokers seek to expunge from their CRD/BrokerCheck Report, among other things, customer complaints and customer arbitrations in which they were named as a Respondent or in which, if not named, the arbitration claim concerned their customers' accounts.[9]

2. Regulatory Developments Concerning Expungement From 1999-Present

Before FINRA became FINRA in mid-2007, it was the NASD[10] and in NASD Notice to Members (NTM) 99-09, the history of expungement was briefly explained:

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the qualification, employment and disclosure histories of more than 641,130 active registered individuals. Web CRD also facilitates the processing and payment of registration-related fees such as form filings, fingerprint submissions, qualification exams and continuing education sessions. Web CRD is a secure system for entitled users only. Firms must complete FINRA's entitlement process noted below to request access to use Web CRD by completing FINRA's entitlement process noted below." *Central Registration Depository (Web CRD)*, FINRA, http://www.finra.org/industry/crd (last visited Feb. 22, 2017).

8. FINRA Expungement Training, *supra* note 2, at 8.

9. For the "events" required to be disclosed on a broker's CRD, and thus the BrokerCheck Report, see FINRA, RULE 4530 (2011), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9819.

10. In July 2007, the National Association of Securities Dealers, Inc. ("NASD") and NYSE Member Regulation merged to form the Financial Industry Regulatory Authority. The arbitration programs were included. *See* Press Release, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority (July 30, 2007), http://www.finra.org/newsroom/2007/nasd-and-nyse-

> NASD Regulation expunges information from the CRD system when ordered to do so by a court of competent jurisdiction. NASD Regulation, recognizing arbitrators' broad authority to grant equitable relief and a party's ability to have an award confirmed in court, also has honored such expungement directives provided they were contained in an arbitrator's award.[11]

NTM 99-09 abolished old arbitrator-ordered expungements, which had been granted with scant guidance from FINRA. What had given rise to Notice to Members 99-09? Before NASD's issuance of the NTM 99-09, it took the position that expungement of information from the CRD system that was ordered by an arbitrator and contained in an Award should be afforded the same treatment as a court-ordered expungement. But the North American Securities Administrators Association (NASAA) disagreed, stating that information submitted to the CRD system was deemed to have been filed with each state in which that person or entity seeks to be registered. Therefore, according to NASAA, information in the CRD system that may be the subject of an arbitrator-ordered expungement was, in many cases, a state record and state laws do not recognize the authority of an arbitrator to expunge a state record or do not otherwise permit such expungements because of state recordkeeping requirements. In response, NASD imposed a moratorium on expunging information from the CRD system based on a directive contained in an Award, unless the Award has been confirmed by a court of competent jurisdiction.

In 2003, after the moratorium was imposed on arbitrator-ordered expungements, the Securities and Exchange Commission weighed in on expungements:[12]

> Since the inception of the CRD system in 1981, NASD generally has honored court-ordered expungements and, until January 1999, NASD also honored arbitrator-ordered expungements that were contained in final awards. In January 1999, after consultation with NASAA, NASD imposed a

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member-regulation-combine-form-financial-industry -regulatory-authority. For ease of reference, I generally refer to FINRA throughout this article.

11. *See* NASD, NOTICE TO MEMBERS 99-09 (1999), https://www.finra.org/sites/default/files/NoticeDocument/ p004582.pdf.

12. Exchange Act Release No. 34-47435 (Mar. 4, 2003), http://www.sec.gov/rules/sro/34-47435.htm.

moratorium on arbitrator-ordered expungements from the CRD system.[13]

Thus, it is now required that expungement Awards be confirmed by a court of competent jurisdiction before FINRA will expunge the customer complaint or customer arbitration.

3. Frequently Asked Questions

In 2004 and 2009, FINRA's process of expungement became more structured with the implementation of Rule 2080 (grounds for expungement) and Rules 12805 and 13805 (expungement procedure), prompting FINRA to issue guidance in FINRA Rule 2080 Frequently Asked Questions.[14] Here are a few key excerpts from FINRA's questions and answers:

> *2. Under the moratorium in effect from January 19, 1999 through April 11, 2004 (Notice to Members 99-09), respondents were required to obtain court confirmation of an arbitration award containing expungement relief. Is it still necessary under Rule 2080 to obtain court confirmation of an expungement award?*
>
> > *Yes. Rule 2080 continues the requirement started with the January 1999 moratorium that a court of competent jurisdiction must order, or confirm arbitration awards directing, expungement before FINRA will expunge customer dispute information from the CRD system. This includes arbitration awards issued after a decision on the merits and arbitration awards in which the parties have agreed to expunge customer dispute information as part of the settlement and then presented the settlement to the arbitration panel for inclusion in a stipulated award.*
>
> *3. How do the requirements of Rule 2080 differ from the procedures used to request expungement under the moratorium?*
>
> > *Under Rule 2080, members and associated persons still must obtain a court order directing expungement or confirming an arbitration*

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13. *Id.*

14. *FINRA Rule 2080 Frequently Asked Questions*, FINRA, http://www.finra.org/industry/crd/rule-2080-frequently-asked-questions (last visited Feb. 22, 2017). The questions and answers seek to provide guidance regarding the operation of FINRA RULE 2080 (2009), which was formerly NASD RULE 2130 (2004).

award containing an expungement directive. In addition, Rule 2080 requires that FINRA be named as a party to the court proceedings, and be served with all appropriate documents, unless FINRA waives that requirement.

5. What affirmative finding(s) must arbitrators make for FINRA to waive participation in the court confirmation process?

The arbitrator must, after complying with Arbitration Code Rule 12805 or 13805, make an affirmative finding that the subject matter of the claim or the information in the CRD system meets one or more of the three standards, set forth in Rule 2080. Without such an affirmative finding, FINRA would have no basis under Rule 2080 to waive the requirement that it be named as a party in the court confirmation process.

(1) *The claim, allegation, or information is factually impossible or clearly erroneous...*

(2) *The registered person was not involved in the alleged investment- related sales practice violation, forgery, theft, misappropriation, or conversion of funds...*

(3) *The claim, allegation, or information is false….*

Frequently Asked Question #5 then mentions, without analysis, a ground that is not addressed in FINRA's Expungement Training and Exam:

***In addition, if the expungement relief is based on judicial or arbitral findings other than those described above, FINRA, in its sole discretion and under extraordinary circumstances, may waive the obligation to name FINRA as a party if it determines that*:**

(1) The expungement relief and accompanying findings on which it is based are meritorious and

(2) The expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.[15]

18. How did FINRA determine the standards for expungement of customer dispute information?

In crafting the standards set forth in FINRA's rules regarding expungement, FINRA was guided by the interests of regulators in having accurate and relevant information to fulfill their regulatory responsibilities, the interests of the brokerage community in having a

15. *Id.* (*emphasis added*).

fair process to protect their reputations where appropriate, and the interests of investors in having access to accurate and meaningful information about brokers with whom they now or in the future may engage in business.[16]

4. January 2016 Changes to Expungement Requests

Between the time FINRA published its September 2015 online expungement training [17] and exam for arbitrators and its October 2016 update, FINRA issued the following additional guidance to parties in such proceedings:

Parties should provide FINRA with the following information for all expungement requests made in cases filed on or after January 1, 2016. This will enable FINRA staff to efficiently process expungement requests:

1. The CRD number of the party requesting expungement;

2. The CRD occurrence number(s) which is the subject of the expungement request;

3. The case name and docket number that gave rise to the disclosure, if applicable;

4. Whether expungement of the same disclosure item was previously requested, and if so, an explanation of the outcome of that request.

Parties should include all subject CRD occurrence numbers on the first page of the pleading in which they request expungement. Providing this information will ensure the accurate and timely processing of all expungement requests. NOTE: Failing to provide this information may unnecessarily delay the proceedings. Individuals with CRD numbers can access their registration and licensing information by requesting an Individual Snapshot Report. [18]

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16. *Id.*

17. FINRA, *FINRA Dispute Resolution Expungement* (Sept. 2015), http://www.finra.org/sites/default/files/FINRA-expungement-training-sept-2015.pdf.

18. *Changes to Expungement Requests*, FINRA, https://www.finra.org/arbitration-and-mediation/changes-expungement-requests (last visited Feb. 22, 2017).

5. FINRA Expungement Training and Exam – October 2016 Update[19]

Just as *The Arbitrator's Guide*[20] is an excellent resource for arbitrators and practitioners, so too is FINRA's training to its arbitrators about the expungement process. While it is for arbitrator education and guidance, the Expungement Training and Exam can certainly be utilized by customer attorneys who challenge the expungement request at a hearing – by citing standards and burdens that FINRA expects the broker to meet and which the attorney believes cannot be met. Here are highlights of the online copyrighted training course and exam that was updated by FINRA in October 2016.

Standards Explained? Most of Them

FINRA's training and exam material focuses its arbitrators on what it refers to as *the three grounds* available for expungement, despite there being a fourth ground on which FINRA provides no guidance to its arbitrators. Here is what FINRA tells its arbitrators about *the three grounds*:

- "The procedures are intended to ensure that expungement occurs only after the arbitrators find and document one of the narrow grounds specified in Rule 2080: 1. The claim, allegation or information is factually impossible or clearly erroneous; 2. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or 3. The claim, allegation or information is false."[21]
- "Even if the parties settle and agree to include expungement relief in a stipulated award, arbitrators must still find and document one of the grounds under Rule 2080 and satisfy all of the procedural requirements under Rules 12805 and 13805 before recommending expungement."
- "FINRA will generally participate in the court confirmation proceeding and oppose confirmation of the recommendation for expungement if it does not meet at least one of the specified standards

19. FINRA Expungement Training, *supra* note 2.

20. FINRA, *FINRA Office of Dispute Resolution Arbitrator's Guide* (Feb. 2017), https://www.finra.org/sites/default/ files/arbitrators-ref-guide.pdf.

21. FINRA Expungement Training, *supra* note 2, at 8.

> under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805."[22]

Missing from FINRA's arbitrator training – but not from its "Frequently Asked Questions"[23] - is the rather vague additional ground for expungement of Rule 2080(b)(2),[24] a sort of Hail Mary pass[25] when brokers realize they can't meet their burden on any of the three primary grounds:

> (b) Members or associated persons petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents unless this requirement is waived pursuant to subparagraph (1) or (2) below…
>
> (2) If the expungement relief is based on judicial or arbitral findings other than those described above, FINRA, in its sole discretion and under extraordinary circumstances, also may waive the obligation to name FINRA as a party if it determines that:
>
> (A) the expungement relief and accompanying findings on which it is based are *meritorious*; and
>
> (B) the expungement would have *no material adverse effect* on investor protection, the integrity of the CRD system or regulatory requirements. (italics added).

FINRA's 2016 Expungement Training and Exam is broken down into a number of Sections, with key excerpts included and examined below.

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22. *Id.* at 23.

23. *FINRA Rule 2080 Frequently Asked Questions*, FINRA, http://www.finra.org/industry/crd/rule-2080-frequently-asked-questions (last visited Feb. 22, 2017).

24. FINRA, RULE 2080 (2009), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8468.

25. *Hail Mary Pass*, WIKIPEDIA, https://en.wikipedia.org/wiki/Hail_Mary_pass (last visited Feb. 22, 2017).

Section 1: Central Registration Depository

The Central Registration Depository (CRD®) has several important uses:

- Investors rely on CRD information, most of which is available to them through FINRA BrokerCheck® (as described below), when making decisions about whether to do business with a particular broker or brokerage firm.
- Regulators use CRD to fulfill their regulatory responsibilities.
- Regulators also use the CRD system as a regulatory tool (e.g., to help identify trends or potential threats to investor protection).
- Brokerage firms rely on CRD when making hiring decisions.
- Most of the information submitted to CRD is made publicly available through BrokerCheck but BrokerCheck does not provide all of the information that is available to regulators through the CRD system.[26]

Sections 2 and 3: Expungement Rules

What Is Expungement?

Brokers who seek to expunge disclosure events from their CRD records generally look to remove a customer dispute, employment termination or internal review. To protect the broker's reputation, brokers may seek to have any reference to the arbitration removed from their CRD record.

- *Expungement is an extraordinary remedy that arbitrators should recommend only under appropriate circumstances.*
- *Arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value.*
- *Once information is expunged from the CRD system, it is permanently deleted and no longer available to the investing public, regulators, or prospective broker-dealer employers.*[27]

26. FINRA Expungement Training, *supra* note 2, at 5.

27. *Id.* at 8.

Expungement Rules

- **Rule 2080:** Grounds for Expungement (examined below)
- **Rule 2081:** Prohibited Conditions Relating to Expungement

  Neither firms nor registered representatives may condition the settlement of a customer dispute on - or otherwise compensate a customer for - the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD. The rule helps ensure that negotiated customer agreements not to oppose do not influence the arbitral decision to recommend expungement. [28]

Awards Since Rule 2081 Became Effective

In 2016, Securities Arbitration Commentator (SAC) presented a "Mini-Survey: Effect of Rule 2081,"[29] since, by then, it had been two years since that rule became effective. SAC surveyed Customer/Member Stipulated Awards issued since August 2014 in which one or more brokers requested expungement. SAC found little impact on expungement Awards.

- "For Rule 2081 to have a significant impact, customers would have to exercise the privilege afforded by the lack of any contractual restraint, yet it remains uncommon for customers or their counsel to oppose a broker's expungement once they settle their dispute."
- "We identified only 23 of the surveyed Awards in which a customer or her counsel objected to at least one expungement request. This amounts to only 7% (23/325) of the entire group in our survey."
- "Looking at just the past twelve months, we calculated an 8% rate (11/136 Awards). Panels recommended expungement in 84% (272/325) of all Customer/Member Stipulated Awards in which a broker made the request. Objections by customers or counsel caused that figure to drop only a few points, to 78% (18/23)."
- "By comparison, in Customer/Member Awards decided during the same period in which the claimant did not settle and lost his case on the merits after at least two evidentiary hearings, expungement requests had only a 58% (66/113) success rate."

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28. *Id.* at 9.

29. The survey appears in the SECURITIES ARBITRATION COMMENTATOR, 2016-06, at 19-20.

- "Recall that the PIABA Expungement Study of October 2013 found expungement rates that ranged from 89% to 96.9% (SAA 2013-38); it seems FINRA's guidance and training on this issue may be impacting the figures."[30]

- **Rules 12805 and 13805** - The Procedure Under the Codes of Arbitration

Before ruling on requests to recommend expungement of customer dispute information under Rule 2080, the Panel must:

1. *Hearing* - Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. It is important to allow customers and their counsel to participate in the expungement hearing in settled cases if they wish to. Specifically, arbitrators should allow:
   - The customer and their counsel to appear at the expungement hearing;
   - The customer to testify at the expungement hearing;
   - Counsel for the customer or a *pro se* customer to introduce documents and evidence at the expungement hearing;
   - Counsel for the customer or a *pro se* customer to cross-examine the broker and other witnesses called by the party seeking expungement; and,
   - Counsel for the customer or a *pro se* customer to present opening and closing arguments if the panel allows any party to present such arguments.

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30. In 2015, PIABA issued another report on expungements with further recommendations. *See* PIABA, *PIABA's Updated Expungement Study*, SECURITIES ARBITRATION COMMENTATOR: BLOG (Oct. 22, 2015), http://www.sacarbitration.com/blog/piabas-updated-expungement-study/. In the report, PIABA proposed, among other things, that FINRA hearing officers, not arbitrators, decide expungements in all settled cases and have FINRA Enforcement Attorneys investigate and, where appropriate, oppose the requests. Customers, said PIABA, should be allowed to present evidence in opposition to the request, if they so desire, and FINRA should give notice of the request to state regulators and allow them to oppose it.

2. *Settlements* - In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of the settlement.
3. *Grounds* - Indicate in the Award which of the Rule 2080 grounds for expungement serves as the basis for recommending expungement and provide a brief written explanation of the reasons for the panel's finding.
4. *Fees* - Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

Unnamed Broker

- Occasionally, says FINRA in its Expungement Training and Exam, a broker may be the subject of an arbitration claim but not named as a party in the arbitration; however, the arbitration would still be reported on the broker's CRD record.[31] In these instances, a party involved in the arbitration case may file an expungement claim during the arbitration proceeding on behalf of the unnamed broker.
- Unnamed brokers may also file a separate arbitration claim on their own seeking expungement.
- If arbitrators choose to recommend expungement under these circumstances, they must still find and document one of *the narrow grounds* under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805 for FINRA to waive its right to be named as a party in the judicial expungement proceeding. (italics added)
- If the unnamed broker did not testify during the arbitration, arbitrators may need to seek testimony and documentary evidence from the unnamed broker during the recorded expungement hearing before ruling on the expungement request.[32]

31. *See* FINRA Expungement Training, *supra* note 2, at 10.

32. *Id.* at 9-12.

Rule 2080 – Grounds for Expungement

When recommending expungement of customer dispute information, FINRA's October 2016 Expungement Training and Exam states that arbitrators must indicate in the Award which of the grounds under Rule 2080 serves as the basis for expungement.

> Rule 2080(b)(1): Upon request, FINRA may waive the obligation to name FINRA as a party if FINRA determines that the expungement relief is based on affirmative judicial or arbitral findings that:
>
> A. The claim, allegation or information is factually impossible or clearly erroneous
>
> *Amplification:* If the evidence shows that the broker was not even employed by the securities firm during the relevant time period, the arbitrators could find that he or she was erroneously named in the arbitration claim, dismiss the claim against the individual and recommend expungement of any mention of the claim from the CRD record under this standard.
>
> B. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds….
>
> *Amplification*: This list of activities is taken from Question 14 of Form U4, which specifies the types of customer complaints that registered persons must report. It is an objective standard based on CRD reporting requirements. This standard would require an affirmative arbitral finding that the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Under this standard, dismissal of a claim, by itself, would not be a sufficient basis for ordering expungement.
>
> C. The claim, allegation or information is false.
>
> *Amplification:* Arbitrators should make such a finding only after considering the merits of the allegations against the broker or securities firm. For example, if the customer alleged that the broker made unauthorized trades and the broker provided evidence contrary to this claim, such as a document signed by the customer directing the trades, arbitrators could find that the claim or allegation was false.

> This is the ground customer attorneys should have the greatest trouble with since it is diametrically opposed to the average Statement of Claim.[33]

Settled Cases

- Investors rarely attend the required expungement hearing after a settlement. When the investor does not attend the hearing, arbitrators will hear only the position of the party requesting expungement.
- Typically, because the case has settled, there has been no hearing on the merits and, thus, no testimony or documentary evidence presented before the parties reached a settlement.
- Even if the opposing party does not appear at the expungement hearing, the party seeking expungement must still demonstrate to the arbitrators that expungement would be appropriate under one of the grounds in Rule 2080.
- The panel should not rely on the fact that the claimant did not appear at the expungement hearing as a factor weighing in favor of or against recommending expungement. In the absence of an opposing party, arbitrators should ask questions of the broker or firm and request any other evidence they believe is relevant to the expungement request.[34]

FINRA Recommends

- Arbitrators may request any documentary or other evidence they believe is relevant to the expungement request, particularly in cases that settle without an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing.
- Arbitrators may require the testimony of additional witnesses when necessary to make an informed decision on the expungement request.

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33. *Id.* at 12.

34. *Id.* at 13-14.

- In settled cases, arbitrators may request an in-person expungement hearing, as opposed to a telephonic hearing, to best evaluate the credibility of testimony and evidence offered in support of or against expungement.

Expungement-Only Cases

- To ensure that customers know about the expungement request, arbitrators should order the associated persons to provide a copy of their Statement of Claim to the customer(s) involved in the underlying arbitration.
- It is particularly important to note that without this directive from the arbitrators, the customer(s) may not even be aware that an expungement claim is pending regarding their prior dispute.
- Notice provides the customer(s) with the opportunity to advise the arbitrators and parties of their position on the expungement request, which may assist arbitrators in making the appropriate finding under Rule 2080. The position of the customer(s) can be made known in writing or through participation in the expungement hearing.

Review Settlement Documents

- Rules 12805(b) and 13805(b) require arbitrators to review the settlement documents to examine the amount paid to any party and any other terms and conditions of the settlement that might raise concerns about the brokerage firm or broker's involvement in the alleged misconduct before recommending expungement.
- To make sure that a recommendation for expungement comports with one of the grounds under Rule 2080 and is recommended only under appropriate circumstances, arbitrators must critically evaluate the settlement and determine whether it raises any concerns.
- Arbitrators should question whether expungement is appropriate in situations where the broker, or the firm, has agreed to pay a large monetary settlement - a settlement amount beyond a nuisance value.

- Arbitrators should evaluate this fact and consider whether a financial settlement raises questions about some culpability on the part of the broker or firm. If arbitrators nevertheless recommend expungement, they should explain in their written rationale why expungement is still appropriate despite a large settlement.[35]

BrokerCheck Report

- Although it is not required under Rules 12805 and 13805, arbitrators should ask the broker seeking expungement (or the party seeking expungement on behalf of the broker) to provide a current copy of the broker's BrokerCheck Report.
- Arbitrators should pay attention to the "Disclosure Events" section when considering whether expungement is appropriate. It shows the broker's additional disclosures, if any, that arbitrators should consider before recommending expungement: all regulatory actions, civil judicial actions, investigation disclosures, customer complaints, criminal matters, financial matters and arbitrations and court actions in which a broker has been involved.
- Arbitrators should ask whether the broker has other pending expungement requests. If a broker is requesting expungement in more than one case, arbitrators should consider the circumstances under which multiple requests are being made.[36]

6. The Conundrum for Customer Attorneys

A consistent 60% of customer cases settle either directly or through mediation, according to FINRA's statistics.[37] After centering the Statement of Claim on allegations of such sales practice abuses as unsuitable, unauthorized or excessive trading, statistics show that few customers take part in expungement proceedings, leaving it up to the broker – whom they accused of such wrongdoing – to convince a panel of arbitrators that either:

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35. *Id.* at 14.

36. *Id.* at 15.

37. *See Dispute Resolution Statistics*, FINRA, http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics#howcasesclose (last visited Feb. 22, 2017).

1. The customers' allegations were factually impossible or clearly erroneous;
2. The broker was not involved in the investment-related sales practice violation; or,
3. The claim, allegation or information was false.

Or the fourth ground: that the expungement relief and accompanying findings on which it is based are *meritorious* and the expungement would have *no material adverse effect* on investor protection, the integrity of the CRD system or regulatory requirements.

In a customer arbitration, it is the customer who has the burden of proving, by a preponderance of the evidence, that:

- Account-related misconduct took place;
- The misconduct directly caused the losses sustained; and,
- Once made aware that the customer's trust had been breached by the broker, the customer mitigated his/her damages by selling open positions and/or closing the account.

If the case settles prior to hearing and the broker seeks to expunge the case from his/her BrokerCheck Report, the burden of proof is shifted. It is now the broker who must prove something that the broker had no burden of proving at the arbitration – that one of the Rule 2080 grounds exists so that, with a clear conscience, the arbitrators can order the deletion of that arbitration from the broker's BrokerCheck Report, as if the arbitration never occurred, as if no allegations – which resulted in a monetary settlement – were ever made.

Here are questions to consider for customer attorneys who settle cases:

1. Should you advise your client to take the money and run or should you recommend – to mix metaphors – that he/she should have his/her cake and eat it too (i.e., take the money and then object to the expungement request)?
2. Should you and your client split the settlement check in accordance with your contingency fee arrangement and go on with your lives or should you deposit the settlement check and then contest the broker's attempt to expunge the case?
3. Or, heresy – should you and your client participate in the hearing and *encourage* the arbitrators to expunge the case from the broker's record?

7. Recommendations

Premise – Your client has settled the arbitration prior to the hearing and has executed a settlement agreement. You deposited the settlement check in your

firm's Special Account and you then receive a notice from the FINRA Case Administrator that the arbitrators who were going to hear and decide the case have been asked by the broker to conduct an in-person expungement hearing. ***Question*** – Should your client testify at the hearing, with you as counsel, recognizing that the settlement agreement will be entered into evidence?

1. **Broker as Respondent – Intentional Misconduct -** If you named the broker as a Respondent and believe you could have met the burden of proof that intentional sales practice abuses directly resulted in your client's losses (even though now satisfied), the client should testify, if the client believes the case should remain on the broker's BrokerCheck Report, so that other customers and potential customers will have proper warning.
2. **Broker as Respondent - Unintentional Misconduct -** If you named the broker as a Respondent but believe the broker's misconduct was based on negligence and the brokerage firm's failure to properly train and supervise him/her, there may be a question whether your client would have met his/her burden of proof at the arbitration. If your client wants other customers and potential customers of the broker to make similar complaints and/or move their account away from the broker – even if the broker's conduct was based on negligence – the client should testify because the allegations were not, in his/her opinion, false.
3. **Product Cases -** If you named the broker as a Respondent in a "product case" (which may have been a tactical and procedural mistake) and believe the broker's misrepresentations were based on the firm's misconduct (e.g., failing to disclose to its brokers the inherent risks of the product or strategy and encouraging its brokers to nevertheless solicit the product/strategy to as many clients as possible), serious thought should be given to attending the hearing and joining the broker in the expungement request. I did this as a matter of routine – with my clients' authorization – in auction rate securities cases, even when I did not name the broker as a Respondent.
4. **Broker Not Named as a Respondent -** If you did not name the broker as a Respondent but the firm still (as is required) amended the broker's U4 and therefore his/her BrokerCheck Report, you may want to take a pass at participating in the hearing. If you did not believe the conduct justified naming the broker as a Respondent, it may be considered hypocritical of you to insist on the case remaining on the broker's record after your client agreed to settle the arbitration with the brokerage firm and possibly other brokers who were named as Respondents.

Conclusion

Having represented customers for decades in arbitrations against brokers, I believe that the purpose of such actions is twofold:[38]

1. To recover losses suffered by my clients and
2. To discourage the recurrence of the misconduct.

Deterrence is often achieved with a significant arbitration Award. Should customers settle, rendering such an Award moot, FINRA provides customers an opportunity to discourage similar misconduct with other customers. Instead of "taking the money and running," more customers should, in appropriate circumstances, show up and be heard at expungement hearings. FINRA encourages them to do so and if customers participate in such hearings, fewer expungement requests will be granted.

38. Full disclosure: I have represented brokers in stand-alone expungement cases where customer complaints were not followed up with arbitration claims, causing such Disclosable Events to remain on the broker's record, or where the brokerage firm settled the case over the broker's objection.

DODD-FRANK: THE ISSUE OF WHO QUALIFIES FOR WHISTLEBLOWER PROTECTION

Joshua Jaffe

I. Introduction

Dr. Eric Ben-Artzi (Ben-Artzi), a highly respected employee at Deutsche Bank, suffered retaliation for doing the "right thing." During his employment, Ben-Artzi discovered a potential violation of securities laws.[1] Deutsche Bank had failed to accurately report certain portfolios in which it held significant investments so that the bank could maintain an image of sustainability throughout the financial crisis.[2] Ben-Artzi attempted to work through internal reporting channels, at increasingly higher levels, to correct the problem.[3] When he pressed his concerns further, upper management subjected Ben-Artzi to hostility, denied him access to necessary records, and eventually terminated his employment.[4] In attempting to do the right thing, Ben-Artzi explained, "I never wanted or expected to be a whistleblower. I reported internally first. . .as the problem was not acknowledged or corrected, I felt compelled to inform the proper law enforcement authorities."[5] "Unfortunately, my family and I are paying a heavy price for doing the right thing," said Ben-Artzi.[6] He later reported these potential violations of securities laws to the Securities and Exchange Commission (SEC).[7] Ben-Artzi reached out to Jordan Thomas, the former Assistant Director of the SEC.[8] Thomas was shocked by the size and scope of the alleged misconduct

1. Labaton Sucharow, *Deutsche Bank Whistleblower Exposes Multi-Billion Dollar Securities Violation* (Dec. 5, 2012), https://www.whistleblower.org/press/deutsche-bank-whistleblower-exposes-multi-billion-dollar-securities-violations.

2. *Id*.

3. *Id*.

4. *Id*.

5. *Id*.

6. *Id*.

7. *Id*.

8. *Id*.

when he consulted Ben-Artzi.[9] "This is exactly the type of significant and unreported securities violations that the SEC Whistleblower Program was intended to address," said Thomas.[10]

Ben-Artzi's situation showcases the classic example of the conflict that arises when an employee discovers a potential securities law violation and must decide whether to report internally, to the SEC, or both. Differing interpretations of the definition of "whistleblower" and the anti-retaliation protections found in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) have resulted in a circuit split between the Second and Fifth Circuit Courts of Appeals.

This paper will delve into the whistleblower protections granted under Dodd-Frank, the existing circuit split on the issue of who qualifies for the anti-retaliation protections provided thereunder, and the policy considerations underlying the courts' decisions. This paper will address the negative implications that a narrow reading of the statute will have on the goals of Dodd-Frank, which are to improve accountability and transparency of the financial system. Finally, the paper concludes that a broader interpretation of whistleblower protections, specifically granting anti-retaliation protection to individuals reporting alleged violations internally, will create new incentives for whistleblowers and will further the goals of Dodd-Frank.

II. Statutory Framework and Regulatory Implementation of Dodd-Frank

A. Dodd-Frank's Whistleblower Program

In 2010, President Barack Obama signed Dodd-Frank into law in an effort to address the failures that triggered the worst financial crisis since the Great Depression.[11] Congress amended Section 922 of the Securities Exchange Act of 1934 (the Exchange Act) to add Section 21F.[12] Section 21F, referred to as the "Whistleblower Protection Program," was added to (1)

9. *Id*.

10. *Id*.

11. Jennifer M. Pacella, *Inside or Out? The Dodd-Frank Whistleblower Program's Antiretaliation Protections for Internal Reporting*, 86 TEMP. L. REV. 721, 723 (2014).

12. 15 U.S.C. §78u-6 (2010).

financially reward individuals reporting securities law violations and (2) to protect those individuals from retaliatory actions by their employers.[13] Dodd-Frank defines a whistleblower as, "any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission."[14]

The SEC is the administrative agency with authority over Dodd-Frank.[15] As such, the SEC has the power to issue such rules and regulations as may be necessary and appropriate to implement the whistleblower provisions of Dodd-Frank.[16]

1. Whistleblower Bounties

Dodd-Frank provides potential whistleblower awards to individuals who meet certain eligibility requirements. To be eligible for an award, an individual must provide "original information" to the SEC relating to a violation of securities laws.[17] "Original information" is information that is derived from the independent knowledge or analysis of a whistleblower that is not known to the SEC from any other source.[18] The information must lead the SEC to bring an enforcement action that results in monetary sanctions exceeding $1 million.[19] If so, the SEC will pay the whistleblower no less than

13. Mystica M. Alexander, *Defining the Whistleblower Under Dodd-Frank: Who Decides?*, 5 CALIF. L. REV. 278, 279 (2014).

14. 15 U.S.C. §78u-6(a)(6) (2010).

15. Michael M. Krauss, *For Whom the Whistle Blows: The Role of Private Enforcement in Dodd-Frank's Regulatory Framework*, 8 ST. THOMAS L. REV. 194, 196 (2014).

16. *Id*.

17. *Id*. at 199.

18. 15 U.S.C. §78u-6(a)(3)(A)-(C) (2010).

19. Krauss, *supra* note 15, at 200.

10% and no more than 30% of the total money collected.[20] Whistleblower awards are paid out of the Investor Protection Fund.[21]

2. The Anti-Retaliation Provision

Once the whistle is blown, Dodd-Frank's anti-retaliation provisions forbid an employer from retaliating against the whistleblower.[22] The anti-retaliation protections apply specifically to "whistleblowers."[23] An interpretative controversy exists in the courts whether Dodd-Frank protects only those making disclosures directly to the SEC or whether it also protects those disclosing the alleged misconduct internally under the Sarbanes-Oxley Act of 2002 (SOX) and any other law, rule, or regulation subject to the jurisdiction of the SEC. SOX prohibits retaliation against whistleblowers who have provided information to an individual with "supervisory authority over the employee" or "such other person working for the employer who has authority to investigate, discover, or terminate misconduct."[24] SOX's whistleblower protection applies even if the whistleblower did not provide information about potential securities laws violations directly to the SEC.[25]

B. SEC's Interpretation

In June 2011, the SEC found it necessary and appropriate to interpret the definition of a whistleblower.[26] The Exchange Act states that for the purposes

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20. 15 U.S.C. §78u-6(b)(1)(A)-(B) (2010).

21. 15 U.S.C. §78u-6(b)(2) (2010) (The Investor Protection Fund is an established fund in the Treasury of the United States. The Fund shall be available to the SEC for paying awards to whistleblowers who bring successful enforcement actions).

22. 15 U.S.C. §78u-6(h)(1)(A) (2010).

23. 15 U.S.C. §78u-6(h)(1)(A)(iii) (2010).

24. 18 U.S.C. §1541A(a)(1) (2010).

25. Pacella, *supra* note 11, at 732.

26. The SEC Whistleblower Rules state for purposes of the retaliation protections afforded by the Dodd-Frank Act, you are a whistleblower if:

of the Whistleblower Protection Program, "you are a whistleblower if. . . you provide information in a manner described in 15 U.S.C. 78u-6(h)(1)(A)."[27] The SEC interpreted Dodd-Frank as offering protection from retaliation to individuals who did not report potential violations to the SEC, so long as they qualify for whistleblower protection under SOX's internal whistleblowing provision.[28]

The SEC found that the anti-retaliation provisions apply to three different categories of whistleblowers.[29] The first two categories provide protection to individuals reporting to the SEC.[30] In contrast, the third category protects individuals who report to persons or governmental authorities other than the SEC.[31]

III. The Unfolding Interpretative Controversy

After the enactment of Dodd-Frank, individuals who had been retaliated against quickly took to the courts.[32] The issue for the courts became one of harmonization. The courts had to determine how to harmonize the definition of a whistleblower found in §78u-6(a)(6), which requires that information be reported to the SEC, with subsection (iii) of §78u-6(h)(1)(A), which does not require any reporting to the SEC. This issue of harmonization has resulted in a split at the circuit level.

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i. You possess a reasonable belief that the information you are providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur; and

ii. You provide information in described in Section 21(F)(h)(1)(A) of the Exchange Act (15 U.S.C. §78u-6(h)(1)(A).

27. 15 U.S.C. §78a-21F(a)(5) (2010).

28. Wadler v. Bio-Rad Laboratories Inc., 141 F. Supp. 3d 1005, 1013 (N.D. Cal. Oct. 23, 2015).

29. Krauss, *supra* note 15, at 208.

30. *Id*.

31. Id.

32. Pacella, *supra* note 11, at 733.

A. Statutory Interpretation Set Forth in Chevron

The Supreme Court expressly provided guidance on how courts should interpret a statute when Congress has not expressly spoken on the issue, and the statute appears ambiguous. When a court reviews the construction of a statute, it is faced with two questions.[33] First, the court must determine whether Congress has directly spoken to the precise question at issue.[34] If the intent of Congress is clear and unambiguous, the court and the agency must give effect to the clear and unambiguously expressed intent of Congress.[35] However, if the court determines that Congress has not directly addressed the precise question at issue, it cannot simply impose its own construction of the statute.[36] Instead, if the statute is silent or ambiguous, the question becomes whether the administrative agency's interpretation is based on a permissible construction of the statute.[37] An agency's interpretation of a statute that Congress has left ambiguous is given deference unless the agency's interpretation is arbitrary, capricious, or manifestly contrary to the statute.[38]

B. Majority of District Courts Favor Broader Protections for Whistleblowers

Prior to the conflicting decisions of the Second and Fifth Circuit Courts of Appeals, a string of federal district court decisions had been gaining momentum in developing a trend of increased protections for internal whistleblowers by interpreting Dodd-Frank to broadly protect both external and internal whistleblowers.[39]

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33. Chevron, U.S.A., Inc. v. Nat. Resources Def. Council, Inc., 104 U.S. 2778, 2781 (1984).

34. *Id*.

35. *Id*.

36. *Id*. at 2782.

37. *Id*.

38. *Id*.

39. Pacella, *supra* note 11, at 723.

1. Whistleblower Files First Anti-Retaliation Claim Under Dodd-Frank

The Southern District of New York was the first court to address the issue of who qualifies for anti-retaliation protections under Dodd-Frank in *Egan v. TradingScreen, Inc.*[40] Patrick Egan was the Head of Sales for TradingScreen, Inc. (TradingScreen).[41] In early 2009, Egan learned that the CEO was diverting TradingScreen's corporate assets to another company that the CEO solely owned.[42] Egan believed the CEO's behavior was costing TradingScreen hundreds of thousands of dollars and posing a threat to TradingScreen's existence.[43] Egan reported the CEO's behavior to the president who passed the information on to the board members.[44] Egan's information resulted in the hiring of an outside firm to conduct an internal investigation.[45] The investigation confirmed Egan's allegations and the board members informed the CEO that he would have to resign.[46] However, the CEO gained control of the board thereby preventing his own resignation.[47] After gaining control, the CEO fired Egan.[48]

After Egan filed a complaint against TradingScreen, TradingScreen moved to dismiss claiming that Egan was not an eligible whistleblower under Dodd-Frank because he never reported the CEO's conduct to the SEC.[49] TradingScreen argued that the plain text of the statutory definition of a "whistleblower" requires that a whistleblower report to the SEC to be protected by Dodd-Frank's anti-retaliation provisions.[50] In contrast, Egan argued that Congress could not have intended to require whistleblowers to

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40. Egan v. Trading Screen, Inc., 2011 WL 1672066 (S.D.N.Y. May 4, 2011).

41. *Id*.

42. *Id*.

43. *Id*. at 2.

44. *Id*.

45. *Id*.

46. *Id*.

47. *Id*.

48. *Id*.

49. *Id*. at 3.

50. *Id*.

report to the SEC to receive Dodd-Frank's anti-retaliation protections.[51] Egan argued that if the protections were limited only to those who reported information directly to the SEC, whistleblowers who reported securities violations to other federal agencies would remain unprotected, a result that Egan deemed irrational.[52]

Although the complaint was dismissed for other reasons, the court gave whistleblowers hope. The court supported the broader interpretation of "whistleblower," providing protection both to those who disclosed the information to the SEC and those who only disclosed the information internally under §78u-6(h)(1)(A)(iii), which does not require direct reporting to the SEC.[53]

2. Middle District of Tennessee Sets Requirements for Anti-Retaliation Protection

About a year after the *Egan* decision, the Middle District of Tennessee further interpreted who qualifies as a whistleblower under Dodd-Frank's anti-retaliation protections. In *Nollner v. Southern Baptist Convention, Inc.*,[54] Nollner and his wife relocated from Tennessee to India to manage the construction of a new building in New Delhi on behalf of the Southern Baptist Community.[55] When Nollner arrived in New Delhi, he discovered violations of the Foreign Corrupt Practices Act (FCPA).[56] Nollner reported these violations to his supervisors multiple times, but his reports were ignored.[57] As a result of these internal disclosures, Nollner was asked to resign from his position.[58] After refusing, Nollner was fired.[59]

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51. *Id*. at 4.

52. *Id*.

53. *Id*. at 5.

54. Nollner v. Southern Baptist Convention, Inc., 852 F.Supp.2d 986, 989 (M.D. Tenn. 2012).

55. *Id*.

56. *Id*. at 989-90.

57. *Id*. at 990.

58. *Id*.

59. *Id*.

Nollner filed a complaint against his employer and other affiliated defendants, alleging that Dodd-Frank's anti-retaliation provisions protect him from termination for reporting the defendants' potential violations of securities laws.[60] The defendants filed a motion to dismiss arguing that they are not "issuers" as defined by the FCPA and are therefore not subject to the SEC's jurisdiction.[61] The defendants further asserted that, even if they were subject to Dodd-Frank, Nollner has not made a protected disclosure covered by §78u-6(h)(1)(A).[62] In contrast, Nollner argued, "the SEC retains enforcement authority over securities violations by issuers, therefore the court should interpret [Dodd-Frank] as extending to those who report potential violations internally, even if the violation is committed by an entity that is otherwise beyond the SEC's jurisdiction."[63]

On the motion to dismiss, the court refused to extend Dodd-Frank's whistleblower protections to companies that have no relationship to the SEC.[64] The court supported its conclusion by interpreting the different enforcement mechanisms of the FCPA.[65] Focusing on civil enforcement, the FCPA grants the SEC enforcement responsibility over FCPA violations by issuers.[66] The complaint was dismissed because the defendants were not "issuers" for purposes of the FCPA, and were not subject to the SEC's jurisdiction.[67]

Similar to *Egan*, the court's opinion provided necessary guidance in determining who qualifies for anti-retaliation protection under Dodd-Frank. By harmonizing the definition of a whistleblower with the subsections listed in §78u-6(h)(1)(A), the court set out four requirements that whistleblowers must satisfy to receive protection: (1) he or she was retaliated against for reporting a potential securities violation; (2) he or she reported the information to the SEC or to another entity (even internally) as appropriate; (3) the disclosure was made pursuant to a law, rule, or regulation subject to the SEC's jurisdiction; and (4) the disclosure was "required or protected" by

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60. *Id*.

61. *Id*.

62. *Id*. at 997.

63. *Id*.

64. *Id*.

65. *Id*. at 996.

66. *Id*.

67. *Id*.

that law, rule, or regulation within the SEC's jurisdiction.[68] The court held that a plaintiff who satisfies the *Nollner* requirements will be protected from retaliation under Dodd-Frank.[69]

3. Win for Whistleblowers as Court Sets Narrow Exception to Reporting to the SEC

In 2012, Richard Kramer and the United States District Court for the District of Connecticut took one small step for whistleblowers and one giant leap for anti-retaliation protections under Dodd-Frank. In *Kramer v. Trans-Lux Corp.,*[70] Kramer was fired after informing his company's board of directors and the SEC about potential violations of the company's pension plan.[71] In 2011, Kramer developed concerns that Trans-Lux failed to adhere to its pension plan.[72] Kramer sent an email to upper management reporting his concerns.[73] Upper management dismissed Kramer's concerns.[74]

Following upper management's failure to remedy the violation, Kramer contacted Trans-Lux's board of directors expressing the same concerns addressed in the email.[75] His concerns were again dismissed.[76] Shortly thereafter, Kramer sent a letter to the SEC informing them about the potential securities laws violations.[77] A few hours later, the board of directors sent letters to Kramer reprimanding him for his disclosures.[78] The CEO stripped Kramer of his responsibilities and, a few months later, fired Kramer.[79]

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68. *Id*. at 995.

69. *Id*.

70. Kramer v. Trans-Lux Corp., 2012 WL 4444820 (D. Conn. Sept. 25, 2012).

71. *Id*. at 1.

72. *Id*.

73. *Id*.

74. *Id.*

75. *Id*. at 3.

76. *Id*.

77. *Id*.

78. *Id*.

79. *Id*.

During the motion to dismiss, Trans-Lux argued that the anti-retaliation provisions apply only to those individuals who have both satisfied the definition of a whistleblower and have engaged in one of the protected activities listed in the subsections of §78u-6(h)(1)(A).[80] In contrast, Kramer argued that Trans-Lux's interpretation would effectively moot subsection (iii) of the anti-retaliation provisions because individuals who have engaged in the activity described in that subsection are not, by definition, whistleblowers.[81] Kramer argued that both those who make disclosures listed in the subsections of §78u-6(h)(1)(A) and those that are required to report internally or those otherwise protected under SOX and the Exchange Act, are clearly entitled to protection against employer retaliation.[82]

The court, relying on *Egan* and the SEC Whistleblower Rules, rejected Trans-Lux's interpretation, finding that it would dramatically narrow the protections available to potential whistleblowers.[83] Interpreting the statute using the *Chevron* framework, the court found Dodd-Frank ambiguous as to whether the protections apply only to individuals who have provided information to the SEC relating to a violation of securities laws.[84] In finding Kramer alleged sufficient facts to support a whistleblower claim based on his internal and external reporting, the court stated that "an individual must only allege that he possessed a 'reasonable belief that the information' provided 'relates to a possible securities law violation' and that he provided the information in a manner described in [the subsections]."[85] Embracing the broader definition of whistleblower set out in *Egan* and *Nollner*, the court in *Kramer* supported harmonizing the reading of §78u-6(h)(1)(A)(iii)'s protections (that do not require reporting to the SEC) as a narrow exception to §78u-6(a)(6)'s definition of a whistleblower.[86]

The district courts to address the issue of who qualifies for Dodd-Frank's anti-retaliation protection mostly supported a broader interpretation that included individuals who report violations of securities laws internally under

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80. *Id*.

81. *Id*. at 4.

82. *Id*.

83. *Id*.

84. *Id*.

85. *Id*. at 5.

86. *Id*.

subsection (iii) of §78u-6(h)(1)(A).[87] However, this momentum came to a screeching halt a year later as a result of the *Asadi v. G.E. Energy*[88] decision in the Fifth Circuit Court of Appeals.

IV. Circuit Split Between the Fifth and Second Courts of Appeals

A. Fifth Circuit Sets Surprising Precedent

In 2013, the Fifth Circuit became the first circuit court to address the issue of whether internal whistleblowers qualify for Dodd-Frank's anti-retaliation protections in *Asadi*. Asadi was G.E. Energy's Iraq Country Executive located in Jordan.[89] Asadi became concerned G.E. Energy's hiring practices violated the FCPA, and he reported his concerns to his supervisor.[90] Following his internal report, Asadi, whose previous performance reviews were consistently positive, received "surprisingly negative" reviews.[91] G.E. Energy then applied constant and aggressive pressure towards Asadi to step down from his role and accept a reduced role in the region with minimal responsibilities.[92] Asadi failed to comply, and a year after he made the internal reports, he was fired.[93] Asadi's complaint alleged that G.E. Energy violated Dodd-Frank's anti-retaliation provisions by terminating his employment following his internal reports of potential FCPA violations.[94] G.E. Energy moved to dismiss arguing that Asadi does not fit within Dodd-Frank's definition of a whistleblower because he did not report directly to the SEC.[95]

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87. Krauss, *supra* note 15, at 211.

88. Asadi v. G.E. Energy, 720 F.3d 620 (5th Cir. 2013).

89. *Id*.

90. *Id*.

91. *Id*.

92. *Id*.

93. *Id*.

94. *Id*.

95. *Id*.

The district court never addressed the issue of who qualifies as a "whistleblower" under Dodd-Frank in granting the motion.[96] Citing to the Supreme Court's decision *Morrison v. Natural Australia Bank, Ltd.*[97], the district court held Dodd-Frank's anti-retaliation provisions do not protect Asadi's extraterritorial whistleblowing.[98]

On appeal, the Fifth Circuit went against the persuasive decisions of several district courts. The Fifth Circuit concluded that the plain language of Dodd-Frank creates a private cause of action only for individuals who provide information relating to a securities law violation to the SEC.[99] Because Asadi failed to do so, his whistleblower protection claim failed.[100]

The Fifth Circuit concluded that the interplay of the definition of a whistleblower and the subsections listed in §78u-6(h)(1)(A) explain the "who" and the "what" of the statute.[101] More specifically, who is a whistleblower under the definition and what actions protect whistleblowers from retaliation under the subsections listed in §78(u)-6(h)(1)(A).[102] The Fifth Circuit, using the *Chevron* framework, found the language of the statute unambiguous on its face, eliminating the need to give deference to the SEC's interpretation of the statute.[103] The court reasoned that the three prongs found in §78u-6(h)(1)(A) describe what actions are protected by a "whistleblower" who has already satisfied that definition under §78u-6(a)(6) by reporting directly to the SEC.[104]

Asadi argued, the anti-retaliation provisions in §78u-6(h)(1)(A) should be construed to protect those who report potential securities violations

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96. *Id*. at 621. (The district court dismissed, concluding that the whistleblower-protection provision "does not extend to or protect Asadi's extraterritorial whistleblowing activities.").

97. Morrison v. Nat. Australia Bank, 561 U.S. 247 (2010) (holding that if there is no "affirmative indication" that the statute has extraterritorial application, the Court must presume that the statute only applies domestically).

98. *Asadi*, 720 F.3d at 621.

99. *Id*.

100. *Id*. at 623.

101. *Id*. at 625.

102. *Id*.

103. *Id*. at 630.

104. *Id*.

internally.[105] The Fifth Circuit rejected Asadi's argument reasoning that the plain text of the statute does not support the proposition that individuals could take actions falling within the third category of protected activity (internally reporting securities violations under SOX) and fail to qualify under the more narrow definition of a whistleblower.[106] The Fifth Circuit used the following example to explain their interpretation of the third subsection of §78u-6(h)(1)(A):

> Assume a mid-level manager discovers a securities law violation. On the day he makes this discovery he immediately reports this securities law violation (1) to his company's chief executive officer (CEO) and (2) to the SEC. Unfortunately for the mid-level manager, the CEO, who is not yet aware of the disclosure to the SEC, immediately fires the mid-level manager. The mid-level manager is clearly a "whistleblower" as defined in Dodd-Frank because he provided original information to the SEC. Accordingly, the first and second category of protected activity would not shield this whistleblower from retaliation. The third category of protected activity, however, protects the mid-level manager. In this scenario, the internal disclosure to the CEO, a person with supervisory authority over the mid-level manager is protected under 18 U.S.C. §1514A, the anti-retaliation provision enacted as part of the Sarbanes-Oxley Act of 2002. Accordingly, even though the CEO was not aware of the report to the SEC at the time he terminated the mid-level manager, the mid-level manager can state a claim under the Dodd-Frank whistleblower protection provision because he was a "whistleblower" and suffered retaliation based on his disclosure to the CEO, which was protected under SOX.[107]

The Fifth Circuit's example misses the mark because a "whistleblower" would rarely report simultaneously both to someone with supervisory authority over them and to the SEC.[108] A whistleblower is likely to be motivated to report internally either because of a sense of loyalty to the company or with a desire to correct instances of misconduct prior to the information going public.[109] Alternatively, a whistleblower may choose to

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105. *Id*. at 626.

106. *Id*.

107. *Id*. at 627-28.

108. Pacella, *supra* note 11, at 745.

109. *Id*.

report externally to avoid the multiple disincentives of reporting internally such as loss of employment, disqualification from bonuses, or loss of workplace friends.[110]

The Fifth Circuit feared Asadi's broader construction of Dodd-Frank's anti-retaliation provisions would render SOX moot.[111] Because an individual who makes a disclosure that is protected by the anti-retaliation provision of SOX could also bring a claim under Dodd-Frank "on the basis that the disclosure was protected by SOX," the Fifth Circuit found it unlikely that an individual would bring a SOX claim because the protections afforded by Dodd-Frank are much more extensive.[112] The Fifth Circuit correctly noted that Dodd-Frank's whistleblower protections provide for greater monetary damages, bypass the agency filing requirement, and provide a longer statute of limitations. The court ignored, however, Dodd-Frank's express incorporation of SOX's anti-retaliation provision in the Act.[113]

Finding the statute to be unambiguous on its face, the court rejected Asadi's argument that the court should defer to the SEC's interpretation of the statute.[114] In denying deference to the SEC's Whistleblower Rules, the court reasoned that "Congress specified a 'whistleblower,' not merely an individual, is protected from employer retaliation on the basis of their protected activities."[115] The court's ruling clearly identified a "whistleblower" under Dodd-Frank as an individual who reports information to the SEC.

B. Second Circuit's Support of Broad Whistleblower Protections Causes Circuit Split

In 2015, the Second Circuit found the plain language of Dodd-Frank's whistleblower protections ambiguous, warranting deference to the SEC's

110. *Id*. at 746.

111. Asadi v. G.E. Energy, 720 F.3d 620, 629 (5th Cir. 2013).

112. *Id*.

113. Pacella, *supra* note 11, at 745.

114. *Asadi*, 720 F.3d at 629.

115. *Id*.

interpretative view of the statute.[116] This decision created the existing circuit split.[117]

As the finance director at Neo@Ogilvy LLC (Neo), Berman discovered his employer was committing accounting fraud.[118] He reported these violations internally to upper management.[119] Subsequently, a member of upper management terminated his employment as a result of his internal disclosures.[120] While employed and for six months after he was fired, Berman did not report any allegedly unlawful activities to the SEC.[121] In October 2013, after the limitations period had ended on his SOX claim, he provided information to the SEC.[122] In January 2014, Berman sued Neo, alleging he was discharged for his internal reporting in violation of Dodd-Frank's anti-retaliation provisions.[123]

The Second Circuit took the opposite stance of the Fifth Circuit. The Second Circuit refused to follow the Fifth Circuit's SEC reporting requirement because its interpretation would leave subsection (iii) with a very narrow scope.[124] Two reasons supported the Second Circuit's refusal to interpret Dodd-Frank's whistleblower protections narrowly.[125] First, a limited number of whistleblowers will report simultaneously.[126] Second, certain employees are unable to report wrongdoing to the Commission until after they have reported the wrongdoing to their employer.[127] In support, the Second Circuit viewed the legislative history finding Congress had made no mention of subdivision (iii), much less of its meaning or intended purposes in

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116. Berman v. Neo@Ogilvy LLC, 801 F.3d 145, 146 (2d Cir. 2015).

117. *Id*.

118. *Id*. at 148.

119. *Id*.

120. *Id*.

121. *Id*.

122. *Id*.

123. *Id*. at 149.

124. *Id*.

125. *Id*.

126. *Id*.

127. *Id*.

any legislative materials.[128] This led the court to find no need to definitively construe the statute.[129] The tension between the narrow definition of a "whistleblower" and the limited protection provided by subdivision (iii) of §78u-6(h)(1)(A) renders the section as a whole sufficiently ambiguous to warrant the court giving deference to the SEC's interpretation.[130]

Additional support for interpreting Dodd-Frank's whistleblower provisions to protect those who report potential securities violations internally was hinted at a year prior to the *Berman* decision in *Liu Meng-Lin v. Siemens AG*.[131] Although *Liu Meng-Lin* was decided on other grounds, the Second Circuit disguised its answer to the question of who qualifies for anti-retaliation protection in the footnotes of the opinion. In the footnotes, the Second Circuit assumed without deciding that internal reporting is sufficient to qualify for Dodd-Frank's anti-retaliation protections.[132] Although mentioned in passing, the statement nonetheless lends additional support to the interpretative battle over the definition of a whistleblower and which whistleblowers are protected from employer retaliation for their disclosures.

V. District Court Case Rejecting Asadi

A month after the *Berman* decision, a California district court kept the momentum going in favor of internal whistleblowers by siding with the SEC and the majority of district courts holding that a person who fails to report to the SEC is nevertheless protected from employer retaliation under Dodd-Frank.[133]

Wadler served as Bio-Rad's general counsel for nearly twenty-five years.[134] Wadler alleged that in 2009, Bio-Rad's corporate officers became aware of certain employees in Vietnam, Thailand, and Russia who may have

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128. *Id*. at 153.

129. *Id*. at 155.

130. *Id*.

131. Liu Meng-Lin v. Siemens AG, 764 F.3d 175 (2nd Cir. 2014).

132. *Id*. at 183 n.1.

133. Wadler v. Bio-Rad Laboratories Inc., 141 F. Supp. 3d 1005, 1024 (N.D. Cal. Oct. 23, 2015).

134. *Id*. at 1008.

violated provisions of the FCPA.[135] In a consent decree requiring Bio-Rad to pay $55.1 million dollars in fines, Bio-Rad admitted to the existence of the violations in Vietnam, Thailand, and Russia.[136] Concerned potential FCPA violations were occurring elsewhere, Bio-Rad hired an outside firm to investigate whether Bio-Rad employees in China were engaging in bribery.[137] The firm concluded that there was no evidence of improper payments.[138]

In 2011, Wadler discovered that although Bio-Rad's sales in China were "in the hundreds of millions of dollars over a number of years," there was virtually no documentation supporting Bio-Rad's China related sales.[139] Wadler became concerned that the lack of documentation was another violation of the FCPA's record-keeping requirements and that it was an effort to conceal violations of the FCPA's anti-bribery provisions.[140] Wadler repeatedly tried to obtain documents from Bio-Rad to further his investigation.[141] Despite the indications by upper management that they would assist in tracking down the needed documents, they repeatedly failed to do so.[142] Wadler alleged that the members of upper management repeatedly "stonewalled" him, leading him to become suspicious that the corruption issues in China were known to them.[143] Wadler took his concerns to the board of directors and the same firm was again hired to investigate the alleged violations.[144] Wadler was effectively shut out of the investigation over his repeated objections that he should be included.[145] The firm once again concluded that there was no evidence of improper payments in

135. *Id*.

136. *Id*.

137. *Id*.

138. *Id*.

139. *Id*.

140. *Id*.

141. *Id*.

142. *Id*.

143. *Id*.

144. *Id*. at 1009.

145. *Id*.

connection with Bio-Rad's China sales.[146] Soon thereafter, Bio-Rad terminated Wadler's employment.[147]

Wadler alleged that Bio-Rad made the decision to terminate him in retaliation for his reporting potential violations to "up the ladder" in violation of SOX and Dodd-Frank.[148] Bio-Rad moved to dismiss relying on the Fifth Circuit's *Asadi* decision.[149] Bio-Rad contended that Wadler's claim under Dodd-Frank failed because the plain language of Dodd-Frank made it clear that the anti-retaliation provisions are only available to those who report information about potential securities laws violations to the SEC.[150] Further, Bio-Rad argued, the term "whistleblower" does not include individuals who only provide information of a potential violation of securities law internally.[151] Wadler, aware of the current split on the issue, contended Dodd-Frank's definition of a whistleblower is ambiguous, and thus the SEC's interpretation of the statute is entitled to deference.[152]

Following the majority of district courts in granting broader anti-retaliation protections for internal whistleblowers, the court recognized that §78u-6(h)(1)(A)(iii) is in direct conflict with Dodd-Frank's definition of a whistleblower.[153]

First, the court pointed to the conflict in subsection (iii) with the assumption that only those who report to the SEC are entitled to Dodd-Frank's anti-retaliation protections, particularly focusing on attorneys and accountants as examples.[154] Interpreting the plain language of Dodd-Frank to require reporting to the SEC, makes compliance with §78j-1(b) of the Exchange Act difficult.[155] The court noted that provision only permits auditors to report illegal conduct, externally, to the SEC only after they have reported potential securities violations internally, and no action has been

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146. *Id*.

147. *Id*.

148. *Id*.

149. *Id*. at 1011.

150. *Id*.

151. *Id*. (citing Asadi v. G.E. Energy, 720 F.3d 620(5th Cir. 2013).

152. *Id*. at 1013.

153. *Wadler*, 141 F. Supp. 3d at 1025.

154. *Id*.

155. *Id*.

taken.[156] This is an indication, the court reasoned, that subsection (iii) was added because Congress wished to cover auditors who made required internal disclosures about potential securities violations.[157] Similarly, the court found that subsection (iii) should be interpreted to protect internal reports by attorneys because they are not permitted to report externally to the SEC except under limited circumstances.[158]

Second, the court noted that were it to find that the whistleblower protections of Dodd-Frank did not apply to internal whistleblowers, there would be a surplusage in subsections (i) and (ii) of §78u-6(h)(1)(A).[159] Those subsections prohibit retaliation against a whistleblower "in providing information to the Commission in accordance with this section" but that language would be entirely unnecessary if only those who provide information to the SEC can be whistleblower under Dodd-Frank.[160]

Third, because subsection (iii) was added at the last minute, the legislative history is non-existent.[161] However, the court ruled that a lack of legislative history should not be construed to suggest that Congress intended to narrow the scope of Dodd-Frank's whistleblower protections.[162] The court determined that it should not impose its own construction of a statute that Congress has left ambiguous.[163]

Fourth, the court rejected the Fifth Circuit's mootness *dicta* by pointing out that some individuals may prefer the administrative forum that is available under SOX, but not under Dodd-Frank.[164] Further, certain kinds of non-economic damages (e.g. emotional distress) are available under SOX but not under Dodd-Frank.[165] Lastly, the court noted that policy reasons support a

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156. *Id*.

157. *Id*.

158. *Id*.

159. *Id*.

160. *Id*.

161. *Id*.

162. *Id*. at 1026.

163. Chevron, U.S.A., Inc. v. NRDC, Inc., 467 U.S. 837, 843 (1984).

164. *Wadler*, 141 F. Supp. 3d at 1026.

165. *Id*.

finding of ambiguity, specifically, the public policy of encouraging reporting of securities violations.[166]

Finding the whistleblower statute to be ambiguous, the court reviewed the SEC's interpretation of the statute to determine if it was a permissible construction.[167] The court noted in its opinion, that every court that has found Dodd-Frank to be ambiguous using the *Chevron* framework has found the SEC's Whistleblower Rules a permissible construction of Dodd-Frank.[168] The SEC's interpretation was found to be permissible because it permits a large class of individuals to qualify as protected individuals, a result which appears consistent with the broad language Congress employed in subsection (iii).[169] Moreover, the SEC's interpretation of Dodd-Frank is reasonable because "a narrow reading of Dodd-Frank would 'significantly weaken the deterrence effect on employers who might otherwise consider taking an adverse employment action.'"[170] Finding the SEC's Whistleblower Rules are entitled to deference under *Chevron* resulted in another win for the whistleblowers.[171]

VI. Policy Considerations Relevant for Defining Who Qualifies as a Whistleblower

The courts that have addressed the issue of who qualifies as a whistleblower under Dodd-Frank have used justiciability considerations, such as mootness and the absence of legislative history, to explain the rationale behind their decisions. However, the policy considerations provide the strongest support for a broad interpretation of whistleblower protections. As discussed below, Dodd-Frank provides a number of advantages over SOX. Ensuring that these advantages apply to internal whistleblowers as well as those reporting directly to the SEC will promote the overall purpose of Dodd-Frank.

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166. *Id*.

167. *Id*.

168. *Id*.

169. *Id*. at 1027.

170. *Id*.

171. *Id*.

A. Incentivizing the Whistleblower

Influencing and encouraging employees to "blow the whistle" on their employers is no easy task.[172] Employees who become whistleblowers face various forms of retaliation in deciding to bring detrimental information about their employers and friends to light.[173] Whistleblowers not only face professional challenges, including retaliation from coworkers, but also suffer financial disincentives as a result from retaliation from their employers.[174] Financial disincentives include poor performance reviews by supervisors, disqualification from bonuses, termination, and difficulty obtaining new employment.[175] In 2009, the Ethics Resource Center conducted a survey of whistleblower employees who experienced retaliation, noting that the fear of retaliation in the workplace is a major reason employees do not report illegal conduct.[176] These disincentives for internal whistleblowers are extremely detrimental to bringing potential violations of the securities laws to the forefront, as whistleblowers are the most valuable source of information.[177] Such disincentives and established fear of retaliation are key reasons that the SEC implemented the Whistleblower Rules, and the Second Circuit's opinion in *Berman* should be the proper interpretation of the whistleblower provisions of Dodd-Frank. Interpreting Dodd-Frank broadly, to include protection for those who report internally, provides additional incentives to whistleblowers who satisfy SOX's internal reporting requirements.

1. Whistleblower's Choice of Forum

The incorporation of SOX into Dodd-Frank allows for whistleblowers to choose their preferred forum. In the years following Dodd-Frank's enactment, whistleblowers readily took advantage of Dodd-Frank's provision allowing whistleblowers to bring actions directly in federal court against

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172. Pacella, *supra* 11, at 754.

173. *Id*.

174. *Id*.

175. *Id*.

176. *Id*. at 755.

177. *Id*. at 756.

their employers.[178] The right to directly bring a private action in federal court is unavailable under SOX.[179] Rather, under SOX, employees alleging violations are first required to exhaust all administrative remedies by filing a complaint with the Secretary of Labor before bringing an action against an employer in federal court.[180] In comparison, Dodd-Frank provides whistleblowers with a direct private right of action in federal district court without the prerequisite that the whistleblower first exhaust all administrative remedies.[181] In the rare instance in which a whistleblower simultaneously "blows the whistle" internally to someone with supervisory authority over him and to the SEC, the whistleblower is provided with a choice. He may either bring a private right of action or receive a reward as a result of a successful enforcement action prompted by his original information.[182] The options under Dodd-Frank, if interpreted broadly, would render SOX effective for those whistleblowers who prefer not to bring their own action even though they have the ability to do so.

2. Extended Statute of Limitations

Under Dodd-Frank, a whistleblower has as long as six years after a violation has occurred to bring a direct action in federal court, but under SOX a whistleblower only has 180 days to file an administrative complaint with the Secretary of Labor.[183] Dodd-Frank's longer statute of limitations period provides another advantage to extending whistleblower protections to protect internal whistleblowers from anti-retaliatory conduct. Thus, interpreting Dodd-Frank's definition broadly allows for employees who are unable to or do not report potential violations of securities laws within 180 days under SOX to continue to be protected and bring whistleblower claims under Dodd-Frank.

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178. *Id*. at 733.

179. *Id*.

180. 18 U.S.C. §1514A(b) (2012).

181. 15 U.S.C. §78u-6(h)(1)(B)(i) (2010).

182. *Id*.

183. Krauss, *supra* note 15, at 205.

3. Remedies

Under Dodd-Frank, whistleblowers have numerous remedies available to them. Statutory remedies under Dodd-Frank include reinstatement with equivalent seniority, double back pay with interest, and litigation fees and costs.[184] Although the remedies are similar under SOX, back pay is limited to back pay with interest.[185]

B. Dodd-Frank Will Render Sarbanes-Oxley Moot

The reasons listed above to encourage the broader interpretation of Dodd-Frank's whistleblower protections and deference to the SEC's Final Rules are the same reasons the Fifth Circuit rejected such a broader interpretation, reasoning that SOX would then be rendered moot. As the court stated in *Asadi*, "construing the Dodd-Frank whistleblower protections to extend beyond the statutory definition of 'whistleblowers' renders the anti-retaliation provision of SOX for practical purposes, moot."[186] Further, the Fifth Circuit stated, "such a construction has this impact because an individual who makes a disclosure that is protected by the SOX anti-retaliation provision could also bring a Dodd-Frank whistleblower-protection claim on the basis that the disclosure was protected by SOX."[187] Simply put, the Fifth Circuit reasoned that when left with the choice of raising a SOX or a Dodd-Frank anti-retaliation claim, it is unlikely that an individual would choose to pursue a SOX claim.[188]

However, the mootness argument is flawed.[189] Dodd-Frank merely expands SOX's anti-retaliation provisions to address weaknesses that have been revealed in the years since SOX's enactment, providing greater protections to whistleblowers.[190] This view is supported by the lack of legislative history interpreting the meaning behind subsection (iii) of §78u-

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184. *Id*.

185. *Id*.

186. Asadi v. G.E. Energy, 720 F.3d 620, 629 (5th Cir. 2013).

187. *Id*.

188. *Id*.

189. Pacella, *supra* note 11, at 746.

190. *Id*.

6(h)(1)(A). The fact that subsection (iii) was added at the last minute without any legislative material does not suggest that Congress intended to narrow the protections granted in earlier versions of Dodd-Frank.[191]

Further, the Fifth Circuit's argument that SOX will be rendered moot is harmful to Dodd-Frank's goal of incentivizing whistleblowers. A number of professions are required to report internally prior to disclosing information externally to the SEC.[192] For example, auditors are subject to §78j-1(b)(1) of the Exchange Act. This provision requires auditors to inform the appropriate level of the management of illegal acts, and if management does not take reasonable remedial action, then the auditor is required to report to the board of directors.[193] Significantly, §78j-1(b)[194] permits an auditor to report illegal acts to the SEC only after the board and management fail to take appropriate remedial action.[195] Thus, auditors would still have remedies available to them to address any retaliation that they may endure for revealing potential violations of securities laws "up the ladder" under SOX and could file an anti-retaliation claim under subsection (iii) in the instance the auditor was unable to report to the SEC.

Lastly, SOX will not be rendered moot because some individuals may prefer the administrative forum available under SOX, instead of the bringing a direct suit in federal court under Dodd-Frank.[196] SOX's administrative forum provides a lower burden of proof by merely requiring a *prima facie* showing of retaliation.[197] When a whistleblower meets his burden of proof, the Secretary of Labor will conduct an investigation to determine whether there is reasonable cause to believe the whistleblower was discriminated against because of his disclosure.[198] SOX's administrative forum will continue to provide an alternative to resolving employer retaliation outside of the federal court system.

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191. Wadler v. Bio-Rad Laboratories Inc., 141 F. Supp. 3d 1005, 1026 (N.D. Cal. Oct. 23, 2015).

192. Berman v. Neo@Ogilvy LLC, 801 F.3d 145, 151 (2d Cir. 2015).

193. *Id*.

194. 15 U.S.C. §78j-1(b)(3)(B) (2010).

195. *Berman*, 801 F.3d at 151.

196. *Wadler*, 141 F. Supp. 3d at 1026.

197. 18 U.S.C. §1514A (b)(2)(C) (2010) (citing 49 U.S.C. §42121(b)(2)(B)(i)).

198. 49 U.S.C. §42121 (b)(2)(A) (2010).

C. Surplusage Concerns

According to the Oxford Dictionary, superfluous is synonymous with unnecessary.[199] As cited by the Supreme Court in *Duncan,*[200] "it is a cardinal principle of statutory construction that a statute ought. . .to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant."[201] The Fifth Circuit feared, "Asadi's suggested construction of the whistleblower protections would read the words 'to the Commission' out of the definition of 'whistleblower' for purposes of the whistleblower protection provision."[202] Asadi's reading, the Fifth Circuit expressed, would violate the surplusage canon, that every word is to be given effect.[203] However, the language in subsections (i) and (ii), requiring reporting to the SEC, would be entirely unnecessary if only those whistleblowers who provide information to the SEC can be protected from employer retaliation under Dodd-Frank.[204]

D. Lack of Legislative History

The Second Circuit in *Berman* stated that due to the late addition of subsection (iii) of §78u-6(h)(1)(A), "it is not at all surprising that no one noticed that the new subdivision and the definition of 'whistleblower' do not fit together neatly."[205] Subdivisions (i) and (ii) were included in the Senate version of Dodd-Frank, which fit precisely into the definition of "whistleblower" and required reporting to the SEC while subsection (iii) does not.[206] The Second Circuit thought it "doubtful that the conferees who

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199. *Definition of Superfluous*, OXFORD DICTIONARY, http://www.oxford dictionaries.com/us/definition/american_english/superfluous (last visited August 2, 2016).

200. Duncan v. Walker*,* 533 U.S. 167, 174 (2001).

201. Asadi v. G.E. Energy, 720 F.3d 620, 627 (5th Cir. 2013).

202. *Id*. at 628.

203. *Id*.

204. Wadler v. Bio-Rad Laboratories Inc., 141 F. Supp. 3d 1005, 1025 (N.D. Cal. Oct. 23, 2015).

205. Berman v. Neo@Ogilvy LLC*,* 801 F.3d 145, 154 (2d Cir. 2015).

206. *Id*.

accepted the last-minute insertion of subdivision (iii) would have expected it to have the extremely limited scope it would have if it were restricted by the Commission reporting requirement in the 'whistleblower definition.'"[207]

E. Promotion of compliance with internal reporting programs

Internal compliance programs are designed to prevent potential securities laws violations with a result of mitigating potential convictions for criminal activity.[208]A problem with the existing circuit split between the Second and Fifth Circuits is that the split has a negative effect on the Dodd-Frank's reliance on individuals as valuable sources of information relating to potential securities laws violations. The realistic effect of the two decisions is that internal whistleblowers are currently left without affirmative assurance that they can take advantage of the anti-retaliation protections offered under Dodd Frank.[209] As a result, whistleblowers are now prompted to report directly to the SEC to ensure that they obtain protection, a devastating effect for internal compliance channels.[210]

The SEC attempted to address corporations' internal compliance concerns when it promulgated the SEC Whistleblower Rules interpreting Dodd-Frank.[211] However, this attempt to encourage internal compliance reporting has been threatened with no clear precedent on protection for internal whistleblowers who disclose potential securities violations.[212]

VII. Conclusion

The current circuit split between the courts of appeals in the Second and Fifth Circuits leave employees who have discovered violations of securities laws and want to "blow the whistle" on the illegal conduct uncertain on how they will be protected from employer retaliation. This uncertainty adversely

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207. *Id*. at 155.

208. Pacella, *supra* note 11, at 726.

209. *Id*. at 750.

210. *Id*. at 761.

211. *Id*.

212. *Id*.

affects the goal of the Dodd-Frank Act, which was to "improve the accountability and transparency of the financial system" and to create "new incentives and protection for whistleblowers."[213]

A broader interpretation, supported by both the district courts and the Second Circuit, will further the goals of Dodd-Frank by providing added incentives to whistleblowers who report internally or externally. As enacted, the statute presents a conflict, and Congress should amend the whistleblower provisions under Dodd-Frank to ensure that the language is clear as to whether internal whistleblowers are protected.[214] The express incorporation of SOX's anti-retaliation provision into subsection (iii) includes internal whistleblowers among those who are protected and presents a conflict with the more limited definition of a "whistleblower."[215] More district courts like *Wadler* are going to face the question of who qualifies for anti-retaliation protection under Dodd-Frank and will be faced with the difficulty of deciding which statutory construction to apply. Interpreting Dodd-Frank to protect whistleblowers, whether reporting internally, externally, or both, will encourage more employees like Ben-Artzi to come forward with information about potential violations of securities laws.

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213. Kramer v. Trans-Lux Corp., 2012 WL 4444820, *5 (D. Conn. Sept. 25, 2012).

214. Pacella, *supra* note 11, at 760.

215. *Id*.

STATISTICAL CONSIDERATIONS IN FILING AND NEGOTIATING CUSTOMER CASES AT FINRA

Dana N. Pescosolido[1]

For Claimants' counsel who have just taken on a new case to be arbitrated at FINRA, there are several decisions that need to be made and questions asked:

- If the case is large enough, is it better to select a panel consisting of all public arbitrators or should I opt for a "non-public" arbitrator and set a "majority-public" panel?
- If it's a smaller-dollar case, should we demand a hearing with a sole public arbitrator or should we have the arbitrator decide the case on the papers?
- How can I best set my client's expectations at a reasonable level so that when it comes time to negotiate a settlement, the client doesn't expect more than we are likely to be able to negotiate?
- When it comes time to negotiate, is my strategy and expectation different based on what type of firm the Respondent is?

While the facts of the case, the quality of your client as a witness, and the regulatory history of the broker are all very important considerations, it is also useful to understand the statistical differences that can influence the decisions you make and that give your client the best chance for a satisfactory outcome. The purpose of this article is to lay out for the practitioner statistical considerations that should at least be considered in making decisions and advising the client.

Doesn't FINRA publish statistics on case outcomes? Yes, and practitioners may find a visit to FINRA Dispute Resolution's statistics page helpful. However, one must look behind the raw statistics and understand the body of awards issued by FINRA Arbitration Panels to fully appreciate the outcomes. For example, FINRA's statistics page reports that Claimants won a monetary award in only 36% of the cases decided by "Majority-Public" panels in 2016. Yet, if one were to read every award (as this author has done),

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one would learn that for cases that were fully contested on the merits **and where the Claimant was represented by counsel,** Claimants' "win rate" before "Majority-Public" panels in 2016 was actually 55% (26 out of 47 cases). Moreover, FINRA's statistics page does not report **how much** Claimants win when they do win. By studying each award, this author has collected data for the last two years (2015 and 2016) which may be helpful in making decisions and advising clients.

Are Majority-Public Panels tougher on Claimants than All-Public Panels? Not really. Conventional wisdom has it that having an "industry guy" on the panel hurts the likelihood that your client will win money because the "industry guy" will be biased in favor of the Respondent firm. But that's not what the statistics say. Maybe it's because the "industry guy" will better understand what the suitability or damage expert says. Maybe it's because the "industry guy" serving as an arbitrator is a right-minded person who feels a duty to "police" the industry and thus holds the broker to a higher standard. Whatever the reason, in 2015 and 2016 combined, Majority-Public Panels awarded Claimants money slightly more frequently than did All-Public Panels, although they awarded a little less on average. Majority-Public Panels awarded Claimants money in 55% of fully contested cases where Claimant was represented by counsel in 2015 – exactly the same percentage as All-Public Panels. In 2016, Majority-Public Panels also awarded money to Claimants 55% of the time – pretty consistent results, right? But in 2016, All-Public Panels only awarded Claimants money in 50% of their awards.

It is true that the amounts awarded favor All-Public Panels slightly, but when you look at the numbers, there isn't enough of a difference to really matter. In 2016, for example, in those cases where monetary awards were given, the median award expressed as a percentage of the compensatory claim was 44% of the claim for All-Public Panels, and 43% of the claim for Majority-Public Panels. In 2015, the median award issued by All-Public Panels was 47%, and for Majority-Public Panels it was 40% of the amount claimed. The median is the point where half the awards were for more and half were for less. The **average** award in 2016 was 51% of the amount claimed in cases decided by All-Public Panels and 48% in cases decided by Majority-Public Panels. (The average is the sum of all observations divided by the number of observations – the arithmetic mean – but one should not get too enamored by "averages", for reasons that shall be explained later.) So as far as the likelihood of your client getting a monetary award, the data over the last two years show that it really doesn't make a difference whether the panel is All-Public or Majority-Public. So, if you have a case that requires some industry

knowledge, the statistics suggest that you won't be hurting your client's case by going with a Majority-Public Panel.

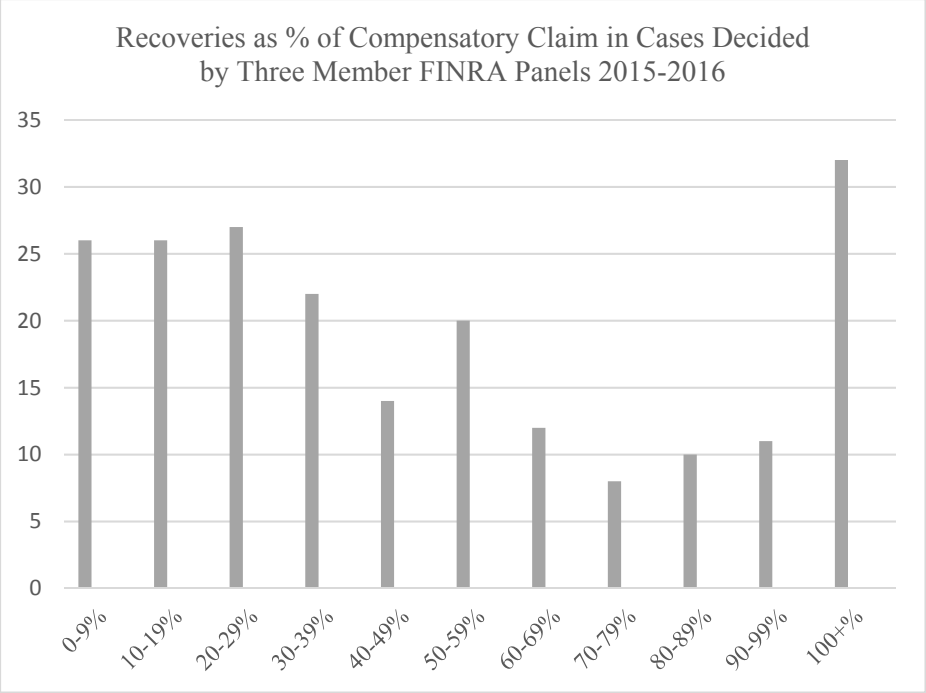
What about a Sole Public Arbitrator where I have a choice of going "on the papers"? Are my chances better if I elect a hearing? Your chances of winning something are slightly better, but not by much. But the likelihood of winning more than half of your claim are significantly higher on the papers. There are two dynamics at work here. First, the less attention a case gets, the lower the "win rate" for Claimants. Second, the less attention a case gets, the more "polarized" the results become. We're not entirely sure why this is, but two years of statistics bear it out. We noted above that the "win rate" for Claimants over the last two years was above 50% when cases were decided by three-member panels. But with a Sole Public Arbitrator in cases that involved a hearing over those two years, Claimants won something only 44% of the time. In cases decided on the papers, Claimants won just 37% of the cases, even when represented by counsel. (If a prospective client suggests that he might represent himself, you can truthfully advise him that in 2015 and 2016 combined, **pro-se Claimants won anything in just 4 of 49 cases that they took to hearing – a miserable 8% win rate.**)

Just as "win rates" declined the less attention a case got, the incidence of "all or nothing" awards increased. In cases decided in 2016 by three-member panels, 60% of cases were "all or nothing" awards (unfortunately for the Claimants, the "nothing" awards outnumbered the "all" awards by five to one – only 10% of the awards were for 100% or more of the compensatory claim). In cases decided by Sole Public Arbitrators following a hearing, the "all or nothing" rate was 71%. And in cases decided on the papers, it was 79%. The stats for 2015 were virtually identical.

The "good news" in cases decided on the papers is that, when the Claimants did win, they won more than half of what they were claiming 76% of the time. And they won 100% in 10 of the 21 cases decided on the papers in 2016.

So, what's the takeaway from this data? Well, if your client wants a greater shot at **some** recovery, opt for more "attention" in the administration of the case. But if your client is more into taking a shot at higher recovery, then go with a decision on the papers.

How can I set my client's expectations at a reasonable level early on? When Claimants do win, how much do they get? Obviously, you are going to counsel your client about how strong you think the case is, but as for **average** and **median** recoveries, you should know this: the averages and medians discussed above are subject to huge "standard deviations." What that means is that the outcomes of securities arbitrations in 2015 and 2016 were not clustered around the middle like a typical "bell curve." They were all over the spectrum. Therefore, outcomes in securities arbitrations are difficult to predict, since they don't tend to cluster near either the median or the arithmetic mean (the average). We plotted 208 outcomes for the two years combined where three-member panels granted some recovery. (N.B. --The chart **does not** show the 160 cases where the Claimant got nothing. If it did there would be a very tall column on the left margin of the table.) We then broke out in deciles the amount of compensatory recovery as a percentage of the compensatory claim and a final column for awards of 100% or more. For example, there were 26 cases in which the recovery was between 0.1% and 9%. Here's what the graph looks like:



As you can see, the decile from 40-49% (where the median and averages were located) was actually below average in the number of outcomes – only 14 of the 208 outcomes were in the same decile as the medians and averages discussed above. However, the chart does reveal some interesting things:

- There is greater representation of outcomes in the lower four deciles than in the next six deciles combined, suggesting that awards on the lower end of the spectrum predominate.
- The "non-decile" of 100+% has the greatest number of outcomes – 32. While that might give some Claimants hope, one must remember that there were 160 cases not on this chart where the Claimants received nothing. So combining the 160 "zero award" cases with the 208 on this chart, only 8.7% of the outcomes (32 of 368 total outcomes) were for 100% or more of the compensatory claim. "Zero" awards (160 of them) were five times more frequent than 100% awards (32).
- When the 160 "zero awards" are factored in, 71% of all outcomes resulted in recovery of less than 40% (261 out of 368 total outcomes). Remember these are not averages or medians – this table shows the distribution of actual outcomes. So if a client is asking how these cases work out, it would be accurate to say that in 2015 and 2016, 71% of the Claimants received less than 40% of what they were claiming. Only 29% received 40% or more.

What about sweeteners (attorneys' fees, punitive damages, non-forum costs and pre-award interest)? How often were they granted and how much did they add? At least one sweetener was awarded in about half the cases where compensatory damages were awarded. In 2016, fees were awarded in about 25% of the cases where compensatory damages were awarded. When they were awarded, they added about 20% to the compensatory award. Punitive damages were awarded much less often (in just 8.6% of cases where compensatory damages were awarded, and they ranged widely from 25% to 250% of the compensatory award). Non-forum costs (mostly expert witness fees) were awarded in 35% of the cases where compensatory damages were awarded and averaged about $25,000 when they were awarded. Pre-award interest was awarded in 24% of the cases where compensatory awards were granted, and the amounts were all over the lot, depending on what interest rate was applied and for how long the interest was to be paid.

In negotiating these cases, evaluate the strength of your claim for sweeteners, and take into consideration these statistics from 2016. Sweeteners

were fairly common and in those cases where compensatory awards were made, raised the median awards by about 10% overall.

Now, every case is different and some are stronger while others are weaker. And as stated above, the facts of the case, the quality of the witnesses and any predispositions of the arbitrators are the most important factors. But in evaluating the settlement value of a case, it is also helpful to know the outcomes that have recently been obtained.

Does it matter what type of firm the Respondent is? Actually, it does. In our study for 2016 we broke out win rates and recovery rates for large national firms, for non-national Broker-Dealers (including regionals down to "mom and pop" BDs), for what we call "platform firms" (those that provide a platform for independent advisers, including compliance and supervision) and for online Broker-Dealers. What we found was that Claimants lost to large national firms more than they lost to non-national BDs, and much more than they lost to "platform firms." Claimants won only 43% of the time against large national firms, but they won 56% of the time against non-national BDs, and 75% of the time against the "platform" firms. Online firms fared the best, with Claimants winning against them just 27% of the time.

The recovery rates followed the same pattern. Claimants who won against national firms won on average 46% of the compensatory claim. Against non-national BDs they won 53% of the compensatory claim, and against the "platform" firms the average win was for 73%.

If you combine these two statistics (win rate and average recovery) you can calculate the actuarial value of the respective classes of the cases. In-house counsel often use an actuarial approach in obtaining management approval for a settlement, so it is useful to understand the concept. For example, if Claimants against national firms had a 43% chance of winning 46% of their Claim, the actuarial value of that type of case – in 2016 – was 20% (.43 x .46). At the other end of the spectrum, Claimants against "platform" firms won 75% of the time and on average won 73% of the compensatory claim, so the actuarial value of those cases was 55% (.75 x .73). Why do national firms do so much better? Is it because compliance and supervision systems at the big national firms are more technologically advanced? Do they just take it more seriously? Whatever the reason, it is useful for negotiation purposes to know that the outcomes were much more favorable for national firms than for "platform" firms – at least in 2016.

Conclusion. It was once said "There are three kinds of lies: lies, damned lies and statistics." That's one way of expressing the notion that in using statistics, one must be careful to understand how they were generated and how reliable they really are. What we have learned here is that predicting the outcome of any particular arbitration is extremely difficult, but what we can say is that in looking back on actual outcomes of cases that were fully contested in 2015 and 2016 and where the Claimant was represented by counsel:

- It didn't seem to matter much whether the three-person panel was an "All-Public" panel or a "Majority-Public" panel. In both circumstances, Claimants won something about half the time, and when they did, the "average" compensatory award was for roughly half of what was claimed.
- The "win rate" for cases decided on the papers was lower than when a sole public arbitrator held a hearing, but the likelihood of getting a bigger award (as a percentage of the claim) was higher in cases decided on the papers.
- As the graph shown above indicates, 71% of Claimants in 2015 and 2016 recovered less than 40% of their claim, even when represented by counsel.
- "Sweeteners" were awarded in about half the cases when the panel awarded compensatory damages, and they added about 10% to those awards.
- Claimants won 100% or more of their claim in about 10% of all cases.
- Big national firms fared better than regional firms and much better than "platform" firms.

In making decisions about filing and in advising clients about realistic expectations and then in negotiating settlements in these cases, the practitioner will be evaluating a number of subjective issues about the quality of the case, the witnesses and the arbitrators. In addition, it is hoped that the statistics in this article will provide some concrete quantitative data based on two years of actual FINRA awards.

INVESTORS, CORNERED
WE ARE ALL WALL STREET BOCADITOS[1]

Jason M. Kueser, Michael Edmiston, and Bradley Stark

Today's individual investor is Wall Street's snack. In the 1950-1970s, the middle class dominated American economics. The Financial Services industry was a mere 2.8% of GDP in 1950 and 4.9% in 1980.[2] By 2006, the financial services industry had swelled to 8.3% of United States GDP.

As this column recently observed, "(t)his explosion in finance is due to rents[3] from 'two activities: asset management and the provision of household credit.' This orgy of fees to the financial industry has garnered the moniker the financialization[4] of America."[5] This explosion of rents was made possible by symbiotic political[6] and financial bubbles.[7]

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1. *Bocaditos definition,* SPANISHDICT.COM, http://www.spanishdict.com/translate/bocadito (last visited Mar. 3, 2017).

2. U.S. Bureau of Economic Analysis, *GDP & Personal Income*, BEA, http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=5 (last visited Mar. 27, 2017).

3. Rents are excess payments, market inefficiencies, largess often the result of crony capitalism or unwarranted subsidies. "Economic rent is an excess payment made to or for a factor of production over the amount required by the property owner to proceed with the deal" *Economic rent definition,* INVESTOPEDIA, http://www.investopedia.com/terms/e/economicrent.asp (last visited Mar. 3, 2017).

4. *Financialization definition*, INVESTOPEDIA, http://www.investopedia.com/terms/f/financialization.asp#ixzz4aHmLlQ6W (last visited Mar. 3, 2017) ("Financialization is an increase in the size and importance of a country's financial sector relative to its overall economy.")

5. Michael S. Edmiston & Bradley Stark, *The Financial Services Industry's Historic Pattern of Opposition to Reform: "Wolf" is the Only Cry*, 22 PIABA B.J. 165, 171-72 (2015).

6. "A set of policy biases that help foster and amplify the market behaviors that generate financial crises. Political bubbles are pro-cyclical. Rather than tilting against risky behavior, the political bubble aids, abets, and amplifies it. During a financial bubble when regulations should be strengthened, the political bubble relaxes them. When investors should hold more capital and reduce leverage, the political bubble allows the opposite. When monetary policy should tighten, the political bubble promotes easy credit." NOLAN MCCARTY ET AL., POLITICAL

Wall Street Consumes Private Investors' Savings

The financialization of America has come on the backs of the middle class private investor. The financial services industry is where the working middle class goes seeking retirement help and instead sees their futures destroyed with conflicted advice and excessive fees. "A majority of Americans over 65 get more than half their income from Social Security, and more than a quarter are almost completely reliant on those monthly checks."[8] While the Financial Services industry and those in the top most income brackets[9] have flourished, the percent of assets owned by Americans over age 65 has declined.[10]

BUBBLES: FINANCIAL CRISES AND THE FAILURE OF AMERICAN DEMOCRACY 14 (2013).

7. "[A]n economic cycle characterized by rapid escalation of asset prices followed by a contraction. It is created by a surge in asset prices unwarranted by the fundamentals of the asset and driven by exuberant market behavior. When no more investors are willing to buy at the elevated price, a massive selloff occurs, causing the bubble to deflate." *Bubble definition,* Investopedia, http://www.investopedia.com/terms/b/bubble.asp#ixzz4aHOQmgFA (last visited Mar. 3, 2017).

8. Soc. Sec. Admin., *Table 9.A1 Importance of Social Security Relative to Total Income*, https://www.ssa.gov/policy/docs/statcomps/income_pop55/2014/sect09.html#table9.a1 (last visited Mar. 3, 2017). *See also*, Paul Krugman, *The Insecure American*, NYTIMES.COM, (May 29, 2015), http://www.nytimes.com/2015/05/29/opinion/paul-krugman-the-insecure-american.html?action=click&pgtype=Homepage&module=opinion-c-col-left-region&region=opinion-c-col-left-region&WT.nav=opinion-c-col-left-region&_r=0.

9. "Tax progressivity at the top has declined since the 1960s." Thomas Piketty et al., *Distributional National Accounts: Methods and Estimates for the United States* 32, (Washington Ctr for Equitable Growth Working Paper Series) (Dec. 2016), http://cdn.equitablegrowth.org/wp-content/uploads/2017/02/24163023/120716-WP-distributional-national-accounts.pdf. But note "the generosity of transfers at the bottom has increased hereby mitigating the dramatic worsening in inequality." *Id.*

10. T. Lynn Fisher, *The Impact of Survey Choice on Measuring the Relative Importance of Social Security Benefits to the Elderly* 67 SOC. SEC. BULL. 2 at 1 (2007), https://www.ssa.gov/policy/docs/ssb/v67n2/v67n2p55.html.

By comparison, 100 CEOs have retirement funds that equal the retirement funds of the bottom 41% of family retirement funds.[11] Worse, 64% of these CEO fortunes receive tax deferment benefits as a result of political influences not available to the middle class. "Unlike ordinary 401(k) holders, most top CEOs have no limits on annual contributions to their tax-deferred accounts."[12]

The "(m)edian pre-tax incomes have hardly grown since 1980."[13] "Since 1980, growth in real incomes for the bottom 90% adults has been only about half of the national average on pre-tax basis and about two-thirds on a post-tax basis."[14] Adjusted for inflation, the minimum wage has declined 37% in purchasing power from March 1968 to October 2016.[15] One study suggests that "for most U.S. workers, real wages – that is, after inflation is taken into account – have been flat or even falling for decades."[16] That study found that the gains that have been made in real wages "have gone to the upper income brackets" and that "[s]ince 2000, usual weekly wages have fallen 3.7% (in real terms) among workers in the lowest tenth of the earnings distribution, and 3% among the lowest quarter."[17] Further, as noted in the chart below, the

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11. "Just 100 CEOs have company retirement funds worth $4.7 billion [which is] equal to the entire retirement savings of the bottom: 59 percent of African-American families [and] 75 percent of Latino families." Sarah Anderson & Scott Klinger, *A Tale of Two Retirements*, INST. FOR POLICY STUDIES (Dec. 2016), http://www.ips-dc.org/wp-content/uploads/2016/12/IPS-Two-Retirements-Report-final-for-dec-15.pdf.

12. ANDERSON & KLINGER, *supra* note 11, at 1.

13. PIKETTY ET AL., *supra* note 9, at 32, "The reduction of the gender gap in earnings has played an important role in mitigating the increase in inequality among adults since the late 1960s but the gender gap is far from being closed especially at the upper earnings end." *Id.*

14. *Id*.

15. *See* FED. RESERVE BANK OF ST. LOUIS, FEDERAL MINIMUM HOURLY WAGE FOR NONFARM WORKERS FOR THE UNITED STATES/CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS: ALL ITEMS (Oct. 2016), https://fred.stlouisfed.org/graph/?g=c3M5.

16. Drew Desilver, *For most workers, real wages have barely budged for decades*, PEW RESEARCH CENTER (Oct. 9, 2014), http://www.pewresearch.org/fact-tank/2014/10/09/for-most-workers-real-wages-have-barely-budged-for-decades/.

17. *Id*.

percentage of children who earn more money than their parents is declining considerably.

Source: The Equality of Opportunity Project[18]

As such, while average Americans have been able to buy less in food and other consumable items, Wall Street has feasted on those same average Americans, as the financial services industry has nearly quadrupled in size (as measured by percentage of GDP). This is akin to a game of Pac-Man where every dot on the board represents average Americans' savings and the ghosts represent US regulators. Unfortunately, in this game, the ghosts are always blue and average Americans' savings are just waiting to be devoured.

These facts are an indictment of our political leaders, financial system, and banks, including the financial advisors who have been charging high fees for financial planning and money management. These facts further demonstrate the on-going ignominious failure of the brokerage industry whose supposed objective is the efficient allocation of capital for the private investor.[19]

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18. THE EQUALITY OF OPPORTUNITY PROJECT, http://www.equality-of-opportunity.org (last visited Mar. 3, 2017).

19. It took the Great Depression to lead to the creation of the S.E.C. and other structural reforms to finance and the financial markets. One scholar notes that "(c)ontemporary trends resemble those of the industrial revolution in the 18th and 19th centuries" but also notes that only 6% of the population had voting rights leaving workers disenfranchised and concludes that "the greatest threat to the future of growth lies not in technology, therefore, but in politics. Avoiding further populist backlashes requires the benefits of technology be more widely shared." Carl

Approximately 25% of the roughly 8% of GDP (estimated to be 2% to 2.2% of GDP) flowing to the financial sector is in the form of rents.[20] This equates to $280 Billon per year in 2010 (extrapolated to $364.44 billion in 2015 at 2% of GDP). Summing up a decade of rents to the financial services industry, at 2% of GDP per year, adds to an astounding $3.21 trillion from 2006 through 2016.

The unending decline of purchasing power of the bottom 90% of income earners, the financialization of America, and the flow of our country's resources to the financial services industry and very top income earners they service is reflected in the structure of our financial markets.[21] "In 1950, institutional investors owned about 7% of the United States stock market; today they own almost 70%. Grouping them as a single investor, BlackRock, Vanguard, and State Street are the largest owner of 88% of the companies in the Standard & Poor's 500. Control of the economy has not been this

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Benedikt Frey, *Growth hinges on technology but the fruits must be shared*, FINANCIAL TIMES (Dec. 12, 2016), https://www.ft.com/content/c552970e-a1e0-11e6-aa83-bcb58d1d2193. This thesis rings true and suggests popping our political and financial bubbles are necessary to future growth from technology and to avoid income inequality and civil unrest. Some commentators suggest this inefficient allocation of capital and the strife it creates bode disaster for America. Nafeez Ahmed, *US Power Will Decline Under Trump, Says Futurist Who Predicted Soviet Collapse*, MOTHERBOARD.COM (Dec. 6, 2016), https://motherboard.vice.com/read/us-power-will-decline-under-trump-says-futurist-who-predicted-soviet-collapse. One scholar notes that repaid assimilation of technology leads to income inequality but notes that this can be explained by the underrepresentation of workers. Simon Kuznets in part won the Nobel Prize for the thesis that economic growth "In poor countries, he found, economic growth increased the income disparity between rich and poor people. In wealthier countries, economic growth narrowed the difference." *See Simon Kuznets biography*, LIBRARY OF ECON. & LIBERTY, (2008), http://www.econlib.org/library/Enc/bios/Kuznets.html. This thesis is supported to various degrees by other scholars. "Robert J. Gordon, the economic historian at Northwestern … also argues that Mr. Scheidel's view is too narrow. Big shocks might be needed to shake societies and their political systems to counteract widening income disparities, he acknowledges, but violence is hardly indispensable." Eduardo Porter, *A Dilemma for Humanity: Stark Inequality or Total War*, N.Y. TIMES (Dec. 6, 2016), https://www.nytimes.com/2016/12/06/business/economy/a-dilemma-for-humanity-stark-inequality-or-total-war.html.

20. U.S. BUREAU OF ECON. ANALYSIS, *supra* note 2.

21. PORTER, *supra* note 18.

concentrated since the Gilded Age.[22] This growing power has undercut middle-class living standards; economic theory holds that when a single investor owns large stakes in competing firms, the investor will want firms to keep prices high and wages low. Price and wage competition lowers profits and stock values."[23] Empirical data shows that, in fact, large increases in bank fees and reductions in interest rates to savers has been a result of institutional investors owning the vast majority of banks.[24]

One of the few significant consumer-oriented protections in recent decades is the Fiduciary Duty rule for retirement accounts issued by the Department of Labor this year.[25] Wall Street aggressively fought this regulation[26] and Congress threatened to defund the Department of Labor[27] despite The White House citing data that it would lead to market efficiency

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22. *See* Paul Krugman, *Why We're in a New Guilded Age*, N.Y. REVIEW OF BOOKS (May 8, 2014), http://www.nybooks.com/articles/2014/05/08/thomas-piketty-new-gilded-age/.

23. Common ownership of banks results in "large increases in bank fees and reductions in interest rates to savers." Eric Posner et al., *A Monopoly Donald Trump Can Pop*, N.Y. TIMES (Dec. 7, 2016), https://www.nytimes.com/2016/12/07/opinion/a-monopoly-donald-trump-can-pop.html.

24. "The empirical impact of institutional investors was revealed in two blockbuster academic papers. One — written by José Azar, Martin C. Schmalz and Isabel Tecu — found that airline ticket prices increased as much as 10 percent because of common ownership." *Id*.

25. U.S. DEP'T OF LABOR, CONFLICT OF INTEREST FINAL RULE, https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2 (last visited Mar. 3, 2017).

26. *See, e.g.*, Katherine Chiglinsky & Elizabeth Dexheimer, *Wall Street Groups Sue to Block 'Unworkable' Fiduciary Rule*, BLOOMBERG (June 2, 2016), https://www.bloomberg.com/news/articles/2016-06-02/wall-street-groups-sue-to-end-obama-s-unworkable-broker-rules; Elena Holodny, *Here's what Wall Street and Washington think about the government's new rule that affects $12 trillion of your money*, BUSINESS INSIDER (Apr. 7, 2016), http://www.businessinsider.com/wall-street-and-politicians-respond-to-dol-fiduciary-rule-2016-4.

27. Mark Schoeff, Jr., *Momentum to defund DOL fiduciary rule seems unstoppable*, INVESTMENT NEWS (June 25, 2015), http://www.investmentnews.com/article/20150625/FREE/150629945/momentum-to-defund-dol-fiduciary-rule-seems-unstoppable.

and save private investors $17 billion a year.[28] Despite this kerfuffle created by industry, brokerage firms have suggested the Fiduciary Duty Rule would not have a material impact on future earnings.[29] In other words, whether private investors' retirement accounts can be totally exploited does not affect Wall Street's bottom line.

The economic weakness of the private investor, of America's middle class, is further reflected by the risk management mechanisms the financial industry has been able to create as a moat around its predation. Compulsory arbitration is the prime example. Even the opening of bogus accounts at the expense of Wells Fargos' customers resulted in no meaningful recourse for the aggrieved. Compulsory arbitration and contractual prohibition against class action lawsuits backstopped paying for this fraud.[30]

These trends were exacerbated by the Great Recession, the largest contraction since the Great Depression.[31] Since the Great Recession, wealth has been further concentrated for the top income earners.[32] Since 1970, the

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28. Michael S. Edmiston & Bradley Stark, *The Financial Services Industry's Historic Pattern of Opposition to Reform: "Wolf" is the Only Cry*, 22 PIABA B.J. 165, 170 (2015).

29. *See* Liz Skinner, *Figuring Out Fiduciary*, INVESTMENT NEWS (May 9, 2016), http://www.investmentnews.com/article/20160509/FEATURE/160509939/the-dol-fiduciary-rule-will-forever-change-financial-advice-and-the (discussing how Bank of America Merrill Lynch "said that meeting the rule requirements won't have a material impact on the firm's earnings."). *See also*, James Comtois, *Fiduciary Rule's Approach Dominates Earnings Calls*, PENSIONS & INVESTMENTS (May 16, 2016), http://www.pionline.com/article/20160516/PRINT/305169987/fiduciary-rules-approach-dominates-earnings-calls (indicating J.P. Morgan did not see any "significant new provisions from the proposal" that would change the firm's position as having been a fiduciary).

30. Michael Korkery & Stacy Cowley, *Wells Fargo Killing Sham Account Suits by Using Arbitration*, NY TIMES (Dec. 6, 2016), https://www.nytimes.com/2016/12/06/business/dealbook/wells-fargo-killing-sham-account-suits-by-using-arbitration.html.

31. NAT'L BUREAU OF ECON. RESEARCH, US BUSINESS CYCLE EXPANSIONS AND CONTRACTIONS, http://www.nber.org/cycles.html (last visited Mar. 3, 2017).

32. In 2015, the 62 wealthiest people on the planet had a combined net worth equal to the bottom half of the world's population, 3.5 Billion people. In 2014, it took the top 85 people and in 2010 it took the top 388 people to reach these numbers. Walter Scheidel, THE GREAT LEVELER: VIOLENCE AND THE HISTORY OF INEQUALITY FROM THE STONE AGE TO THE TWENTY-FIRST CENTURY 1 (2017).

top 100th of the first percentile (0.01%) has raised their share of the country's net worth by a multiple of six while the top tenth of the first percentile (0.10%) has seen its net worth quadruple.[33] With a combined worth of $2.34 trillion, the Forbes 400[34] own more wealth than the bottom 61% of the country combined, a staggering 194 million people.[35]

These bleak circumstances for the vast majority of Americans are not a reflection of western capitalism, they are unique to America. European countries tell a different story.[36] These bleak circumstances are a reflection of political influence in the American economy.[37]

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33. *Id*.

34. Forbes lists the 400 wealthiest people in the country and breaks down the data by demography and industry. *Forbes 400: The Wealthiest in America*, FORBES, http://www.forbes.com/forbes-400/#c1fc785410c2 (last visited Mar. 3, 2017).

35. Chuck Collins & Josh Hoxie, *Billionaire Bonanza: The Forbes 400 and the Rest of Us*, INST. FOR POLICY STUDIES (Dec. 1, 2015), *at* http://www.ips-dc.org/billionaire-bonanza/. "America's 20 wealthiest people...now own more wealth than the bottom half of the American population combined, a total of 152 million people in 57 million households. The Forbes 400 now own about as much wealth as the nation's entire African-American population – plus more than a third of the Latino population – combined. The wealthiest 100 households now own about as much wealth as the entire African American population in the United States. Among the Forbes 400, just 2 individuals are African American. The wealthiest 186 members of the Forbes 400 own as much wealth as the entire Latino population. Just five members of the Forbes 400 are Latino." *Id*.

36. "The diverging trends in the distribution of pre-tax income across France and the United States—two advanced economies subject to the same forces of technological progress and globalization—show that working-class incomes are not bound to stagnate in Western countries. In the United States, the stagnation of bottom 50 percent of incomes and the upsurge in the top 1 percent coincided with drastically reduced progressive taxation, widespread deregulation of industries and services, particularly the financial services industry, weakened unions, and an eroding minimum wage." Thomas Piketty et al., *Economic Growth in the United States: A tale of two countries*, WASHINGTON CENTER FOR ECON. GROWTH (Dec. 6, 2016), http://equitablegrowth.org/research-analysis/economic-growth-in-the-united-states-a-tale-of-two-countries/.

37. FED. RESERVE BANK OF ST. LOUIS, *supra* note 15.

Political Bubbles cause Financial Bubbles, leaving Investors Cornered

Investors are cornered inside a Political Bubble[38] inflated by financial sector rents. "(B)ehind every financial bubble there is a corresponding 'political bubble'."[39] One author applied the Minsky model[40] of financial bubbles to describe both the economic and corresponding political bubbles in our financial history.[41] Stuck inside these political and financial bubbles, the less the net worth of the investor, the more cornered the investor. As we saw earlier with the different tax deferred retirement vehicles available to CEOs compared the remainder of society, economic strength allows an elite few to avoid the consequences and rents of residing in such bubbles.

The big difference between political bubbles and their corresponding financial bubble is their aftermath. The clean-up and causes of a financial bubble are self-evident and dynamic but ideology obstructs reforms of a political bubble.[42] "The rigidity of ideological beliefs inhibits the rational adaption of policy to the circumstances of a financial crisis."[43] "For adherents of free market conservatism, an apparent market failure is proof positive of government interference with the laws of economics. This suggests that policymaking in the pop [of the bubble] will also be countercyclical. Policy decisions may be made or delayed in ways that exacerbate the crisis."[44] As

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38. NOLAN MCCARTY ET AL., *supra* note 6, at 13.

39. *Id*. at 13.

40. Hyman P. Minsky, *The Financial instability Hypothesis*, LEVY INSTITUTE (May 1992), *at* http://www.levyinstitute.org/pubs/wp74.pdf. For further information, see Investopedia Staff, *5 Steps of a Bubble*, INVESTOPEDIA, http://www.investopedia.com/articles/stocks/10/5-steps-of-a-bubble.asp (last visited Mar. 3, 2017).

41. *See generally* NOLAN MCCARTY ET AL., *supra* note 6.

42. "While economic and political beliefs behave quite similarly in the rise of a bubble, there are important differences in the aftermath of the bubble's pop. Economic expectations can change dramatically and decisively over a short period of time when actors realize that economic fundamentals can no longer sustain the value of appreciated assets. But as the italicized clause of the Oxford definition reveals, ideologues permit no such correction of their world view. The rigidity of ideological beliefs inhibits the rational adaption of policy to the circumstances of a financial crisis." NOLAN MCCARTY ET AL., *supra* note 6, at 16.

43. *Id*.

44. *Id*.

John Maynard Keynes observed, "[p]ractical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist."[45] "Greed and interest are often what link finance to the political side of the bubble. Opportunist financiers will seek political alliances with opportunist politicians and compatible ideologues. Together such coalitions will exploit political opportunities to advance these interests."[46]

Living in Wall Street's Political Bubble and its Inevitable Financial Bubbles[47]

As the percentage of GDP flowing to the financial services sector ballooned from 4.9% in 1980 to 8.3% of GDP in 2006, the country has gone from one financial bubble to the next. Starting with the Savings and Loan Crisis of 1985-1995 caused by deregulation and a bubble in junk bonds, the U.S. progressed to the DotCom bubble of mid-1990s to the mid-2000s led by conflicted analyst advice and erosion of the Glass-Stegall act, and most recently crashed into the Great Recession caused by a lack of regulation of derivatives and relaxation of lending ratios by the S.E.C. in mid-2000s to 2009. A three decade long political bubble promoting deregulation created three distinct financial bubbles.

The financial services sector spends more on lobbying than any business in America.[48] "The system that allocates finance allocates power and rents;

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45. "The ideas of economists and political philosophers, both when they are right and when they are wrong are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist." JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 383-84 (1936).

46. NOLAN MCCARTY ET AL., *supra* note 6, at 17.

47. As the percentage of GDP flowing to the financial services sector ballooned from 4.9% in 1980 to 8.3% of GDP in 2006, the country has gone from one financial bubble to the next. If we count the S&L Crisis of 1985-1995 caused by deregulation and a bubble in Junk Bonds we went to the Dot Com bubble of mid 1990s to 2003 and then the recent Great Recession caused by a lack of regulation of derivatives and relaxation of lending rations by the S.E.C. from mid-2000s to 2009.

if that system is not fair, there is little hope that the rest of the economy can be."[49] The deregulation of Glass-Steagall is a prime example of how a political bubble begets a financial bubble and vice versa. "Under the old regime, commercial banks, investment banks, and insurance companies had different agendas, and so their lobbying efforts tended to offset one another. But after the restrictions were lifted, the economic interests of all the major players in the financial industry became aligned, giving the industry disproportionate power in shaping the political agenda. The concentration of the banking industry only added to this power."[50] In 1934 there were 14,434 banks.[51] Today 6,058[52] banks exist. "In 1984, the top five U.S. banks controlled only 9% of the total deposits in the banking sector. By 2001, this percentage had increased to 21%, and by the end of 2008, close to 40%." As of 2014, the five largest banks held nearly 48% of all banking assets.[53] Commensurate with this concentration within the industry, the salaries of individuals in financial services has increased significantly relative to other industries.[54]

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48. Insurance, Securities, and Investment firms spent $3.8 billion in lobbying from 1998-2016. *Top Industries*, OPENSECRETS.ORG, https://www.opensecrets.org/lobby/top.php?showYear=a&indexType=i (last visited Mar. 3, 2017).

49. Luigi Zingales, *Capitalism After the Crisis*, 1 NAT'L AFFAIRS 22, at 29 (2009).

50. *Id.* at 31.

51. *Id.* at 30.

52. The concentration of banks has been relentless! Every year since 1984 has seen a reduction of the total number of banks, FDIC, Number of Institutions, Branches, and Total Offices. *Commercial Banks - Historical Statistics on Banking*, FED. DEPOSIT INS. CORP., https://www5.fdic.gov/hsob/HSOBRpt.asp (last visited Mar. 3, 2017). The population during this time has increased form 235.82M to 323.4M. *U.S. Population by Year*, MULTPL.COM, http://www.multpl.com/united-states-population/table (last visited Mar. 3, 2017). Thus, while the population has increased by 37.1%, the number of banks has decreased by 63.2% during that same time frame.

53. 5-*Bank Asset Concentration for United States*, FED. RESERVE BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/DDOI06USA156NWDB (last visited Mar. 3, 2017).

54. *See* Robin Greenwood & David Scharfstein, *The Growth of Finance*, 27 J. ECON. PERSPECTIVES 4-5 (2013) ("in 1980, the typical financial services employee earned about the same wages as his counter- part in other industries; by 2006, employees in financial services earned an average of 70 percent more.")

To give perspective to the monumental size and lost opportunity costs to this market inefficiency of rents flowing to the financial services industry, the total world-wide spending on renewable energy, the bulwark against the existential threats of climate change and exhaustion of fossil fuels, is $348 billion globally.[55] As noted above, financial services industry rents, extrapolated to 2015 at 2% of GDP, total $364.44 billion.[56] Thus, the annual rents flowing to the financial services sector in our country exceeds the worldwide expenditures on renewable energy!

As one scholar describes: "(i)f the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension, with a double loss to society: talents are wasted in search for better duping opportunities and the mistrust towards the financial sector increases."[57]

Thus, the concentration of ownership control and rents flowing to the financial sector has led to record amounts of money spent on lobbying and the regulatory capture of Congress and regulators.[58] It is a political bubble seemingly without end driven by bogus ideological arguments that have no underpinnings in economics. The brazen actions by those in the financial sector should be outrageous but have become accepted.[59] While Wall Street

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55. Pilita Clark, *Big oil in $1B decade-long plan to fight climate change*, FINANCIAL TIMES (Nov. 5, 2016).

56. U.S. Bureau of Econ. Analysis, *GDP & Personal Income*, BEA, http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=5 (last visited Mar. 27, 2017).

57. Luigi Zingales, Harvard University, NBER, and CEPR, Does Finance Benefit Society?, Am. Fin. Ass'n Presidential Address (Jan. 2015), *available at* http://faculty.chicagobooth.edu/luigi.zingales/papers/research/Finance.pdf at 16, 22.

58. "Regulatory capture happens when a regulatory agency, formed to act in the public's interest, eventually acts in ways that benefit the industry it is supposed to be regulating, rather than the public." *Regulatory capture definition*, INVESTOPEDIA, http://www.investopedia.com/terms/r/regulatory-capture.asp (last visited Mar. 3, 2017).

59. For example, after being fined $185 million for opening millions of fake customer accounts, the CEO of Wells Fargo was allowed to "retire" with $134.1 million. *See* Matt Levine, *Wells Fargo Opened a Couple Million Fake Accounts*, BLOOMBERGVIEW.COM, (Sep. 9, 2016), https://www.bloomberg.com/view/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts; Matt Krantz, *Sen. Warren Isn't Done with ex-Wells CEO*, USA TODAY (Oct. 13, 2016),

has operated under the cloak of giving business access to capital and facilitating growth and investment, a look at the numbers reveals the truth – Wall Street, and its functions, are a negative drain on the economy and particularly, the American middle class. The only "value" Wall Street creates is value for itself – at the expense of everyone from the companies it supposedly helps to the investors that entrust Wall Street with their financial futures.[60] With a political bubble enabling its actions, the acts of Wall Street inflating its financial bubbles have become financial post-truths; told only after Wall Street snacked on its bocaditos.

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http://www.usatoday.com/story/money/markets/2016/10/13/sen-warren-isnt-done-ex-wells-fargo-ceo/91996292/.

60. *See* Steve Denning, *Wall Street Costs The Economy 2% of GDP Each Year*, FORBES (May 31, 2015), https://www.forbes.com/sites/stevedenning/2015/05/31/wall-street-costs-the-economy-2-of-gdp-each-year/#2ce831434cd1 ("the excessive financialization of the US economy reduces GDP growth by 2% every year, according to a [] study by the International Monetary Fund."); *see also* Jordan Weissmann, *How Wall Street Devoured Corporate America*, THE ATLANTIC (Mar. 5, 2013), https://www.theatlantic.com/business/archive/2013/03/how-wall-street-devoured-corporate-america/273732/ (discusses how the financial sector's "bite" out of the country's wealth has increased from 10% of US corporate profits in the 1980s to 30% of US corporate profits today, and also contains a fantastic graphic showing the direct inverse movement of the share of US corporate profits by the manufacturing industry and the financial services industry going back to 1948).

EXPERTS CORNER
SELLING ANNUITIES POST DOL RULE: THREATS TO BROKERAGE GENERAL AGENCY AND INDEPENDENT AGENTS

Vincent Micciche

I. Overview of Traditional Insurance Brokerage Pre DOL

The Broker General Agent (**BGA**), sometimes referred to as Managing General Agent (**MGA**) acts as an independent firm or contractor working for numerous insurance companies whose main function is to support the sale of one or more insurance products by select insurance brokers/agents (**producers**). Producers then sell the policies to their clients. BGA's can specialize in one segment of the insurance industry or sell policies across a wide range of companies and products including fixed annuities, fixed index annuities and non-variable forms of life insurance.

In addition to providing basic sales support, most BGA's provide valuable additional services for individual producers, including taking online applications, processing and tracking of cases, providing immediate policy quotes and assistance in securing underwriting requirements. Higher end BGA's may provide more advanced services including, detailed policy analysis, research and case design, access to tax and legal specialists, education on products and advanced sales concepts and practice management utilities.

In some instances, there may be a third party independent marketing organization (**IMO**) that assists in sales support that is also cut in.

What they all share is that they are intermediaries in the distribution chain, they are involved in processing and sales support and they receive a portion of the total compensation in every transaction they process.

Compensation

Similarly, compensation follows the same hierarchy all flowing from the Insurance Company (**Company**). The General Agent/BGA tier receives a negotiated payment called an override from the company on the business submitted. Producers receive "street level" compensation paid directly by the company and may share in a portion of the BGA's override in the form of an expense reallowance. Generally, the total compensation in any given transaction is split between the BGA and the producer.

Functional Duties

The BGA's primary duties are to process insurance business acquired by agents and ensure that the applications are submitted to the company in good order (**IGO**). Equally important and valuable from the company perspective is the ability of the BGA to develop business for the company by recruiting agents and supporting their sales. Notably, BGA's are not responsible for supervision of the agents they work with and are, therefore, not burdened with compliance duties beyond the aforementioned IGO requirements and ensuring that the agents are appropriately licensed in the jurisdictions in which they conduct business.

Probably more noteworthy is the fact that BGA's cannot appoint agents. Appointment of agents can only be effected by the Insurance Company, leaving them with plenary control of the agent as they can revoke that appointment at will.

Because they have no obligation to supervise and have no control over the agents, BGA's have enjoyed the enviable position of being able to receive substantial compensation for facilitating the sale of insurance products with very limited exposure to litigation and regulatory risk.

II. Impact of the DOL Fiduciary Rule on Sellers of Annuities

Now a Fiduciary

The most significant effect of the rule is the transformation of previously non-fiduciary sales persons to a fiduciary status.[1]

Anyone that is involved in selling an annuity product to a qualified plan is deemed to be a fiduciary where such person **makes a recommendation** relating to:

- the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or invested after the securities or other investment property are rolled over, transferred, or distributed from the Plan, or
- how investment property should be invested after it is rolled over, transferred or distributed from the Plan, or

1. 29 C.F.R. §§ 2509, 2510, & 2550 (2016) (publishing the rule and the prohibited transaction exemptions).

- the management of investment property, or rollovers, transfers, or distributions from a Plan, including recommendations as to the amount, form or destination of such rollover.

Affirmative duties pursuant to ERISA section 404 include:

- Acting solely in the interest of Employee Plan participants and beneficiaries, with the exclusive purpose of providing benefits to them (duty of loyalty);
- Carrying out duties with the care and skill of a prudent expert (or hiring an expert if necessary);
- Diversifying Employee Plan investments (unless clearly prudent not to do so); and
- Following Employee Plan documents (unless inconsistent with ERISA).

Modification of Prohibited Transactions

The rule defines prohibited transactions for Employee Plans from Section 4975 of the IRS Code *and also applies them to IRA's.* It specifically prohibits:

- Selling, exchanging or leasing of any property between the Plan and a disqualified person;
- Lending money or other extension of credit between the Plan and a disqualified person;
- Furnishing goods, services or facilities between the Plan and a disqualified person;
- Transferring to, or use by or for the benefit of, a disqualified person, of any Plan assets;
- An act by a disqualified person who is a fiduciary whereby he deals with the income or assets of the Plan for his own interest or for his own account; and
- Receiving any consideration for his own personal account by a disqualified person who is a fiduciary from any party dealing with the Plan in a transaction involving the income or assets of the Plan.

From the Perspective of the Independent Insurance Agent/Producer

The independent producer generally finds working with BGA's more desirable than a dedicated General Agent of a major insurance company. The payouts are higher, processes are streamlined, compliance is relaxed by comparison and the producer has access to significantly broader product choices to present to his or her customer.

The BGA's ability to attract and retain business from these independent producers has required them to excel in the delivery of these services to differentiate themselves from competitors. Traditionally, the independent producer's decision of where to place business pre-DOL was greatly influenced by three major factors: **Payout - Service - Product Selection.**

All of this changed dramatically in April 2016 when the final DOL Fiduciary Rule was published. It imposes several new obligations on producers working with qualified plans, ***the most significant being the duty to act in a customer's best interest, acknowledgement of a fiduciary status and having to place that business through a Financial Institution (Institution) recognized under the rule.***

Although insurance regulation occurs at a state level and varies by jurisdiction, it is universally accepted that suitability is the standard that must be met by the agent selling insurance products. That standard is well defined in the **Suitability in Annuity Transactions Model Regulation** promulgated by the National Association of Insurance Commissioners (**NAIC**) in 2010.[2] It essentially mirrored the NASD suitability rule 2310[3].

Put simply, heretofore, the independent producer was free to recommend numerous commission based products to employee plans and IRA's provided those recommendations met the suitability standard. If those products were non-securities like fixed annuities or indexed annuities being placed through a BGA or IMO, those transactions were subject to little or no supervision. A certification of suitability by the producer was sufficient.

The fixed insurance sales environment has always been more lucrative and compliance friendly when compared to other disciplines within the financial services industry. At the same time, FINRA's style of regulation and enforcement has been seen by many as increasingly severe and business unfriendly. Not surprisingly, this growing disparity caused many independent

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2. NAT'L ASS'N. OF INS. COMM'R, SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION (2015), *available at* http://www.naic.org/store/free/MDL-275.pdf.

3. NASD, RULE 2310 (1996).

producers to consider withdrawing their securities licenses and pursue a fixed insurance only practice model. The advantages were compelling:

- Indexed product commissions can be as much as 4 to 5 times that of securities counterparts (variable annuities);
- Great sales support is available and bonuses are prevalent;
- No broker/dealer means fewer rules and restrictions, lower operating expenses and significantly higher net compensation; and
- No FINRA also means less regulatory and litigation risk.

The disadvantages of that practice model are also compelling. The lack of a diversified portfolio of products and services to offer one's customer presents significant challenges in meeting even minimal suitability standards – remember affirmative duties of ERISA section 404. In addition, it may give the appearance of a salesman more interested in commissions than acting in his client's best interest. The adage, "When you're a hammer, everything looks like a nail" is somewhat prophetic and the focal point of what is now the eye of the storm in the industry and the driver of the DOL rule – ***Conflict of Interest***.

The value of qualified assets is *over 25 Trillion dollars*![4] This is, by far, the largest and most sought after segment of investable assets. Every insurance company and bank is competing for their share.

It is very difficult to meet the fiduciary standard under the DOL rule in the presence of a material conflict of interest. Recommending commission-based investments is inherently conflicted and, in its original form, was prohibited under the then proposed DOL rule. Due to the overwhelmingly negative industry response and significant lobbying efforts of the insurance industry, the final DOL rule included significant relief and limited options to those wishing to continue legacy product sales. Those options will be examined in the next section. Post DOL, the independent producer will need to conduct qualified business under a "level fee arrangement", continue with brokerage business under an available exemption or find a "carve out" that fits his or her model.

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4. *Retirement Assets Total $25.3 Trillion in Fourth Quarter 2016*, (Mar. 22, 2017), INVESTMENT CO. INSTITUTE, https://www.iciglobal.org/iciglobal/research/retirement/*us_system/ret_16_q4* (last visited Apr. 27, 2017).

III. Practical Options for the *Insurance Only Producer*

This section assumes that the Insurance Only Producer is NOT a career agent of an insurance company or a registered representative of a broker dealer or an associate IAR of a Registered Investment Adviser. Agents of insurance companies, registered representatives of broker dealers and IAR's are all affiliated with Financial Institutions that have the facility to accommodate the new requirements imposed by the DOL. Specifically; they will be able to utilize "level fee" arrangements.

Choice 1 "Best Interest Contract Exemption" (BIC)[5]

The BIC exemption provides relief from the conflict of interest prohibited transactions associated with a Fiduciary Adviser receiving compensation as a result of the Fiduciary Adviser's advice to a Retirement Investor provided the Fiduciary Adviser satisfies the requirements intended to reduce the risk of biased advice.

The BIC has four primary requirements:

1. Documentation

Must enter into a written contract that includes each of the following requirements:

Affirmative Acknowledgement of fiduciary status
Impartial Conduct Standards

- The Fiduciary Adviser must provide investment advice that is in the **Best Interest** of the Retirement Investor, at the time of the advice;
- All compensation received by the Fiduciary Adviser and its Affiliates for the transaction **must be reasonable within the meaning of Section 408(b)(2) of ERISA;** and
- **The Fiduciary Adviser's statements** about recommended investments, fees and compensation**,** Material Conflicts of Interest, and any other matters relevant to the Plan's investment decisions, **are not misleading** at the time they are made.

5. 29 C.F.R. § 2550 (2016).

Warranties That:

- The Financial Institution has adopted and will comply with written policies and procedures reasonably and prudently designed to ensure that its Advisers will adhere to the Impartial Conduct Standards;
- It has specifically identified and documented its Material Conflicts of Interest and has adopted measures to prevent such Material Conflicts of Interest from causing violations of the Impartial Conduct Standards; and
- Neither the Adviser nor any Related Entity uses quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that encourage Advisers to make recommendations that are not in the Best Interest of the Retirement Investor.

2. Disclosures

Initial Disclosures

- State the Best Interest standard of care;
- Inform the Retirement Investor of his or her right to obtain copies of the Financial Institution's written policies and procedures and specific disclosures of costs, fees and compensation (including Third Party Payments) associated with the recommended transaction;
- Include a link to the Financial Institution's website and inform the Retirement Investor that the website includes model contract disclosures and copies of the Financial Institution's policies and procedures to ensure that its Advisers are meeting the Best Interest standard of care;
- Describe Material Conflicts of Interest and disclose any fees and state the type of compensation that the Financial Institution, its Affiliates, and its Advisers expect to receive, which may be done by reference to web disclosure;
- Disclose whether the Financial Institution offers Proprietary Products or receives Third Party Payments;
- Provide contact information for a representative of the Financial Institution; and
- Describe whether the Adviser and Financial Institution will monitor the recommended investments.

The above disclosures must be made when an account is opened, at the same time as or prior to the execution of the first transaction.

Website Disclosures

The Financial Institution must maintain a public website that contains the following six items:

- A discussion of the Financial Institution's **business model** and the **Material Conflicts of Interest** associated with that business model;
- A schedule of **typical** account or contract **fees** and service **charges;**
- A **model contract** or other model notice that includes the terms required under the BIC Exemption. This notice must be reviewed at least quarterly and updated within 30 days if necessary;
- A written description of the Financial Institution's **policies and procedures** that accurately describes or summarizes key components of the policies and procedures relating to conflict-mitigation and incentive practices in a manner that permits Retirement Investors to make an informed judgment about the stringency of the Financial Institution's protections against conflicts of interest;
- A list of all **product manufacturers** and other parties with whom the Financial Institution maintains arrangements that provide Third Party Payments for specific investment products or classes recommended to Retirement Investors and a description of these arrangements. The description must include a statement on whether and how these arrangements impact Adviser compensation and a statement on any benefits the Financial Institution provides to the product manufacturers or other parties in exchange for the Third Party Payments; and
- Disclosure of the **Financial Institution's compensation and incentive arrangements with Advisers** including, if applicable, any incentives (both cash and non-cash compensation or awards) to Advisers for recommending particular product manufacturers, investments or categories of investments to Retirement Investors, or for Advisers to move to the Financial Institution from another firm or to stay at the Financial Institution, and a full and fair description of any payout or compensation grids. Information that is specific to an individual Adviser's compensation or compensation arrangement is not required. Compensation may be described by providing dollar amounts, formulas or other descriptions that reasonably present an accurate picture of the compensation incentives.

3. Notice to DOL

Before receiving any compensation in reliance on the BIC Exemption, the Financial Institution must **notify** the **Employee Benefit Security Administration of the DOL** of its intention to rely on this class exemption.

4. Recordkeeping

The Financial Institution must maintain for **six years** the records necessary to enable the DOL, IRS, or any fiduciary, participant, beneficiary, employer or employee organization to determine whether the conditions of the exemption have been met. Failure to maintain the required records will result in the loss of the exemption only for the transaction(s) for which the records have not been maintained.

To rely on the BIC Exemption, the written contract and other communications **may not contain the following prohibited terms:**

- Provisions to arbitrate or mediate individual claims in venues that are distant or that otherwise unreasonably limit the ability of Retirement Investors to assert claims;
- A waiver or qualification of a Retirement Investor's right to bring or participate in a class action or other representative action in a dispute with the Adviser or Financial Institution; or
- Exculpatory provisions disclaiming or limiting liability of the Adviser or Financial Institution for a violation of the contract's terms or of the fiduciary rules under ERISA.

Provisions that limit the Retirement Investor's recovery to an amount representing liquidated damages for a breach of contract claim. The agreement, however, may require an IRA customer to knowingly waive his or her right to punitive damages or rescission of recommended transaction.

A BIC exemption requires a Financial Institution to be a party to the contract. This is where it gets complicated. Under present interpretation of the DOL rule, a financial institution is one of the following:

- Bank;
- Broker/Dealer;
- Insurance Company;
- Registered Investment Advisor; or
- Similar Institution.

Unlike Registered Representatives of a broker dealer, Investment Advisors Representatives (IAR's), Registered Investment Advisors and career

agents of an insurance company, the independent insurance agent in some ways lacks direct affiliation with a Financial Institution. As an agent, he or she is appointed by a company and thus has affiliation but it's a little more nuanced. If an Insurance Company is going to assume the role of the Financial Institution behind the BIC, it will be assuming orders of magnitude increasing its duties and liability. As a practical matter, companies are exploring all other options and determining which offers the best blend of risk and reward.

The insurance only producer must be affiliated with a Financial Institution to utilize a BIC and, when evaluating the aforementioned choices, is likely to apply additional criteria beyond Payout, Service and Product Selection. ***Advisers, as fiduciaries, will be required to prove that they have acted in their client's best interest by documenting use of a reasonable process and adherence to professional standards in deciding to make the recommendation and determining that it was in the client's best interest.***

The adviser, in evaluating these choices, will need to understand:

- the additional requirements of time needed to fulfil his duties;
- the additional infrastructure needed to achieve compliance;
- the compensation compression that will result from lower fees and expenses;
- the increased exposure to litigation and regulatory risk;
- the increases in cost of doing business in this area; and
- the capacity and willingness of the Financial Institution to pick up some of the administrative tasks.

Choice 2 Utilize the Prohibited Transaction Exception (PTE) 84-24[6]

This exemption permits insurance agents, insurance brokers and pension consultants that are parties in interest or fiduciaries to affect the purchase of insurance or annuity contracts and receive a commission on the transaction. This exemption pertains only to **fixed annuity** contracts and specifically excludes variable and indexed annuities.

Conditions

- Neither the issuing insurance company nor the selling party may be a trustee (other than a passive trustee), administrator, discretionary manager or sponsoring employer of the purchasing Plan;

6. 29 C.F.R. § 2550 (2016).

- The selling party must act in the **Best Interest** of the purchasing Plan;
- The selling party must disclose any **Material Conflict of Interest**;
- Statements by the selling party **may not be materially misleading**;
- The combined total distribution fees must not exceed **reasonable compensation**; and
- The terms must be at least as favorable as available in a similar arms-length sale and product offered by other parties.

Documentation requirements

Written disclosures to the independent fiduciary of the Plan before the sale:

- Disclosure of any limitation on the products offered by the selling party (i.e., only a certain range of products or only products of certain insurers);
- Disclosure of the selling party's commission expressed as a dollar figure, if feasible, or, if not, as a percentage of gross annual premiums, asset accumulation or contract value, for all relevant years, and disclosure of any fees paid to any other intermediaries by the selling party or the insurer;
- Disclosure of all charges, fees, discounts, penalties or adjustments applicable under the annuity; and
- A written acknowledgment of the purchasing Plan, before the purchase date, of receipt of all the above items.

The above disclosures do not need to be provided for a second annuity purchase or increase in the original annuity if executed within one year of the of the prior disclosures (unless the information has changed).

The selling party may receive only stated and disclosed commissions and not any other revenue sharing, administrative fees or marketing payments.

Choice 3 No longer serve qualified plans

In some cases, this may be the most reasonable option for the insurance only producer as it provides the best risk/reward ratio and involves the least amount of effort. It can be business as usual, selling commission based products to customers that are not qualified plans without any change to the process or requirements.

Choice 4 Become a Financial Institution or affiliate with one

Practically speaking, the insurance only producer could become a **Registered Investment Advisor** and execute a BIC contract with his clients. In addition to selling commission based product, they would be able to provide "**level fee advice**" which is another means of complying with the DOL rule. This option would require significant changes in his business model including:

- Additional licensure (series 65);
- Creation or acquisition of Written Policies and Procedures (**WSP's**);
- Creation of a functional compliance department; and
- Become subject to audit and regulatory oversight beyond a state insurance department.

Similarly, the producer could become a **Broker/Dealer** which would require all the above except a series 65 and:

- Be required to submit annual audit financials prepared by a PCOAB auditor;
- Acquire additional licensing related to operating a broker/dealer (Financial and Operations Principal) and a supervising principal;
- Maintain minimum net capital requirements according to the Securities Exchange Commission (**SEC 15c3-1**); and
- Comply with SEC record keeping requirements (**SEA 17a-3 and 17a-4**).

Assuming this was an economically feasible option, there is a serious question as to whether a small firm exception would be available from the SEC or FINRA. In the present regulatory scheme, **self-supervision is not allowed**.[7]

In short, the question will be whether to affiliate with or become a financial institution if the producer wishes to continue to work in the qualified market.

The initial cost of becoming an institution is significant time and effort and expenses ranging conservatively from tens to hundreds of thousands of dollars. Ongoing expenses related to infrastructure, personnel and regulatory compliance would be at least as much.

The advantages of affiliation include: access to existing compliant operations and more importantly, expertise. The disadvantages are loss of autonomy and diminished control of the adviser's book.

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7. FINRA, RULE 3110(a)(3) (2015).

IV. Practical Considerations for the BGA

The BGA, like the independent producer, faces the same choices: affiliating with a financial institution, becoming one or leaving the qualified marketplace.

The decision tree for the BGA is substantially similar to that of an independent producer as examined in the previous section with a few additional considerations.

Becoming a broker dealer or RIA has clear advantages for the BGA including:

- Autonomy;
- Control of the business model and culture;
- Ownership of the book of business; and
- Larger portion of total compensation available.

The disadvantages are mostly economic. As discussed earlier, startup and operating expenses are substantial and may require significant augmentation of infrastructure. In addition, the loss of business during startup and transition could be substantial as well.

Another factor to be evaluated is organizational adjustment to a substantially more rigorous regulatory environment. The need for competent personnel overseeing compliance is critical for several reasons. Obviously, technical compliance with rules, regulations, and recordkeeping and capital requirements is critical. Equally important and maybe more challenging is creating a culture that recognizes the value of compliance as an essential feature of the organization that defines its ability to build and preserve business.

Strategic Considerations
Background

The client base of a BGA is comprised of producers that were formerly able to sell lucrative insurance products in the qualified market with relatively light regulatory requirements and a low prospect of personal exposure to lawsuits. The risk/reward ratio was very favorable. The producer could focus most of his or her energy on developing business and sales as opposed to administrative duties.

The producer looked to the BGA for help in growing the business

Post DOL, the producer's attention may shift from a focus on maximizing profitability to preserving his or her practice. The producer's criteria for evaluating BGA's will be greatly expanded and include, among other things, compliance support, education, technical guidance, and professional expertise. In addition, environmental considerations will carry more weight as increased regulatory attention is given to screening the "business culture" of firms.

FINRA has begun doing just that and has been examining member firms regarding "culture" and atmosphere. FINRA is now taking a closer look at the firm's efforts to train and advance ethics and best practices. It is conducting interviews with executives, circulating questionnaires, and examining sources of revenue by products and services. In addition, the regulators are utilizing high tech surveillance to monitor sales trends and patterns of firms and advisors.[8]

This should come as no surprise as FINRA executives have been lecturing the industry for years on the movement towards **principles-based regulation** and away from rules-based.[9] A good example of this was the change in the suitability rule in recent years from NASD Rule 2310 to FINRA Rule 2111. The new rule is moving toward a quasi-fiduciary standard as it expanded the definition of "recommendation" to include consideration of strategies as well. Simultaneously the criteria to be considered in "knowing your customer" were also expanded.[10]

The regulators are now fine tuning their approach to surveillance and enforcement by focusing on risk assessment of qualitative data combined with pattern recognition software. Put another way, the producer whose book is concentrated in high commission products will have a bull's eye painted on his back.

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8. Alexandra Scaggs, *FINRA to Join SEC, Treasury in Efforts to Collect Trading Data,* BLOOMBERG (May 16, 2016), https://www.bloomberg.com/news/articles/2016-05-16/sec-treasury-ask-wall-street-dealers-to-report-bond-trade-data.

9. *See, e.g.,* Cheryl L. Haas-Goldstein & Tracey K. Ledbetter, *FINRA's Proposed Rules: "Risks" and Concerns in Switching to Principles-Based Supervision*, EVERSHEDS SUTHERLAND (Oct. 10, 2008), *available at* https://us.eversheds-sutherland.com/portalresource/lookup/poid/Z1tOl9NPluKPtDNIqLMRV56Pab6TfzcRXncKbDtRr9tObDdEuWZDq0!/fileUpload.name=/FINRArules_Sutherland.pdf.

10. *Compare* NASD, RULE 2310 (1996) *with* FINRA, RULE 2111 (2014).

Post DOL, the BGA's services will be distinguished by the expertise, guidance, culture and ethical leadership they bring to the producers they serve.

Practical Considerations

Necessity to compete will demand an expansion of products, services and support. The inability or unwillingness to offer securities and advisory services to their producers will place the BGA at a competitive disadvantage. This leaves the BGA wanting for status as a Financial Institution which again can be accomplished one of three ways: buying one, building one or affiliating with one. We have already reviewed the pros and cons from more of an operational perspective. The strategic elements are as follows:

1. Build

If one could afford the time and expense of starting one from scratch, it would allow them to craft the structure that most ideally suited their business model and afford them the highest degree of control and profitability.

Building from scratch involves considerable time and effort and necessarily a loss of business during transition. Because registration can take longer than projected, the risk of loss by attrition is high.

A popular consideration lately is forming an RIA. While it appears fairly simple and requires minimal licensing (a series 65), it also has technical requirements that may disqualify many. For many years, the minimum requirement of assets under management (**AUM**) for SEC registration was $25,000,000, recently that was raised to $100,000,000![11] If that threshold cannot be met, one needs to register as an RIA state by state, which involves substantially more reporting, paperwork and fees.[12] In addition, there is rumor of this requirement being increased yet again.

Another risk that may be underestimated is the cultural transition in moving from a sales focused enterprise to a regulated entity that is extremely

11. SEC, INVESTOR BULLETIN: TRANSITION OF MID-SIZED INVESTMENT ADVISORS FROM FEDERAL TO STATE REGISTRATION (2011), *available at* https://www.sec.gov/files/transition-of-mid-sized-investment-advisers.pdf.

12. Les Abromovitz, *Differences Between State and SEC Regulation of Investment Advisors*, THINKADVISOR (Jan. 1, 2012), http://www.thinkadvisor.com/2012/01/01/differences-between-state-and-sec-regulation-of-in.

principles- and process-intensive. There is a universe of difference between a ***Salesman*** and a ***Fiduciary***. Each has its strengths and importance and balancing these elements at an institutional level plays a critical role in its success or failure. Here is where experience and seniority carry a premium.

2. Buy

This option greatly reduces the risk of transition-related losses and attrition. It also affords the same level of control and autonomy as building from scratch. In addition, a mature firm has already gained operational efficiency that simply takes time and experience to acquire. Another potential advantage is the ability to acquire experienced staff and enjoy the benefits of the professional and strategic relationships they have formed – good will.

The disadvantage of acquisition is the legacy risk that follows. Even a relatively small firm may have thousands of customer accounts – each bringing the risk of litigation. The ability to thoroughly assess potential regulatory risk that may be impending is very limited. The buyer would be highly reliant on representations made by the seller. Some of the litigation risk may be contained by contract using indemnification clauses however, that would have no effect on regulatory risk.

3. Affiliation

This option may be the most efficient. It carries many of the benefits of buying an operational firm, in particular, expertise, trained staff and familiarity with the market and regulatory environment. The design of this relationship can be highly flexible and the distribution of duties and responsibilities is negotiable within reason.

The disadvantage of this option is the risk of exposure. In essence, the BGA is bringing an entire book of existing business and the producers with whom he has cultivated relationships. Depending on the size and power dynamic between the parent and affiliate, there is a risk of loss of control and even ownership of the business the affiliate brings. It is not uncommon for BGA's to be courted by larger organizations that boast size, strength and vast resources. While these may be appealing features, they may also present a threat.

While this option may present the greatest opportunity, it probably also presents the greatest risk. The BGA faces a terrible conundrum –the bigger the

institution you are affiliating with, the greater the risk of being consumed by it.

Summary

The BGA faces challenges and inconvenient realities that have almost instantly materialized and has very little time to react to them. Some of these threats are serious and are able to not only hurt profitability but also cause the extinction of the business. Even though broker dealers are more equipped to deal with the challenges presented by the DOL, they are withdrawing registrations at an alarming rate.

As always, crisis and opportunity go hand in hand. There is little disagreement in the industry, that there will be fewer players in the near future serving the qualified plans market. The independent channel will likely shrink while the larger institutions grow.

Large institutions are doing a bit of fear mongering these days while trying to appear to be helpful partners to the independent channel. Pardon my cynicism, but I think many of these "altruistic" gestures are actually predatory strategies designed to encourage the independents to fold their hands and sell out. You might think of this as a fire sale and buyers with the wherewithal can acquire valuable franchises for cents on the dollar. They will do everything possible to make the independents believe that their time is running out.

While many may see this as a great time to cash out, it's a great time to be a seasoned independent. Those that are left standing will have a generational opportunity for growth and expansion of wealth.

Uniform Regulation Is Inevitable

Almost everyone agrees that the DOL has limited ability to surveil and enforce. Many industry observers believe that the SEC feels it was upstaged by the DOL who overstepped its role. This may explain the fact that the SEC is promising its version of a Fiduciary Rule soon. I think we can all agree that power and control are addictive and we can reasonably expect regulators to compete for that control. Keep in mind that FINRA is, by far, the largest and most effective regulator and the enforcement arm of the SEC. It has made overtures for years that it should be the sole regulator and that argument is gaining steam as the SEC continues to complain of understaffing and lack of resources. In my opinion, oversight and enforcement of all RIA's and broker dealers will be the domain of FINRA in the near future.

The most intriguing question may be what becomes of insurance producers? The answer may be determined by the course the insurance industry itself chooses. At present, they continue to compete for investment assets while trying to avoid traditional securities regulation mainly through the recreation of the indexed annuity. Notably, the present iteration of this product is a far cry from its ancestors and one of the most effective and sought after guaranteed income instruments particularly attractive to qualified plans.

In 2008, the industry defeated SEC Rule 151A, which classified indexed annuities as securities rather than insurance.[13] Emboldened by that victory, the industry has continued to design and heavily promote the product – mainly to retirement plans. Clearly, the DOL will erode that strategy and move the product closer to a classic security, at least with respect to retirement plans. It is becoming increasingly difficult for companies to escape the reach of FINRA. Ultimately, companies will likely need to retreat to selling traditional insurance products only or continue to sell hybrid products and embrace full securities regulation.

The ambiguity and duplicative effect of multiple regulators in the financial services industry is serving to make compliance expensive and complicated and doing little to protect the public.

The good news is this is very survivable for those willing to evolve. The cost of survival is high and the reward is likely higher. It will require a major makeover for the BGA and the assumption of greater duties, accountability and liability. Even though the cost of doing business is going up and compensation is going down, the increases in market share of the survivors will more than make up for shrinking margins.

13. 17 C.F.R. § 230 (2010).

RECENT ARBITRATION AWARDS

Jason Kueser

The awards highlighted in this volume of the PIABA Bar Journal share one thing in common: an award of attorneys' fees to Claimants.

In some cases, the award of attorneys' fees is based on statute, and, in others, the award was based on the fact that both parties had submitted the issue of attorneys' fees to the Panel. This can be an important issue for counsel to consider in filing claims on behalf of their clients because even if there is not a statutory basis for an award of attorneys' fees, the prospect of collecting attorneys' fees may not be futile.

Mercedes Imbert De Jesus and Rafael Vizcarrondo, Claimants v. UBS Financial Services, Inc., UBS Financial Services, Inc. of Puerto Rico, and Ramon Manuel Almonte, Respondents, Case No. 14-02464[1]

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1. Claimants asserted the following causes of action: breach of duties owed to Claimants; violations of the Uniform Securities Act of Puerto Rico and the Puerto Rico Bill of Rights for the Elderly; breach of fiduciary duty; breach of contract; negligence; negligent supervision; unsuitable investments and strategy; failure to supervise; failure to comply with the requirements set forth in the "Laws of Banks of Puerto Rico," 7 L.P.R.A. 1, et seq.; and secondary or vicarious liability. The causes of action relate to, among other things, Claimants' investments in Puerto Rico closed-end mutual funds concentrated in Puerto Rico bonds.

Unless specifically admitted in the Statement of Answer, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, as amended, Claimants requested: compensatory damages of not less than $19,000,000.00; commissions and fees paid by Claimants of not less than $1,200,000.00; rescission of the transactions at issue and a ruling that Claimants are entitled to recover the full restitution consisting of the purchase price plus interest less distributions; disgorgement of all transaction costs in Claimants' accounts and a ruling that Claimants are entitled to recover the fees, interest, commissions and any other costs or expenditures incurred in the transactions executed in Claimants' accounts; punitive damages in an amount to be determined by the Panel; pre-judgment, post-judgment and continuing interest; attorneys' fees; costs and expenses; and any other relief to which they may be entitled.

In the Statement of Answer, Respondents requested denial of the Statement of Claim in its entirety with prejudice, that all FINRA fees and costs be assessed against

San Juan, Puerto Rico

Claimants' Counsel: Timothy J. Dennin, Esq., Timothy J. Dennin, P.C., Northport, New York, Rafael Lugo, Esq. and Joseph Marrero-Mathieu, Esq., Lugo Sotomayor Law & Associates, P.S.C., San Juan, Puerto Rico and Jose A. Andreu Fuentes, Esq., Andreu & Sagardia, San Juan, Puerto Rico.

Respondents' Counsel: Matthew E. Wolper, Esq., Richard Szuch, Esq. and Wesley Holston, Esq., Bressler, Amery & Ross, P.C., Fort Lauderdale, Florida and Guillermo J. Bobonis, Esq., Bobonis, Bobonis & Rodríguez Poventud, San Juan, Puerto Rico.

Arbitrators: Frances Johnson Wright, Public Chairperson; John D. Mattingly, Public Arbitrator; Susan Meek, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the recorded in-person hearing, and the post-hearing submissions, the Panel decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants the sum of $12,716,722.00 in compensatory damages.
2. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants interest in the sum of $2,517,911.00, accrued at the rate of 9% per annum from December 31, 2013, to March 13, 2016.
3. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants the sum of $163,000.00 in expert witness fees.
4. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants the sum of $600.00 representing reimbursement of the non- refundable portion of the claim filing fee previously paid by Claimants to FINRA Office of Dispute Resolution.
5. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants the sum of $3,179,180.50 in attorneys' fees representing 25% of the compensatory damages amount awarded in paragraph 1. The attorneys' fees are awarded pursuant to the Puerto

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Claimants, expungement of this arbitration from Respondent Almonte's (CRD # 1014799) Central Registration Depository records and such other and further relief the Panel deemed just and equitable.

Rico Uniform Securities Act, 10 L.P.R.A. §890(a)(2) and based on the fact that Claimants and Respondents UBS and UBSPR requested attorneys' fees and such further relief the Panel deemed just and proper in their respective pre-hearing briefs.

6. Any and all relief not specifically addressed herein, including Claimants' request for punitive damages, is denied.

This award represents a sizeable award in a Puerto Rico Bond case, including a multi-million dollar award of pre-judgment interest, and attorneys' fees pursuant to Puerto Rico Uniform Securities Act, 10 L.P.R.A. §890(a)(2). The Panel also ordered Respondents to pay 100% of the forum fees, which totaled $64,500.

Ana Elisa Ciordia-Robles as Beneficiary of the AECR Living and Grantor Trust, Claimant v. UBS Financial Services Inc., UBS Financial Services Inc. of Puerto Rico, and UBS Trust Co. of Puerto Rico, Respondents, Case No. 15-01774[2]

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2. Claimant asserted the following causes of action: breach of fiduciary duty, negligence, negligent supervision, fraud, breach of contract, breach of contract – third-party beneficiary, violation of the Puerto Rico Uniform Securities Act, violation of Sections 10(b) of the Securities Exchange Act and Rule 10b-5 of the Securities and Exchange Commission. The causes of action relate to Claimant's alleged unsuitable and high-risk investments in UBS Puerto Rico closed-end bond funds.

Unless specifically admitted in the Statement of Answer, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested: compensatory damages in an amount between $500,000.00 and $1,000,000.00; rescission; punitive damages; interest; costs; attorneys' fees; and such other and further relief as the Panel deemed just and proper.

In the Statement of Answer, Respondents UBS, UBSPR and UBS Trust requested: that Claimant take nothing by her claims and that her claims be dismissed in their entirety, with prejudice; that all FINRA fees and costs be assessed against Claimant; that the Panel make specific findings to allow the expungement of any record of this arbitration from the Central Registration Depository ("CRD") records of Carlos A. Rodriguez and any other relevant UBS employee; and for such other and further relief as the Panel deemed just and appropriate.

San Juan, Puerto Rico

Claimant's Counsel: Jeffrey Erez, Esq. and Jeffrey Sonn, Esq., Sonn & Erez, Miami, Florida and Eliezer A. Aldarondo-Lopez, Esq., Aldarondo & Lopez Bras, Guaynabo, Puerto Rico.

Respondents' Counsel: Peter Neiman, Esq. and Ross Firsenbaum, Esq., Wilmer, Cutler, Pickering Hale, New York, New York and Roberto Quinones, Esq., McConnell Valdes, LLC, San Juan, Puerto Rico.

Arbitrators: Kenneth R. Starr, Public Chairperson; George Allen Whitehouse, Public Arbitrator; Sam Gowin, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, and the post-hearing submissions (if any), the Panel decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents UBS and UBSPR are jointly and severally liable for and shall pay to Claimant Ciordia-Robles the sum of $751,114.00 in compensatory damages.
2. Respondents UBS and UBSPR are jointly and severally liable for and shall pay to Claimant Ciordia-Robles interest on the above-stated sum at the rate of 4.25% per annum from the date the Award issues until the Award is satisfied.
3. Respondents UBS and UBSPR are jointly and severally liable for and shall pay to Claimant Ciordia-Robles the sum of $60,982.59 in costs.
4. Respondents UBS and UBSPR are jointly and severally liable for and shall pay to Claimant Ciordia-Robles the sum of $145,700.00 in attorneys' fees pursuant to 10 L.P.R.A. §890 (Puerto Rico Uniform Securities Act).
5. Respondents' request for expungement on behalf of Carlos A. Rodriguez (CRD# 4888179) is denied.
6. Any and all claims for relief not specifically addressed herein, including Claimant's request for punitive damages, are denied.

This award represented nearly 100% of the capital lost, plus costs, and attorneys' fees. As with the first award referenced above, attorneys' fees were again awarded pursuant to Puerto Rico Uniform Securities Act, 10 L.P.R.A. §890(a)(2). The Panel also ordered Respondents to pay Claimants' costs, as well as approximately 95% of the hearing session fees, which totaled $26,450.

Beverly Bien and David H. Wellman, Claimants v. Mid Atlantic Capital Corporation, Respondent, Case No. 15-00333[3]

Denver, Colorado

Claimants' Counsel: Bruce D. Oakes, Esq. and Richard B. Fosher, Esq., Oakes & Fosher, LLC, St. Louis, Missouri

Respondent's Counsel: Erin N. Fischer, Esq., Mid Atlantic Capital Group, Pittsburgh, Pennsylvania

Arbitrators: Thaddeus J. Tecza, Public Chairperson; Mari C. Bush, Public Arbitrator; Jo-Marie Lisa, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, the Panel decided in full and final resolution of the issues submitted for determination as follows:

1. Respondent is liable for and shall pay to Claimant Beverly Bien an initial investment loss in the amount of $240,321.00.
2. Respondent is liable for and shall pay to Claimant Beverly Bien compensatory damages in the amount of $437,286.00.

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3. Claimants asserted the following causes of action in the Statement of Claim and Amended Statement of Claim: breach of fiduciary duty, negligence, negligent misrepresentation, omissions, violation of Colorado's Securities Act, common law fraud, breach of contract, restitution, and negligent supervision. The causes of action relate to

Claimants investments in Sonoma Ridge Partners and KBS real estate investment trusts ("REIT"), and securities in Contango Oil and Gas, Inc., iShares Silver and Market Vectors Gold Miners.

Unless specifically admitted in the Statements of Answer, Respondent denied the allegations made in the Statement of Claim and Amended Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, as amended, Claimants requested: Compensatory damages in the amount of $300,000.00; punitive damages; pre-judgment interest; reasonable attorneys' fees and costs; filing and forum fees; and such other and further relief which this Panel deems just and proper under the circumstances.

At the close of the hearing, Claimants requested initial investment losses and provided the Panel with several theories of appropriate compensatory damages that should be awarded.

In the Statement of Answer, as amended, Respondent requested: Dismissal of all claims with prejudice; reasonable attorneys' fees and costs associated in defending against this action; and any further relief that the Panel deems just and proper.

3. Respondent is liable for and shall pay to Claimant Beverly Bien interest at the rate of 8% per annum beginning February 6, 2015 until the total amount of $677,607.00 (total of paragraphs 1 and 2 above) is paid in full.
4. Respondent is liable for and shall pay to Claimants an initial investment loss in the amount of $52,090.00, plus interest at the rate of 8% per annum beginning February 6, 2015 until the amount of $52,090.00 is paid in full.
5. Respondent is liable for and shall pay to Claimant David H. Wellman compensatory damages in the amount of $47,397.00, plus interest at the rate of 8% per annum beginning February 6, 2015 until the amount of $47,397.00 is paid in full.
6. Respondent is liable for and shall pay to Claimants attorneys' fees in the amount of $118,560.00, pursuant to U.S. Offshore, Inc. v. Seabulk Offshore, Ltd., 753 F. Supp. 86, 92 (S.D.N.Y. 1990), Marshall Co., Inc. v. Duke, 114 F.3d 188 (11th Cir. 1997).
7. Respondent is liable and shall pay to Claimants costs in the amount of $26,812.82.
8. Claimants must reassign ownership of all Sonoma Ridge Partners and KBS REIT investments to Respondent.
9. Respondent's request for attorneys' fees is denied.
10. Any and all claims for relief not specifically addressed herein, including punitive damages, are denied.

This award represents another example of a sizeable award relative to relief requested, plus an award of pre-judgment interest, costs, and attorneys' fees. Attorneys' fees were awarded pursuant to U.S. Offshore, Inc. v. Seabulk Offshore, Ltd., 753 F. Supp. 86, 92 (S.D.N.Y. 1990), in which the court held that "[i]f both parties sought attorney's fees, as was apparently the case here, then both parties agreed *pro tanto* to submit that issue to arbitration, and the arbitrators had jurisdiction to consider that issue and to award them," and Marshall Co., Inc. v. Duke, 114 F.3d 188 (11th Cir. 1997), in which the court held that "[t]he district court properly held it was within the power of the arbitrators to award attorney's fees in this case to the brokerage firm." The Panel also ordered Respondents to pay 100% of the forum fees, which totaled $15,750.

Julian P. Cash, Claimant v. Cantor Fitzgerald & Co., Respondent, FINRA Case No. 15-02231[4]

New York, New York

Claimant's Counsel: Eric Stern, Esq., Sack & Sack, LLP, New York New York.

Respondent's Counsel: David A. Paul, Esq., Cantor Fitzgerald & Co., New York, New York.

Arbitrators: Richard Gee, Public Chairperson; Graham Daw, Public Arbitrator; Thomas A. O'Neill, Non-Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, the Panel decided in full and final resolution of the issues submitted for determination as follows:

1. Respondent is liable for and shall pay to Claimant compensatory damages in the amount of $252,373.00, which includes the $11,497.00 check that Respondent previously paid to Claimant.
2. Respondent is liable for and shall pay to Claimant attorneys' fees in the amount of $84,124.33 because both parties requested attorneys' fees.
3. Respondent is liable for and shall pay to Claimant $300.00 to reimburse Claimant for the $300.00 non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution.
4. Respondent's request for attorneys' fees is denied.
5. Any and all relief not specifically addressed herein, including punitive damages, is denied.

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4. Claimant asserted the following causes of action: breach of contract; breach of implied contract; quantum meruit- unjust enrichment; breach of the covenant of good faith and fair dealing; failure to pay wages under Ct. Gen. Stat. 31-72; and violation of the Connecticut Unfair Trades Practices Act.

Unless specifically admitted in the Statement of Answer, Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested compensatory damages in the amount of $423,358.00; interest; costs; punitive damages; attorneys' fees; and such other and further relief that the Panel may deem just and proper.

At the hearing, Claimant requested damages in the amount of $662,107.39.

In the Statement of Answer, Respondent requested dismissal of the Statement of Claim in its entirety; costs and expenses; attorneys' fees; and such other and further relief as the Panel deems appropriate.

This award represents another case where an arbitration panel entered an award for attorneys' fees seemingly only on the basis that both parties had requested attorneys' fees as there is no mention of a statutory or contractual basis for such an award. The Panel also awarded Respondents to pay approximately 87% of the forum fees.

CASES & MATERIALS

Joseph Wojciechowski

Clearing Firm Liability And New York Contract Law

Pershing LLC v. Rochdale Sec. LLC, 2016 N.Y. Misc. LEXIS 3448 (N.Y Sept. 23, 2016).

This case involves a clearing firm appealing an adverse arbitration award. The underlying facts of the case involve a criminal trading scheme involving approximately $1 billion of Apple stock orchestrated by former Rochdale agent David Miller. The scheme resulted in Pershing clearing these trades in Apple stock, accepting the shares into a Rochdale firm account and paying for the shares. Not surprisingly, Rochdale did not have anywhere near $1 billion to pay for the shares. Rochdale claims Pershing should have either denied or reversed the trades because it was obvious the trades were either fraudulent or the product of a massive error. Rochdale was able to sell the Apple shares the following day, but Rochdale insisted on executing the sell orders in an advantageous fashion, using minute-by-minute market conditions to attempt to actually turn the fiasco into a profit. Pershing, instead, required immediate sale of all shares, resulting in a loss to Rochdale of more than $5 million, putting the firm in net-capital violation and effectively putting Rochdale out of business.

Pershing also proceeded to sell Rochdale out of its fixed-income portfolio on October 29, the day Superstorm Sandy was wreaking havoc over New York in order to make up part of the $5 million it owed Pershing. Rochdale filed a Statement of Claim against Pershing, alleging that its panicked, self-serving reaction to the fraudulent trades destroyed Rochdale's business. Pershing counter-sued for breach of its Clearing agreement and sought attorney's fees pursuant to an indemnification clause.

The Panel found in favor of Rochdale, ordering Pershing to pay a multi-million award, plus attorney's fees, and also awarded Pershing $780,000, including attorney's fees. The net award to Rochdale was approximately $7.6 million. Pershing moved to vacate the award arguing the FINRA arbitrators manifestly disregarded the law by ignoring key terms of the Clearing Agreement, namely the indemnification provision. Pershing also challenged the award of attorneys' fees to Rochdale, arguing such an award was not authorized by law, contract, or FINRA rules.

The court, interpreting New York law, denied the petition to vacate, holding that contractual limitations on liability are not enforceable where the party seeking its enforcement has acted willfully, recklessly, or in a grossly negligent manner, citing *Kalich-Jarcho, Inc. v. City of New York,* 58 NY2d 377, 384-85 (1983). With respect to the attorney's fees issue, the court held that FINRA arbitrators are within their authority to award attorney's fees where both parties request them. *See also, In re. Bear Stearns & Co. v. Int'l Capital & Mgt., Co.,* 99 AD3d 402 (1st Dept. 2012).

9th Circuit Vacates Arbitration Award Four years Later

Move, Inc. v. Citigroup Global Markets, Inc., 2016 U.S. App. LEXIS 19930 (9th Cir. Nov. 4, 2016)

Move, Inc. filed an arbitration action in September 2008 alleging Citigroup mismanaged $131 million of Move's funds by investing in auction-rate securities. The chairperson of the FINRA Panel, who Move ranked "1", disclosed on his Arbitrator Disclosure Report that he was an attorney licensed to practice law in California, New York, and Florida. This disclosure was later affirmed by the arbitrator. After twenty hearing sessions, the Panel returned an award denying Move's claims.

Four years later, Move learned through a publication that the Chairperson of the arbitration panel had lied about being a licensed attorney and that he was actually impersonating a licensed attorney with a substantially similar name. FINRA confirmed that the Chairperson lied about his qualifications and removed him from its arbitrator roster. Move then filed a complaint and a motion to vacate the arbitration award arguing the Chairperson's misrepresentations warranted vacatur under 9 U.S.C. §§ 10(a)(3) and (4). Although 9 U.S.C. § 12 provides that notice of a motion to vacate must be served within three months after the award was delivered, Move argued the deadline should be equitably tolled. Citigroup argued equitable tolling was not available under the FAA and even if it were, that Move did not demonstrate tolling was justified. Citigroup argued further that vacatur was not justified on the merits. The District Court agreed with Citigroup.

The Ninth Circuit reversed and ruled that equitable tolling was available under the FAA and that Move's right to a fundamentally fair hearing under Section 10(a)(3) was prejudiced by the misconduct of the Chairperson. The court stated "It is hornbook law that limitations periods are customarily subject to equitable tolling . . . unless tolling would be inconsistent with the

text of the relevant statute." The court then considered whether Move was entitled to vacatur under Section 10(a)(3) given the misrepresentations of the chairperson. Move ranked the Chairperson number 1 on its ranking list and provided evidence that it was critical to them that an experienced attorney led the Panel. The court concluded that based on the unique facts of this case, the arbitration award had to be vacated.

10th Circuit Rules Arbitration Award Is Non-Dischargeable

Cooley-Linder v. Behrends, 2016 U.S. App. LEXIS 20395 (10th Cir. Nov. 14, 2016)

This case shows the numerous procedural steps that must be taken to protect an arbitration award from being discharged through bankruptcy. The Tenth Circuit affirmed a Colorado district court's ruling in a bankruptcy adversary ruling that an arbitration award was a non-dischargeable debt. The FINRA claim alleged violations of state and federal securities laws. The Panel entered an award against all respondents (Capwest and Behrends), none of whom attended the hearing. The award specifically stated "the Panel found multiple violations of the Colorado state and federal securities laws (as defined in Section 3(a)(47) of the SEC Act of 1934)." Behrends then filed for Chapter 7 bankruptcy. The bankruptcy court granted plaintiffs' relief from the automatic stay allowing plaintiffs to seek confirmation of the award in state court. Plaintiffs then filed an advisory complaint in bankruptcy court seeking to have the confirmed award declared nondischargeable.

The court ruled that preclusive effect can be given to a default judgment because by not defending the claim, Behrends admitted all of the facts asserted in it. These admissions included securities fraud allegations. Also, the arbitration panel specifically tracked the language of Section 523(a)(19)(A) in its award, finding "numerous violations of federal and Colorado state securities laws." Lastly, the arbitration award and judgment qualified as a judicial order memorializing the debt.

1st Circuit Reiterates "Grand Canyon" Scenario

Tutor Perini Corp. v. Banc of Am. Secs., LLC, 2016 U.S. App. LEXIS 20844 (1st Cir. Nov. 21, 2016)

Plaintiffs brought suit against a brokerage firm's parent company making multiple allegations specific to losses sustained in auction-rate securities. Banc of America Securities ("BAS") represented the auction-rate securities as being suitable for Plaintiff's investment needs which were to avoid risk and maintain liquidity. In the summer of 2007, Banc of America Securities began to question the stability of the ARS market, internally of course and without disclosure to Plaintiff or any other clients, referring specifically to a "contagion". Shortly after this internal fear of contagion was expressed, in September 2007, BAS represented to Plaintiff that it was a good time to buy. Only a few months later, the ARS auctions began to fail. The court affirmed the dismissal of most claims, but reversed the lower court holding triable claims exist for negligent misrepresentation and violation of the Massachusetts unfair trade practice act. Of particular note, the Court stated "a statement that discloses a level of risk may be so understated as to be misleading." *Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228, 245 (5th Cir. 2009). As noted in *Lormand,* the court held that "a defendant can be on the hook for downplaying a 'near-certain' risk, *Id.* at 59 - a concept that calls to mind the Grand-Canyon scenario, where a defendant sees 'disaster looming on the horizon' but opts to whitewash reality."

Illinois Rules Fixed-Indexed Annuities Are Not Securities

Babiarz v. Stearns, 2016 IL App. (1st) 150988 (1st Dist. 2016)

This case is the first of its kind in Illinois in which a court affirmed the dismissal of an investor's claims under the Illinois Securities Law of 1953, holding that fixed-indexed annuities were insurance products, not securities under Illinois Law. The annuity in question was an Allianz Endurance 15, which was a fixed indexed annuity. Whether an investment is an insurance product or security is outcome determinative in many cases in Illinois. If the investment is defined as being an insurance product, then under Illinois Insurance Code, 735 ILCS 5/13-214.4, the applicable statute of limitation is only two years and claims for breach of fiduciary duty are limited to misappropriation of funds. Plaintiff argued the fixed-indexed annuities were investment contracts, which are securities governed by the Illinois Securities

Law, 815 ILCS 5/1 *et seq*. Notwithstanding administrative decisions by the Illinois Securities Department defining specific fixed-indexed annuities as securities under Illinois law, the court determined these annuities were insurance products and not securities, mostly because they were not registered as securities. Rather, the annuities were registered insurance products. As such, the two year limitation period applied and Plaintiff's breach of fiduciary duty claims were limited statutorily to claims involving misappropriation, which was not part of this case.

D.C. Circuit And 10th Circuit At Odds Over Constitutionality of SEC ALJs

Raymond J. Lucia Cos. v. SEC, 832 F.3d 277 (D.C. Cir. 2016)

The SEC imposed a lifetime ban on Raymond Lucia, whose "buckets of money" program landed him in hot water with regulators and clients alike. He challenged the SEC's lifetime ban based on several grounds, but most notably, he challenged the constitutionality of the SEC administrative hearing process, arguing the appointment of the judge who heard the case was unconstitutional. Lucia's argument was that the judge was a constitutional officer who must be appointed pursuant to the Appointments Clause, U.S. Const. art. II, Section 2, cl. 2.

The D.C. Circuit rejected these arguments. The Appointments Clause stands for the proposition that "all officers of the United States are to be appointed in accordance with the Clause", meaning, under Lucia's interpretation, the SEC ALJ, who was appointed by the SEC and not the President, a court of law, or a Department head, was unconstitutionally appointed. The Supreme Court has held that generally, an appointee is an Officer, and not an employee who falls beyond the reach of the Clause, if the appointee exercises "significant authority pursuant to the laws of the United States." *Buckley v. Valeo,* 424 U.S. 1, 126 (1976). The D.C. Circuit outlined the "main criteria for drawing a line between inferior Officers and employees not covered by the Clause" as "1) the significance of the matters resolved by the officials, 2) the discretion they exercise in reaching their decisions, and 3) the finality of those decisions." (*citations omitted).* The court placed significance on D.C. Circuit precedent, *Landry v. FDIC,* 204 F.3d 1125, 1134 (D.C. Cir. 2000), which held FDIC ALJs, who perform similar functions as SEC ALJs, were "employees" and therefore not subject to the Appointments Clause. Further, the fact that the SEC maintains review authority over ALJ decisions, including the right to decline review, was

important. A decision by the SEC ALJ does not become final until the Commission issues a finality order, which requires an affirmative act. Significantly, the Commission alone issues "final orders", not the ALJ. As such, the Commission's regulatory scheme limits the power of the ALJ and therefore, does not issue "final decisions" in accordance with the 3rd criteria above.

Bandimere v. SEC, 844 F.3d 1168 (10th Cir. 2016)

Only months after the D.C. Circuit Court upheld the constitutionality of SEC ALJs in *Lucia*, the 10th Circuit came to the opposite conclusion, holding, in a 2-1 decision, that SEC ALJs are "inferior officers" requiring appointment under the Appointments Clause.

The 10th Circuit, contrary to the D.C. Circuit, was not bound by precedent and instead relied substantially on the Supreme Court's decision in *Freytag v. Comm'r*, 501 U.S. 868 (1991) in holding that the mere fact the ALJ did not technically issue final orders was not outcome determinative, because doing so ignored the detailed and critical functions performed. The court applied the *Freytag* criteria to SEC ALJs: 1) the position was created by law; 2) the duties, salary, and means of appointment are specified by statute; and 3) the exercise of significant discretion in carrying out important functions. All three are satisfied and therefore, the 10th Circuit held that SEC ALJs are not mere employees but "inferior officers" and as such are unconstitutional because they are not appointed. It analyzed the *Lucia* case and simply disagreed with it, questioning its reliance on the fact that SEC ALJs technically do not issue final orders. The Court admitted it is a relevant factor, but certainly not outcome determinative.

11th Circuit Holds, Under Georgia Law, Broker/Dealer Supervisory Duties Flow to "Non-Customers"

Owens v. Stifel Nicolaus & Co., No. 15-12911, 2016 U.S. App. LEXIS 9726 (11th Cir. May 27, 2016)

This case is another in an important and developing line of cases holding broker/dealers can be liable to "non-customers" for negligent hiring, retention and supervision in connection with selling away by their financial advisors. Here, two investors were solicited to invest in Cardiac Network, Inc. (CNI), neither of whom were actual clients of Stifel. Before the solicitation, the financial advisor approached Stifel to add CNI to its portfolio of recommended

investments and Stifel declined to do so. The solicitation to the investors was made by the financial advisor in his capacity as a Stifel financial advisor, identified himself as an employee of Stifel using his Stifel email address and phone number to communicate about CNI. After a few conversations, the clients invested, and signed an agreement disclaiming the involvement of a broker/dealer after the fact. CNI turned out to be a "pump and dump" scheme. The investors filed suit in Georgia state court, later removed to federal court, alleging several causes of action against Stifel dependent on theories of apparent agency and negligent supervision and hiring.

The 11th Circuit affirmed in part and reversed in part the ruling of the district court granting Stifel's motion for summary judgment. *See, Owens v. Stifel, Nicolaus & Co.,* No. 7:12-CV-144, 2014 U.S. Dist. LEXIS 76523 (M.D. Ga. June 5, 2014). The court affirmed the district court with respect to causes of action dependent on apparent agency or apparent authority, holding the facts of the case indicated the financial advisor was clearly acting outside the authority vested in him by Stifel for his own benefit. The court reversed the district court with respect to the plaintiff's negligence claims in connection with supervision and hiring of the financial advisor. The court reasoned that, under Georgia law, "a jury could find it foreseeable that a financial advisor with 'red flags' in his employment and investment management history would use his position to identify, build relationships with, and exploit marks, irrespective of whether the marks ever formalize a client relationship with the brokerage."

California Court Rules Broker/Dealer Must Supervise Affiliated RIA

Milliner, et al. v. Mutual Securities, Inc., No. 15-cv-03354-THE, 2016 U.S. Dist. LEXIS 128289 (N.D. Cal. Sept. 19, 2016)

Investors filed a class action against a broker/dealer for its role in facilitating, approving, and not supervising the conduct of advisors dually registered with a RIA, Bock Evans Financial. All investors were required to become clients of Mutual Securities (MSI) which approved of the Bock Evans investment advisory activity as an outside business. The RIA, invested 100% of its clients' accounts in foreign mining stocks, resulting in 93% losses across the class. The Plaintiffs sought summary judgment from the court that MSI owed Plaintiffs a duty to supervise its registered representatives including a duty to supervise the outside investment advisory activities.

The Court first addressed whether SRO rules and regulations governing MSI defined the duty owed to the Plaintiffs. The court determined that case law supports this proposition, holding FINRA rules define the scope of the common

law duties owed to Plaintiffs. The court then determined that MSI approved of the Bock Evans outside business and therefore owed a duty to adhere to the letter of FINRA RULE 3280 (2015) regarding private securities transactions, which the court held requires broker/dealers to supervise their investment advising activities as its own.

The court then relied on NASD NOTICE OF MEMBERS 91-32 (1991), 94-44 (1994), and 96-33 (1996) as being directly applicable to FINRA RULE 3280 (2015), and also cited to NASD NOTICE OF MEMBERS 01-79 (2001) as further support of the industry standard requiring broker/dealers to supervise approved RIA activities. "[I]f a broker/dealer approves the outside advisory activities of its registered individuals who receive asset-backed fees, the broker-dealer must properly supervise the activities as its own. Such is the case here."

Investor Suit Against UBS Bank Involving Puerto Rico Funds Survives Dismissal

Gonzalez Morales v. UBS Bank, USA, No. 2:14-cv-888-JNP-BCW, 2016 U.S. Dist. LEXIS 88972 (D. Utah July 8, 2016)

Investors sued UBS Bank after relying on Jose Ramirez (Whopper) of UBS Puerto Rico, who was also an authorized agent of UBS Bank, in connection with certain bank loans. Plaintiffs alleged that Ramirez represented to them that the loans from UBS Bank would only be available to them if the loan proceeds were used to purchase UBS Puerto Rico Closed End funds. He also represented that he would handle all aspects of document preparation, that the annual interest rate on the loans would only be 1%, and that Ramirez would act as a liaison to the Bank.

Plaintiffs received loans totally $5 million. UBS Bank foreclosed on Plaintiffs' accounts and liquidated them to pay down the loan balance of which more than $1 million was still owed. Plaintiffs originally filed their complaint in Puerto Rico but was transferred to Utah, alleging violation of the Bank Holding Company Act, 12 U.S.C. § 1972(1)(A), illegal contract, conversion, and breach of fiduciary duty. UBS Bank moved to dismiss the case under Fed. R. Civ. P. 12(b)(6).

The court denied UBS Bank's motion to dismiss with respect to the Bank Holding Company Act and fiduciary duty claims, and granted it as to the illegal contract and conversion claim. The court ruled that Plaintiffs adequately pleaded the elements for a violation of the Bank Holding Company Act: 1) the bank imposed a noncompetitive tying arrangement, meaning the bank conditioned the extension of credit upon the borrowers obtaining or offering

additional property or services from the bank; 2) the arrangement was not usual or traditional in the banking industry; and 3) the practice conferred a benefit on the bank.

The court also determined under the circumstances the Plaintiffs sufficiently pleaded UBS Bank acted as a fiduciary, despite contractual language specifically advising Plaintiffs of the existence of potential adverse interests. The court ruled in favor of Plaintiffs because of Plaintiff's relationship with UBS Puerto Rico and Ramirez, who acted at a minimum with apparent authority of the Bank and upon whose representations they relied.

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.

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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, Andrew Stoltmann at andrew@stoltlaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-MSRB-2016-015* was submitted to the Securities and Exchange Commission by Marnie C. Lambert on December 9, 2016 (prepared with the assistance of Aaron Israels, Jason Kane and Darlene Pasieczny).

Mr. Brent Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number SR-MSRB-2016-015 Proposed Rule Change Re: Customer Complaint and Recordkeeping Rules

Dear Secretary Fields:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I thank you for the opportunity to comment on SR-MSRB-2016-015. PIABA is 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 regulators in the securities industry, of which the Municipal Securities Rulemaking Board ("the MSRB") is one, relating to both investor protection and disclosure.

The MSRB, through SR-MSRB-2016-015, has proposed an amendment to several rules that would modernize and extend customer complaint and related recordkeeping to municipal advisors. For example, the proposed amendment to Rule G-10 would require brokers, dealers, municipal securities dealers, and municipal advisors to provide certain information about the firm to investors, including information about how to file a complaint with regulators, on a yearly basis. The proposed amendments to Rules G-8 and G-9 would require dealers and municipal advisors to keep electronic records of customer complaints using a standard set of product and problem codes, and to keep those records for at least six years.

PIABA commends the stated purpose of these proposed changes: improving investor protection and investor education. While the current Rule G-10 requires that an investor be given a brochure that details how to file a complaint about their dealer and protections afforded by the MSRB, that

brochure is generally not delivered to the investor until **afte**r they have filed a complaint, which diminishes the overall effectiveness of the existing Rule in its application.

The proposed amendments to Rule G-10 would do away with the brochure requirement, replacing it with annual notifications to customers (whether or not a complaint has been filed) that provide certain information to the customer, such as "(i) that the regulated entity is registered with the MSRB and the SEC, (ii) the MSRB's website address, and (iii) that there is a brochure available on the MSRB website that describes the protections available under MSRB rules and how to file a complaint with financial regulatory authorities."

A common problem generally faced by victims of investment fraud or inappropriate investment advice is that they don't know that they are actually afforded protections and remedies by many self-regulatory organizations (and other laws). As such, PIABA supports the proposed amendment to Rule G-10, in part, because rule is aimed at educating investors before they encounter a problem, so that if they encounter one, they understand what their rights are and what they can do about it. By understanding that certain remedies exist, PIABA's hope is that investors will be more likely to exercise their rights in a more timely and efficient manner.

PIABA also supports the proposed amendments due to their potential to give investors greater access to information about the municipal securities industry as a whole. Many investors may be unaware of the fact that the industry is regulated by the MSRB and the SEC. Educating investors of this simple fact could in turn result in them going to those sources for more information related to investor education and protection.

There is to doubt that the proposed Rule G-10 will be more beneficial to investors than the current rule. PIABA believes that the more investors know, and the earlier they know it, the more likely they will be able to protect themselves if the first place and/or hold those that break the rules (or violate the laws) responsible for resulting damages. The earlier investors can be educated in this way, the better.

As to the proposed changes to Rule G-8, PIABA commends the MSRB's effort to modernize the municipal securities industry's recordkeeping requirements. However, the proposed amendments are still not sufficient in that they do not appear to provide a mechanism for investors to access the information required to be provided.

Under the current Rule G-8, dealers and municipal advisors are required to keep written records of customer complaints and follow up taken by the firm to address those concerns. The system now being proposed would require more detailed information about the complaint to be kept by the regulated entity in an electronic format easier to access than paper records. While it appears that

the proposed amendments to Rule G-8 were proposed to try to ease the burden on regulators who may be required to search those complaints, there is no mention of how or if investors will have access to the same information.

Generally, a firm's history of complaints and corrective measures taken to resolve those complaints are (and should be) important factors for an investor to consider before making an informed decision about investing with any particular municipal advisor, municipal securities dealer, or other brokers/dealers. Thus, PIABA urges the MRSB to go a step further and also implement a plan to make those same records easily accessible to the public. PIABA appreciates the opportunity to comment on the proposed rule changes discussed herein.

Very truly yours,
Marnie Lambert
PIABA, President

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-039* was submitted to the Securities and Exchange Commission by Marnie C. Lambert on November 28, 2016 (prepared with the assistance of Adam Gana and Benjamin Edwards).

Brent Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: SR-FINRA-2016-39 – Proposed Rule Change to Adopt FINRA Rule 2165 Relating to Financial Exploitation of Seniors and Other Vulnerable Adults

Dear Secretary Fields:

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") relating to investor protection. In particular, our members and their clients have a strong interest in rules relating to the protection of elderly and retired investors and the supervision of associated persons who serve these investors.

SR-FINRA-2016-39 seeks comments on proposals to amend FINRA Rule 4512 (Customer Account Information)[1] and adopt new FINRA Rule 2165 (Financial Exploitation of Specified Adults) to address the financial exploitation of seniors and other vulnerable adults. New FINRA Rule 2165 would permit "qualified persons" of firms to place temporary holds on disbursements of funds or securities from the accounts of specified customers where there is a reasonable belief of financial exploitation of those customers. Rule 2165 does not create an obligation to place a hold on funds or securities where financial exploitation may be occurring, but it provides member firms

1. PIABA supports the proposed amendment to FINRA Rule 4512 because it will result in the identification of a trusted contact for the immediate reporting of possible financial exploitation of a customer.

with a safe harbor from other FINRA Rules when firms do exercise this discretion in placing temporary holds.

On November 30, 2015, PIABA commented on Regulatory Notice 15-37 (the "November 2015 PIABA Letter") in support of FINRA moving forward with a rule change that addresses the serious issue of financial exploitation. However, PIABA also suggested that several important changes be made to proposed Rule 2165 and those suggestions have not been addressed in the most recent iteration of the proposed rule. PIABA discusses the two most significant omissions below:

A. Rule 2165 Does Not Obligate Firms to Report to Relevant Authorities Financial Exploitation and Abuse

Proposed Rule 2165(b)(1) (Temporary Hold on Disbursements) states that:

> A member *may place* a temporary hold on a disbursement of funds or securities from the Account of a Specified Adult if: (A) The member reasonably believes that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted; and (B) The member, not later than two business days after the date that the member first placed the temporary hold on the disbursement of funds or securities, provides notification orally or in writing, which may be electronic, of the temporary hold and the reason for the temporary hold to: (i) all parties authorized to transact business on the Account; and (ii) the Trusted Contact Person(s), unless the Trusted Contact Person is unavailable or the member reasonably believes that the Trusted Contact Person(s) has engaged, is engaged, or will engage in the financial exploitation of the Specified Adult; and (C) The member immediately initiates an internal review of the facts and circumstances that caused the member to reasonably believe that the financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted.

As detailed in the November 2015 PIABA Letter, mandatory reporting is an essential component of the Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation ("Model Act") adopted the North American Securities Administrators Association, Inc. ("NASAA") earlier this year.

Ideally, for the sake of investor clarity, states adopting their own versions of the Model Act will try to maintain uniformity with respect to the ways in which customers are protected. For example, the Model Act, implicitly recognizing the importance of mandatory reporting to the goal of preventing incidents of

financial abuse, **requires** "qualified individuals"[2] to report to state securities regulators and adult protective services agencies if they have a reasonable belief that financial exploitation has been attempted or has occurred. Nonetheless, not every state will adopt the Model Act and those states that do adopt the Model Act may choose to implement a reporting requirement that is not mandatory. Unfortunately, inconsistent approaches among states will invariably lead to uneven protection for vulnerable adults.

As previously suggested by PIABA, making the reporting obligation of proposed Rule 2165 mandatory, rather than discretionary, would provide the uniform protection needed vulnerable adults in our nation. The only "reason" that FINRA provided as to why proposed Rule 2165 would not be revised to require member firms to report a reasonable belief of financial exploitation to appropriate authorities was that reporting requirements should be left to the states. *See* SR-FINRA-2016-39 at 72-73. This approach by FINRA will simply leave states that do have reporting requirements with responsibility for determining whether broker-dealers are complying with such requirements. It does nothing to change the obligations of member firms to report reasonably believed financial exploitation of vulnerable investors and will leave many such investors unprotected.

B. A Firm Should Have an Obligation to Place a Temporary Hold on Disbursement of Funds or Securities When It Has Reasonable Suspicion of Financial Exploitation or Abuse

Without restating PIABA's entire position from its November 2015 Letter *verbatim*, PIABA emphasizes its belief that the permissive language of Rule 2165 would allow a broker-dealer to *ignore* evidence of financial exploitation of a vulnerable adult. As the rule is currently written, a broker-dealer or registered person who has a reasonable belief that a vulnerable adult is being financially exploited does not have to place a temporary hold on the disbursement of funds or securities. To adequately protect the elderly investing population in those circumstances, a member firm should be *required* to place a temporary hold. That is the only means of preventing or mitigating the dissipation of its vulnerable customers' assets.

PIABA does not stand alone on this issue. FINRA's approach drew significant criticism from other public advocates. For example, Georgia State

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2. NASAA's Model Act defines "qualified individual" as any agent, investment adviser, representative or person who serves in a supervisory, compliance, or legal capacity for a broker-dealer or investment adviser. Section 2 (7), Definitions.

explained that while it supported the effort, the proposed rule gave the industry a safe harbor to keep assets within the firm without imposing any obligation to actually do anything.[3] The University of Miami School of Law also asked for changes, explaining that the rule "creates no obligation" to do anything about known exploitation.[4] In an article forthcoming in the *University of Cincinnati Law Review*, Professor Benjamin P. Edwards characterized FINRA's approach as "illusory rule-making activity" because this purported senior protection rule does not actually require FINRA's member firms to protect seniors.[5] The rule does not even help seniors looking to protect themselves because it provides for no mechanism for the public to differentiate between firms that "that commit to senior-protection policies from those that do not."[6]

Under the rule as written, a broker-dealer could simply ignore evidence of financial exploitation without consequence. FINRA stated it "believes that a member can better protect its customers from financial exploitation if the member can use its discretion in placing a temporary hold on a disbursement of funds or securities from a customer's account." *See* SR-FINRA-2016-39 at 26. However, the permissive, rather than mandatory, language incentivizes member firms to simply ignore the rule. Absent the mandatory language no member firm would be motivated to incur the additional costs of implementing the necessary compliance measures to protect its elderly investors. If member firms are not motivated to comply with this rule, then the rule cannot and will not be effective.

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3. GEORGIA STATE UNIVERSITY COLLEGE OF LAW INVESTOR ADVOCACY CLINIC, COMMENTS ON PROPOSED FINRA RULE ON FINANCIAL EXPLOITATION OF SENIORS AND VULNERABLE ADULTS 1-2 (2015), available http://www.finra.org/sites/default/files/15-37_georgia-state-law_comment.pdf ("the Proposal also allows a Qualified Person to use their discretion to ignore a reasonable belief that financial exploitation is likely and do nothing").

4. UNIVERSITY OF MIAMI SCHOOL OF LAW INVESTOR ADVOCACY CLINIC, PROPOSED RULES RELATING TO FINANCIAL EXPLOITATION 5 (2015), available http://www.finra.org/sites/ default/files/15-37_University-Miami-School-Law_comment.pdf (explaining that the proposed rule "would allow a broker-dealer to *ignore* evidence of financial exploitation" without reporting the suspected exploitation or putting a hold on the account) (emphasis in original).

5. *See* Benjamin P. Edwards, *The Dark Side of Self-Regulation*, UNIVERSITY OF CINCINNATI LAW REVIEW, forthcoming. Available at SSRN: https://ssrn.com/abstract=2829592.

6. *Id.*

Thus, PIABA reiterates its suggestion that a broker-dealer be required to place a temporary hold on the disbursement of funds or securities when financial exploitation of a vulnerable customer is reasonably believed to have been attempted or to have occurred. Moreover, if a member firm does not act on a reasonable belief of financial exploitation, or ignores information that may lead to a reasonable belief of financial exploitation, that firm should be subject to some penalty.

C. Conclusion

In summary, PIABA asks that FINRA amend proposed Rule 2165 to address the issues set forth above and in the November 2015 PIABA letter. PIABA thanks you for the opportunity to comment on this important topic.

Very truly yours,
Marnie Lambert
PIABA President

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-033* was submitted to the Securities and Exchange Commission by Hugh Berkson on September 23, 2016 (prepared with the assistance of David P. Neuman and William B. Young).

Mr. Robert W. Errett, Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549–1090

Re: **SR-FINRA-2016-033; Proposed Rule Change Relating to Broadening Chairperson Eligibility in Arbitration** - (Proposed Rule Change to Amend Rule 12400 of the Code of Arbitration for Customer Disputes and Rule 13400 of the Code of Arbitration for Industry 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 rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes in order to protect the rights and fair treatment of the investing public.

PIABA submits this comment because, while the bar association believes the proposed rule is certainly a positive step in regards to increasing the number of arbitrators in proposed chair pools, PIABA does not want to see the quality of the pools watered down or have an increase in "traveling arbitrators" to attain a greater number of chair-qualified arbitrators. Also, PIABA feels the formation of a chairperson mentor program would help address shortages of chair-qualified arbitrators. Lastly, PIABA believes the rule should go farther in terms of education, background and overall arbitrator background transparency.

Background

Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("ACT"), Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend Rule 12400 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code") and Rule 13400 of the Code of Arbitration Procedure for Industry Disputes ("Industry Code") (together "Codes") to provide that an attorney arbitrator would be eligible for the chairperson roster if he or she completes chairperson training and serves as an arbitrator through award on at least one arbitration, instead of two arbitrations (as the rules currently require), administered by a self-regulatory organization ("SRO") in which hearings were held.

The text of FINRA rules require chairpersons, who play a vital role in the administration of arbitration cases, to have arbitrator experience and training to ensure the quality and efficiency of arbitrations. FINRA Rules 12400 and 13400 address the Neutral List Selection System ("NLSS")[1] and arbitrator rosters and provide, among other matters, that an arbitrator is eligible for the chairperson roster if he or she has completed chairperson training provided by FINRA and:

*Has a law degree and is a member of a bar of at least one jurisdiction and has served as an arbitrator through award on at least two arbitrations administered by an SRO in which hearings were held (an "attorney arbitrator"); or

*Has served as an arbitrator through award on at least three arbitrations administered by an SRO in which hearings were held.[2]

FINRA's Office of Dispute Resolution ("ODR") offers 71 hearing locations, including at least one in each state of the United States, one in San Juan, Puerto Rico, and one in London, UK. ODR maintains a roster of approximately 6,750 arbitrators, of which approximately 3,060 are currently classified as public. Approximately 1,000 of the 3,060 are chair qualified. Despite the size of the public chairperson roster, forum users have raised

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1. The NLSS is a computer system that generates, on a random basis, lists of arbitrators from FINRA's rosters of arbitrators for the selected hearing location for each proceeding. FINRA maintains a roster of non-public arbitrators (as defined in FINRA Rules 12100(p) and 13100 (p), a roster of public arbitrators (as defined in FINRA Rules 12100(u) and 13100(u), and a roster of arbitrators who are eligible to serve as chairperson of a panel.

2. See proposed change to Rule 12400 and Rule 13400 of the Code of Arbitration Procedure.

concerns of a diminished public chairperson roster resulting from amendments to the "public arbitrator" definition.[3] FINRA reclassified approximately 13.8 percent (487 out of 3,512) of its public arbitrator roster as non-public, and approximately 2.6 percent (93 out of 3,512) of its public arbitrator roster were temporarily disqualified and made ineligible for service.[4] Many of the arbitrators who were reclassified or disqualified were chair-qualified.

Currently the public chairperson roster in each hearing location ranges from fewer than 40 to over 200. Forum users recognize the risk that when the caseload increases, the ratio of cases to qualified public chairpersons is higher, and FINRA may not have a sufficient number of public chairpersons on its roster. To expand the roster of public chairpersons in locations where the ratio of cases to qualified public chairperson is higher, FINRA asks many public chairpersons to service in multiple hearing locations. FINRA reimburses these chairpersons for their travel, lodging and meals.

However, party representatives have told FINRA staff that it is inconvenient to schedule hearings with out-of-town arbitrators. Moreover, during inclement weather, arbitrators may not be able to travel to the hearing location, which would then require parties to reschedule and incur additional costs. In addition, some forum users suggest that these arbitrators may also need instruction on the state laws, procedures, and customs for the hearing venue.

FINRA has had limited success in enrolling new public chairpersons. One reason is that for the last few years, FINRA arbitration caseload has remained low, and public arbitrators were not serving on a sufficient number of cases through award to meet the case experience requirements for attorney arbitrators outlined above. In 2015, only 24% of cases closed by award. However, thus far in 2016, there has been an increase in case filings (up 20% compared to the same period in 2015). If this trend persists, the need for more public chairpersons could outpace the qualification pipeline under the current eligibility criteria.

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3. See Securities Exchange Act Release No. 74383 (February 26, 2015), 80 FR 11695 (Order Approving Filing No. SR-FINRA-2014-028) (in part narrowing the public arbitrator definition by adding disqualifications relating to, among other things, affiliations with the securities industry concerning an arbitrator's family member or place of employment.

4. There were an estimated 2,932 public arbitrators after the amended public arbitrator definition became effective. Arbitrator recruitment since July 2015 added approximately 128 to the public arbitrator roster, there reaching approximately 3,060 public arbitrators as of this rule filing.

FINRA is proposing to amend Rules 12400(c) and 13400(c) to provide that an attorney arbitrator would be eligible for the chairperson roster if he or she completes chairperson training and serves as an arbitrator through award on at least on arbitration, instead of two arbitrations, administered by an SRO in which hearings were held. Reducing the case experience requirement from two arbitrations to one arbitration could add more than 270 attorney arbitrators across 59 of the 71 hearing locations, resulting in a nearly 30 percent increase in the number of arbitrators who might be eligible to serve as public chairpersons once they take chairperson training.

Comments

In general, PIABA supports the proposed rule because the bar association feels strongly that public investors would generally benefit from a larger pool of qualified public chairpersons. However, PIABA does not want to see the chairperson pool increased in quantity at the expense of quality. PIABA feels strongly that quality pools are paramount to a fair and equitable arbitration proceeding, as well as the public investors' confidence in the overall arbitration process. Lastly, to the extent possible, the traveling arbitrator needs to be eliminated and the size of regional pools needs to be increased, in particular for those areas with higher rates of out-of-state arbitrator names appearing on public and chair-qualified ranking lists. PIABA's membership sees the same out-of-state arbitrators appearing too often in the ranking lists.

Forum users from small and mid-size cities are seeing the particular problem of traveling arbitrators. The scheduling issues referenced above can delay the process, which costs more time and money for everyone involved. Likewise, out-of-state arbitrators may not be as familiar with the hearing state's laws and procedures, which decrease the arbitrator's chances to fairly and adequately adjudicate over the arbitration.

Additionally, 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. Combined with the fact that out-of-state arbitrators may not be familiar with the hearing state's laws, 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 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).

PIABA also strongly believes there should be greater transparency in arbitrator background and qualifications, as well as the selection process. The present system, while providing education, employment history and potential conflict disclosure, has not always succeeded in eliminating the appearance of possible impropriety and bias. The investing public should feel confident the panel that is seated to hear their case has been fully vetted and free from any potential conflict or innate bias. Only then will the system work, free from second guessing and overall cynicism with the process.

PIABA also believes a Chairperson Mentor program would be helpful to increase both the quality and quantity of chair-qualified arbitrators. There are hundreds of public arbitrators with the requisite background that would surely benefit from the experience and guidance of a chair mentor. Also, from a more practical standpoint, the arbitrator application process should be simplified. The current process is very burdensome and intimidating and surely drives away many potential arbitrators which further weakens the number and quality of arbitrators available in the FINRA system.

Conclusion

In summary, PIABA supports FINRA's proposed rule amendment to the extent it will increase the number of chair-qualified arbitrators, as long as quality and experience does not suffer as a result. Transparency in arbitrator qualifications and background, as well as the overall selection process, is paramount. As such, PIABA believes the amended chairperson qualification rules, while a positive step, do not go far enough in addressing the current shortcomings outlined above. PIABA thanks FINRA for the opportunity to comment on this proposal.

Sincerely,
Hugh Berkson, President
Public Investors Arbitration Bar Association

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The following PIABA Comment Letter regarding the *NASAA's Proposed Amendment to the Statement of Policy Regarding REITs* was submitted to the North American Securities Administrators Association by Marnie C. Lambert on September 12, 2016 (prepared with the assistance of Scott Ilgenfritz).

Mark Stewart, Counsel
NASAA Legal Department
750 First Street N.E., Suite 1140
Washington D.C. 20002

RE: NASAA's Proposed Amendment to the Statement of Policy Regarding Real Estate Investment Trusts

Dear Mr. Stewart:

I am writing on behalf of the Public Investors Arbitration Bar Association ("PIABA").[1] PIABA's members and their clients have a strong interest in the Model Rules and Statements of Policy issued by NASAA. As you know, our respective Associations often find themselves on the same side with respect to rules and regulations that govern the conduct of securities firms and their representatives. I thank NASAA for the opportunity to comment on NASAA's Proposed Amendment to the Statement of Policy Regarding Real Estate Investment Trusts ("Proposed Amendment"). However, in the interest of full disclosure, I should preface all that follows in this letter with the admission that PIABA does not believe that non-traded REITs should be sold to retail investors. Period. Having said that, PIABA commends NASAA on its effort to try to protect investors from the evils of highly risky, illiquid and opaque non-traded REITs since they do not seem to be going away.

1. As you know, PIABA is 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.

INTRODUCTION

PIABA also wants to acknowledge that this is not the first time that NASAA has tried to implement investor protections by imposing a concentration limit or revising the definition of "net worth." PIABA is aware that NASAA's efforts in this regard were nearly uniformly shot down by the securities industry. Based upon PIABA's limited research into NASAA's history on these issues, just a sampling of a few of the nearly 90 comment letters that NASAA apparently received in at the of 2006 (when versions of some of the changes now in the Proposed Amendment were previously proposed) reflect what NASAA was (and now, is) up against. More specifically, it is clear that groups such as the Securities Industry and Financial Markets Association ("SIFMA"), the Financial Services Institute ("FSI") and, not surprisingly, the National Association of Real Estate Investment Trusts, seemed to all take pages out of the same playbook when they touted the benefits of direct participation programs ("DPPs"') and insisted that the existing then-NASD rules regarding suitability of those products were sufficient to protect investors.[2] At least one of the commenters felt that the proposed language was not even appropriate for State securities regulators and that it was calling on them to ... **regulate**.[3]

The three sample industry comment letters regarding NASAA's earlier proposal are ironic in that they almost seem offended that NASAA did not trust them to properly apply the existing FINRA rules for DPP sales and they felt that DPPs were such an important part of proper portfolio diversification that it would be unfair to keep a certain segment of the investing public from buying them (*e.g.*, those who could not afford to lose a significant amount of their net worth on DPPs). Little did NASAA, or any of us, know that the very people that NASAA's previous proposal was trying to protect would

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2. *See* September 9, 2016); https://www.financialservices.org/assets/0/56/288/3c6ceec2-5d8e-44d0- http://www.sifma.org/comment-letters/2007/sifma-submits-comments-to-several-state-regulators-on-the-nasaa- statement-of-policy-for-direct-participation-programs/ (last visited a232-f845c39e7881.pdf (last visited September 9, 2016); https://www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/members/secureDocuments/NASA A%20submission%20BOG.pdf (last visited September 9, 2016).

3. FSI's November 27, 2006 letter states that some of the provisions of the previous proposal "would harm IBDs "[Independent Broker Dealers"], affiliated financial advisors and their clients, by "[i]nterjecting the state regulator's own judgment into suitability decisions that are best left to an investor in consultation with his financial advisor."

desperately need the protection just a few short years later.

In the "Background" section of NASAA's Notice to which PIABA's comment letter is responsive, NASAA states that it is "evaluating concentration limits for direct participation programs ('DPPs')", but that the "Concentration Limit Proposal" in the Notice is "the first in an anticipated series in this regulatory area" and "focuses on proposed amendments to the NASAA REIT Guidelines ..." PIABA presumes that the "regulatory area" to which the Notice refers is the regulation of DPPs. PIABA supports additional efforts of NASAA to protect retail investors related to the sales of DPPs.

This letter addresses the substantive amendments included in the "red-line" version of the NASAA REIT Guidelines attached as Exhibit A to the Notice. From PIABA's perspective, there is still some problematic language in NASAA's Proposed Amendment relating to concentration limits. More specifically, PIABA finds the following elements of NASAA's Proposed Amendment troubling:

- Proposed Section IV.B.1. Concentration Limit – the proposed language establishes what amounts to a default concentration limit of ten percent (10%);
- Proposed Section IV.B.1. Concentration Limit – the proposed language only establishes a concentration limit for non-traded REITs (and not all DPPs);
- Proposed Section IV.B.1. Concentration Limit – the proposed language automatically carves out "Accredited Investors" under either the income or net worth standards in Regulation D, Rule 501;
- Proposed Section IV.B.2. Concentration Limit – the proposed definition of "liquid net worth" does not specifically exclude the value of investments in retirement accounts;
- Proposed Section IV.B.3. Concentration Limit – the proposed language regarding fiduciary accounts is generally confusing to the point that PIABA is not sure what it means and, thus, how to respond;
- Proposed Section IV.B.5. Concentration Limit – the proposed disclosure language does not create any safer standards or any additional liability for the sponsor or selling broker, but provides them with a potential "out" on liability if they made "every reasonable effort" to be sure the shares sold are within the concentration limit based on "information provided" by the investor regarding his "financial situation and investment objectives;" and
- Proposed Section IV.A.3. – Concentration Limit – the proposed language distinguishing adherence to the concentration limit from a suitability determination does not change long-existing obligations of brokers selling DPPs and its inclusion does not change such obligations.

Notwithstanding the foregoing, if non-traded REITs are going to continue to be sold by FINRA members to retail investors, PIABA does support the idea of a national, uniform minimum concentration limit for non-traded REITs. However, NASAA's proposed 10% limit is too high given the way in which the proposed concentration limit is to be calculated, what it will be applied to and what is to be included in an investor's "liquid net worth." PIABA's more specific comments/concerns about the Proposed Amendment are set forth at the end of this letter, but it makes sense to first consider the foundation upon which NASAA's Proposed Amendment (or its successor, if any) will be laid.

BACKGROUND

As you know, non-traded REITs are registered with the SEC and are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934. As such, non-traded REITs must make public a prospectus of the securities for sale, as well as regular financial statements of the issuer and information about the issuer's management.[4] Still, problems persist with non-traded REITs (and other DPPs) because they are nothing more than illiquid, high commission versions of other, low-cost investment alternatives.[5] That being the case, regulators are often issuing guidance and reminders to FINRA member firms about sales practices related to non-traded REITs and other DPPs.

Nonetheless, to date, regulations have been largely ineffective. According to Dr. McCann, non-traded REITs are not only riskier than traded REITs, but they also do not perform as well.[6] He compared the performance of more than

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4. *See* http://www.slcg.com/pdf/workingpapers/Non%20Traded%20REITs%20 White%20Paper.pdf ("A Primer on Non-Traded REITs and other Alternative Real Estate Investments") at page 2 (last visited September 7, 2016). Co- Author of this white paper, Craig McCann, Ph.D., CFA, is a Principal at Securities Litigation & Consulting Group ("SLCG") and has written many white papers and blogged about various securities, including non-traded REITs.

5. *See, e.g.* http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20 McCann%20non- traded%20REITs.pdf ("An Empirical Analysis of Non-Traded REITs") (last visited September 7, 2016) and http://slcg.com/pdf/workingpapers/ Fiduciary%20duty%20and%20Non-traded%20REITs.pdf ("Fiduciary Duty and Non-Traded REITs") (last visited September 7, 2016). Dr. McCann has also authored expert reports and testified many times in FINRA arbitration hearings about various securities, including non-traded REITs.

6. *See* http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann

80 non-traded REITs to a diversified portfolio of traded REITs over 20 years and found the difference to be more than $45 billion. That is, investors in those non-traded REITs effectively gave up more than $45 billion they could have made in similar, traded investments. Dr. McCann refers to this as "wealth loss" and he attributes most of the underperformance to the high upfront fees and expenses of non-traded REITs – they can average over 13% of the total purchase price and most of that 13% goes to the broker that sold the product to the investor. As Dr. McCann illustrates, the problems with REITs are further exacerbated due to the structure of non-traded REITs, which is rife with conflicts of interest because sponsors of non-traded REITs often use affiliated firms as advisors and managers.[7]

Non-traded REITs, and other such non-traditional investments, are often referred to as Non-Conventional Investments ("NCIs") by FINRA and they have been particularly problematic for regulators for years. Before responding more fully with respect to the concerns raised above, it is worthwhile to look briefly at what FINRA has done to try to improve the odds that investors understand what non-traded REITs are (or aren't) and to increase the likelihood that the non-traded REITs that are sold to investors have been properly vetted before they are offered. It is not surprising that one of the primary purposes for recent regulatory guidance has been to emphasize and "remind" FINRA members of their obligation to ensure that the non-traded REITs sold to their customers are suitable for the customers. Additionally, FINRA has grappled with trying to increase the transparency of the pricing/stated value of non-traded REITs, which is particularly important for unsophisticated investors who do not understand that these complicated securities are unlike the stocks, bonds or mutual funds they hold in their investment accounts.

%20non-traded%20REITs.pdf ("An Empirical Analysis of Non-Traded REITs") (last visited September 7, 2016).

7. Statistics kept by the Financial Industry Regulatory Association ("FINRA") about customer arbitration claims against its members show that from 2012 through July 2016, out of **40** specific types of securities that can be involved in customer claims, the only securities in dispute more often than REITs were more traditional securities - common stocks, municipal bond funds, municipal bonds and mutual funds (the list also includes corporate bonds in 2015). Granted, the FINRA Claim Information Sheet does not specify non-traded (versus traded) REITs, but the experience of PIABA members has been that the REITs involved in our cases have primarily been non-traded REITs.

• NTM 03-71

In November 2003. the National Association of Securities Dealers ("NASD," FINRA's predecessor) issued Notice to Members ("NTM") 03-71[8] regarding NCIs. The purpose of NTM 03-71 was to remind brokerage firms of their obligations when recommending NCIs to customers. According to NTM 03-71, brokerage firms are to take many steps **prior to** even recommending NCIs to customer.

• NTM 05-26

Still concerned about the growing number of complex and non-conventional products, in April of 2005, the then- NASD issued more guidance regarding such products in NTM 05-26.[9] NTM 05-26 was helpful in that it left very little to the imagination when it came to how firms should be dealing with new investment products. It provided that the vetting process of new products should consist of following firm policies and procedures and that those policies and procedures should result in obtaining answers to questions specified in NTM 05-26. NTM 05-26 also discussed "best practices" revealed in a survey of certain firms that create proprietary products and/or distribute third-party products. The "take-aways" are that firms' procedures should be mandatory, formal, thorough, detailed and that they may require some follow up even after a new product is officially approved. Of course, as NTM 05-26 notes at the end, "... [E]even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and level of commitment on the part of the firm's leadership."

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8. *See* http://www.finra.org/sites/default/files/NoticeDocument/p003070.pdf (last visited September 7, 2016).

9. *See* http://www.finra.org/sites/default/files/NoticeDocument/p013755.pdf (last visited September 7, 2016).

• RN 15-02

In October 2014, the U.S. Securities and Exchange Commission ("SEC") approved certain FINRA rule amendments in order to supposedly increase transparency for investors related to non-traded REITs. Those amendments are found in Regulatory Notice 15-02,[10] which modified then-NASD Rule 2340 regarding customer account statements and FINRA Rule 2310 regarding DPPs. The amendments went into effect on April 11, 2016.

RN 15-02 prohibits firms that want to participate in a public offering of a non-traded REIT from doing so unless the issuer has agreed to disclose in periodic filings a per-share estimated value that was developed in a manner that was designed to ensure its reliability. The two presumably reliable valuation methods specifically set forth in RN 15-02 are the "net investment method" and the "appraised value method."

Unfortunately, while transparency regarding the stated values of non-traded REITs is important, it does not change the fact that the non-traded REITs are generally not good for anyone but the broker, the sponsor/issuer and those affiliated with the them. Indeed, even though FINRA Rule 2340 now requires that non-traded REIT values be included in customer account statements, customers may still be faced with a disclosure that the stated value is not really what is says it is (*i.e.*, where a distribution includes return of capital or because the securities are not readily traded the price received in a sale may not be the value stated).

The grim reality is that most customers will never fully appreciate the uncertainty of determining a value for a security that is not traded on a national securities exchange regardless of how many ways the value is determined or how many disclosures about the value are given.

COMMENTS RELATED TO PROPOSED AMENDMENT

• Proposed Section IV.B.1. Concentration Limit – the proposed language establishes what amounts to a default concentration limit of ten percent (10%);

While PIABA generally supports NASAA's attempt to create a national, uniform concentration limit for non-traded REITS, it simply cannot condone a limit as high as ten percent (10%) in all situations. Moreover, a REIT may

10. *See* http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf (last visited September 7, 2016).

increase this limit if it determines (and the securities regulators agree) it would be appropriate. For many retail investors, ten percent (10%) of their net worth represents a substantial sum of money. To have the money invested in a highly risky, illiquid product is rarely appropriate. Further, investors may be invested in multiple DPPs, each one individually representing ten percent (10%) of the investor's net worth. This is simply too great an exposure for retail investors in these sorts of products.

• *Proposed Section IV.B.1. Concentration Limit – the proposed language only establishes a concentration limit for non-traded REITs (and not all DPPs);*

Although PIABA's understanding is that the Proposed Amendment is the first of a series, the current proposal presents the risk that investors could wind up with large portions of their net worth invested in non-traded REITs, as well as other DPPs with the same types of risks and similar lack of liquidity as non-traded REITs (*e.g.*, limited partnerships, private placements and the like). Certainly such a result is not intended, but as the Proposed Amendment is currently worded, it could actually be harmful to investors if they are allowed to be over- concentrated in DPPs.

• *Proposed Section IV.B.1. Concentration Limit – the proposed language automatically carves out "Accredited Investors" under either the income or net worth standards in Regulation D, Rule 501;*

PIABA does not support carving out "Accredited Investors" under Regulation D, Rule 501 from the protections the Proposed Amendment is intended to bestow. The income and net worth standards set forth in Regulation D have not been updated since 1982 and are woefully outdated. As a result, a much larger portion of the population is already captured under the definition of "Accredited Investor" than was originally intended. Additionally, just because an investor qualifies as an "Accredited Investor" under the artificially low income and net worth dollar amounts, does not necessarily mean that they have the financial resources to take on the risks typically associated with non-traded REITs. Further, investors who are otherwise "accredited" under Regulation D still may not be sophisticated enough with respect to investments to appreciate the significant risks and illiquidity of non-traded REITs and other DPPs. "Accredited Investors" should be provided with the same protections as other retail investors.

• *Proposed Section IV.B.2. Concentration Limit – the proposed definition of "liquid net worth" does not specifically exclude the value of investments in retirement accounts;*

If the Proposed Amendment is passed and implemented such that a national, uniform concentration limit goes into effect for non-traded REITs, then NASAA should go back to what it previously proposed regarding net worth calculations. PIABA is adamant that NASAA was right in its previous proposal when it excluded certain retirement accounts and benefits from the net worth calculation. If broker/dealers are going to continue to be permitted to sell non-traded REITs to retail investors, the retirement accounts and benefits of those investors should be excluded from their "liquid net worth."

• *Proposed Section IV.B.3. Concentration Limit – the proposed language regarding fiduciary accounts is generally confusing to the point that PIABA is not sure what it means and, thus, how to respond;*

PIABA certainly means no disrespect to NASAA and those that clearly worked long and hard on the Proposed Amendment, but PIABA does not understand what the intended application of the proposed language in this section is. What is a "fiduciary account" in this instance and has that changed due to the Department of Labor's action on the Fiduciary Duty Rule? How, if at all, does the proposed language correlate or relate to an investor's other accounts (*i.e.*, "non-fiduciary accounts")? Are items included in the proposed liquid net worth and concentration limit calculations meant to be kept separate as between "fiduciary accounts" and "non-fiduciary accounts" or are they meant to be aggregated? For example, given the Proposed Amendment, if Joe Investor has 10 "non-fiduciary accounts" worth $100,000 each and is also the beneficiary of a single "fiduciary account" worth $1 million, what total dollar amount would be used for net worth/concentration limit purposes?

• *Proposed Section IV.B.5. Concentration Limit – the proposed disclosure language does not create any safer standards or any additional liability for the sponsor or selling broker, but provides them with a potential "out" on liability if they made "every reasonable effort" to be sure the shares sold are within the concentration limit based on "information provided" by the investor regarding his "financial situation and investment objectives."*

While PIABA appreciates that NASAA has spelled out the requirement that sponsors and those selling shares on behalf of the sponsors make every effort to determine that a purchase satisfies the concentration limit, the

proposed language does not appear to provide any protection (additional or otherwise) to investors. When investors see this language in the prospectus, assuming they read and understand it, they may take it to mean that the sponsor or selling broker has exercised some special level of due diligence beyond what is already required of them by the rules. Such an understanding could result in the investor attributing legitimacy or suitability to the product that he otherwise would not have and that can be more dangerous than remaining silent on the subject of the duties of those selling these risky non-traded products. PIABA's view is that such a risk is not outweighed by any benefit to the investor and that the safer route would be to exclude the disclosure in its entirety.

• *Proposed Section IV.A.3. – Concentration Limit – the proposed language distinguishing adherence to the concentration limit from a suitability determination does not change long-existing obligations of brokers selling DPPs and its inclusion does not change such obligations.*

Again, while PIABA appreciates that NASAA has reminded those involved in the sale of non-traded REITs that adhering to a concentration limit does not satisfy other suitability rules, it should be recognized that many brokers have continued to erroneously use the REIT's own suitability guidelines and the "Accredited Investor" thresholds as a proxy for FINRA's required suitability analysis. Thus, the reality is that notwithstanding the proposed language in this section, brokers will likely also misuse the concentration limit in that manner. It is entirely unclear what purpose the inclusion of that "disclosure" language has *vis-a-vis* the investor. That being the case, it is PIABA's opinion is that the risk of an investor misunderstanding the legal significance of the proposed "disclosure" language outweighs the benefit to the investor of including it such that the proposed language should be excluded.

CONCLUSION

Thank you for taking on the unenviable task of trying to add some protections to retail investors nationally who are being sold unsuitable non-traded REITs. If Congress and the other "powers that be" refuse to prohibit the sale of DPPs like non-traded REITs to retail investors, then the best PIABA can hope for is to increase protections available to retail investors related to the sale of those securities. It is PIABA's sincere hope that as many investor protections as possible will be included in the final amended version of NASAA's Statement of Policy Regarding Real Estate Investment Trusts.

PIABA thanks you for the opportunity to comment on the Proposed Amendment.

Very truly yours,
Marnie C. Lambert
PIABA EVP/President-Elect
Chair of NASAA Committee

cc: Michael Pieciak [*via* email only to Michael.Pieciak@vermont.gov]
Mark Heuerman [*via* email only to Mark.Heuerman@com.state.oh.us]

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-032* was submitted to the Securities and Exchange Commission by Hugh Berkson on September 7, 2016 (prepared with the assistance of Darlene Pasieczny).

Mr. Robert W. Errett, Deputy Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: SR-FINRA-2016-032. Proposed Rules Change Relating to FINRA Rule 2232 (Customer Confirmations) To Require Members To Disclose Additional Pricing Information

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") relating to both investor protection and disclosure.

SR-FINRA-2016-032 proposes amendments to FINRA Rule 2232 (Customer Confirmations) to require members to provide additional pricing information on customer confirmations in connection with non-municipal fixed income transactions with retail customers. If a member trades as a principal with a non-institutional customer in corporate debt or agency debt security, the rule proposal would require the member disclose the member's mark-up / mark-down from prevailing market prices if the member also executes one or more offsetting principal transactions on the same trading day, in the same side as the customer trade, and in an aggregate size equal or greater to the size of the customer trade. The proposal is a revised version of two prior proposals, FINRA Regulatory Notice ("RN") 14-52 and FINRA RN 15-36, for which FINRA received numerous comments, including from PIABA.

FINRA explains that the rule change proposal is an effort to curb mark-up / mark-down abuses regarding transactions in fixed income securities. Such abuses are real. As PIABA noted previously, in just the past few years, FINRA

has ordered violating firms to pay millions of dollars in fines and customer restitution. Increased transparency on customer confirmations is a necessary step.

1. Same-day Transaction Requirement

The present proposal retains the temporal requirement of a same-day transaction requirement that was proposed in RN 15-36. PIABA previously urged FINRA that this was too limited, and repeats that concern here. However, FINRA notes in Footnote 11 of the published Federal Register proposal for 2016-032 that:

> Any intentional delay of a customer execution to avoid the proposed rule or otherwise would be contrary to [Rule 5310 Best Execution and Interpositioning] duties to customers. If the proposed rule change is approved, FINRA will monitor trading patterns to ensure firms are not purposely delaying a customer execution to avoid the disclosure. A firm found to purposefully delay the execution of a customer order to avoid the proposed disclosure may be in violation of the proposed rule, Rule 5310 and Rule 2010 (Standards of Commercial Honor and Principles of Trade.

If the present proposal is implemented, PIABA strongly encourages FINRA to contemporaneously issue guidance emphasizing the above warnings. PIABA also thanks FINRA for its commitment to monitor trading patterns and prevent firms from "gaming the system" by delaying trades to at least the following day and avoid the disclosure rules.

2. "Look Through" for Non-Arms-Length Transactions

PIABA supports FINRA's proposal that would require members to "look through" where a transaction with a member's affiliate was not at arm's length, in order to determine whether the "same trading day" requirement has been triggered.

3. "Prevailing Market Price" Standard

In the present iteration of the rule proposal, FINRA has changed the prior disclosure of a "reference price," the price actually paid by the firm for the bond that same day, to disclosure of the mark-up or mark-down from the

"prevailing market price." PIABA remains unconvinced that industry commenters' purported concerns regarding increased compliance costs justify the significant change in methodology. FINRA notes that firms are already required under Rule 2121 to ensure that mark-ups and mark-downs are fair, and thus should be calculating these numbers to ensure compliance. However, firms may determine "prevailing market price" differently, and may not be consistent across customers. This may create investor confusion and render the disclosure less effective in curbing mark-up/mark-down abuses. PIABA encourages FINRA, at minimum, to monitor and review of firm policies on this matter.

Thank you for the opportunity to comment. PIABA applauds FINRA for continuing to work to implement enhanced disclosures on customer confirmations.

Sincerely,
Hugh Berkson, President
PIABA

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-030* was submitted to the Securities and Exchange Commission by Hugh Berkson on September 7, 2016 (prepared with the assistance of Jeffrey Pederson).

Mr. Robert W. Errett, Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2016-030. Proposed Rule Change Relating to Motions To Dismiss in Arbitration

Dear Secretary 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") relating to both investor protection and disclosure.

I thank the Commission for the opportunity to comment on the proposed amendments to FINRA Rules 12504 and 13504, amendments which address motions to dismiss in FINRA arbitration cases.

SR-FINRA-2016-030 proposes changes to FINRA Rule 12504 and 13504 by providing an additional ground for moving to dismiss a party's claim prior to the conclusion of the party's case in chief. Namely, SR-FINRA-2016-030 proposes that a motion to dismiss may be founded on the ground that **"the non-moving party previously brought a claim regarding the same dispute against the same party that was fully and finally adjudicated on the merits and memorialized in an order, judgment, award, or decision."** PIABA is wary of any expansion to the rules allowing dismissal prior to the completion of an investor's case in chief in light of previous abuse of this rule by respondents in FINRA arbitrations. Any change to these rules should be narrow and reiterate FINRA's discouragement toward the filing of such motions.

By way of background, the FINRA rules concerning pre-hearing dismissal were modified in 2009 with RN 09-07. The changes were to stop the flow of frivolous motions to dismiss that respondents in FINRA arbitrations were filing as a matter of course. FINRA found that such motions to dismiss were in an apparent effort by respondents to "delay scheduled hearings sessions on the merits, increase customers' costs, and intimidate less sophisticated customers." RN 09-07.

With the 2009 rule change, FINRA limited dismissal motions to circumstances where 1) the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release, and 2) the moving party was not associated with the accounts, securities or conduct at issue. FINRA Rules 12504(a)(6) and 13504(a)(6). In addition to limiting dismissal motions to these narrow grounds, FINRA proclaimed that motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged. FINRA Rules 12504(a)(1) and 13504(a)(1).

The proposal contained in SR-FINRA-2016-030 notes that FINRA's Dispute Resolution Task Force reviewed the topic of motions to dismiss in FINRA arbitration. It determined that the present rule appears to be working as intended to prevent frivolous motions to dismiss, but also reached a consensus that in instances where arbitrations involve claims previously adjudicated by a court or arbitrated by a panel, respondents should be able to seek early dismissal. The proposed change would add that one additional category, dismissal for claims previously adjudicated fully and finally on the merits, to Rules 12504(a)(6) and corresponding 13504(a)(6).

PIABA believes that a current ground for dismissal under the present rule, that "the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release," and the proposed additional language are in line with the same reasoning: that a final, enforceable resolution has already been reached. However, in light of the previous abuse of dismissal rule, PIABA believes it is extremely important that FINRA continues to discourage motions to dismiss prior to the conclusion of a party's case in chief. PIABA also believes FINRA should articulate that any rule change is to be narrowly construed, and emphasize that it applies to adjudications on the merits where the non-moving parties have had a full and fair opportunity to argue their claims.

The term "same party" in the proposed new ground for dismissal also should be narrowly defined to mean just the specific party named in the previous arbitration. Without clarification, a claimant might be improperly precluded from pursuing claims against respondents not originally named in an adjudicated case. For example, presume a claimant wins an award against a brokerage firm. The firm fails to pay the award and withdraws from FINRA

registration, or goes through an asset purchase agreement with another firm. Those claimants should not be precluded from pursuing claims in a separate arbitration against related but previously unnamed parties (e.g. control persons of the firm, the broker), who also have liability for the same dispute. Given the high number of unpaid arbitration awards, it is essential that claimants be able to pursue valid claims against additional respondents for a better chance at recovering their investment losses.

Finally, PIABA would like any change to the rule to stress the importance of continuing to permit the non-moving party to have a full opportunity to oppose such motion to dismiss, and to present evidence and testimony to the arbitrators on the merits of the motion prior to their decision.

Thank you for the opportunity to comment.

Sincerely,
Hugh Berkson, President
PIABA

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2016-029* was submitted to the Securities and Exchange Commission by Hugh Berkson on September 7, 2016 (prepared with the assistance of Dayton Haigney).

Brent Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2016-029. Rule Proposal Re: Dispute Resolution Party Portal

Dear Secretary Fields:

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") relating to both investor protection and disclosure.

PIABA submits this letter in response to the request for comments to SR-FINRA-2016-29, which pertains to the mandatory use of the FINRA Party Portal for all represented parties and changes to the procedural rules to implement the proposal. PIABA generally supports the proposed rule changes in that they will make the FINRA system more efficient for parties involved in arbitration.

The implementation of the proposed changes will essentially transform the FINRA dispute resolution arm into a mandatory electronic filing forum. The federal courts slowly implemented electronic filing over twenty years ago. Most state courts have either adopted or are in the process of rolling out electronic filing systems. As such, attorneys are used to the protocols associated with electronic filing. FINRA should be commended for undertaking the transformation of its arbitration and mediation arm into an electronic filing forum. A review of the rule proposal indicates that the process has been carefully considered.

As mentioned at the outset, PIABA favors the rule proposal. However, PIABA wishes to highlight a few concerns.

CONFIDENTIALITY AND REDACTION

The rule changes, as proposed, are a bit confusing with respect to confidentiality and redaction. For example, under FINRA Rule 12300, simplified proceedings are exempt from the redaction of Social Security, tax id, and financial account numbers. If electronic filing through the Party Portal becomes mandatory, parties in simplified proceedings who file unredacted pleadings and exhibits would be exposed to a heightened risk of identity theft. Individual investors pursuing arbitration claims are more likely to be the victims of identity theft than broker-dealers. PIABA feels that it is best to err on the side of caution and require the redaction of *all* documents submitted through the Portal, including documents in simplified proceedings.

DISCOVERY CORRESPONDENCE

The proposed changes require the parties to file discovery correspondence, including requests and discovery responses/objections (but not discovery production itself), through the Party Portal. This filing would include Discovery Guide responses under Rule 12506, as well as other discovery requests under Rule 12507, which currently require service. Per the proposal, "FINRA wants parties to file their explanations about why they are not timely producing documents and why they are objecting to production. FINRA believes that having this correspondence in the Party Portal would be efficient for FINRA staff and the parties." Current Rules 12506 and 12507 require service only on the parties, and Rule 12508 expressly states "Objections should not be filed with the Director".

PIABA strongly supports the filing of discovery correspondence. PIABA has complained long and hard that respondents in FINRA arbitrations often refuse to produce even the most basic presumptively discoverable items required by the Discovery Guide. Filing discovery correspondence and responses may finally give FINRA and arbitration panels a chance to see the abuse of discovery by respondents (and may serve as a detriment in continuing such abuses). Moreover, PIABA hopes that FINRA collects information regarding the frequency and types of objections filed by financial institutions. Likewise, arbitrator chairpersons should be trained to keep an eye on discovery

responses and objections in order to proactively intervene to prevent abuses and reduce the need for the parties to file discovery motions.

The proposal is unclear as to how matters involving *pro se* parties who chose not to utilize the Portal should be handled. In such an instance, it makes sense for *pro se* parties to still be required to file discovery correspondence with FINRA outside of the Party Portal. PIABA believes that brokerage firms could be less likely to engage in discovery abuse against *pro se* parties if they know FINRA can still keep an eye on the discovery process.

SERVICE

The rule proposal provides for instances where filings must be served by means other than the Portal. It seems that the FINRA review of this area was quite comprehensive. Nonetheless, the service requirements are spread through a number of different rules. It may be prudent for FINRA to issue a Notice to Members setting forth a list of the specific filings which must be made outside of the Party Portal once the rule is implemented. This will allow practitioners an opportunity to review all the exceptions to filing via the Portal in one place.

PAYMENT

The rule proposal also provides for payment of forum fees only by credit card or Automated Clearing House (ACH) payments. However, it is not uncommon for individual claimants, even when represented, to pay their filing and other forum fees by personal check. Additionally, some law school securities arbitration centers do not have the ability to pay by credit card or ACH. For these reasons, it is likely that the vast majority of fees have been and will continue to be paid by credit card or check. PIABA urges that the rule should be fashioned to also allow the payment of fees by personal check when using the Portal.

CONCLUSION

PIABA applauds FINRA for undertaking the task of overhauling the rules and systems to implement a mandatory electronic filing system for represented parties. This rule will no doubt make the handling and processing of claims

more efficient for claimants, respondents, arbitrators/mediators and FINRA staff.

Thank you for your consideration herein.

Sincerely,
Hugh Berkson, President
PIABA